20.5: Bailouts and Resolutions

Learning Objectives

- What is a bailout and how does it differ from the actions of a lender of last resort?
- What is a resolution, and how does it differ from a bailout?

As noted above, lenders of last resort provide liquidity, loans, and confidence. They make loans to solvent institutions facing temporary solvency problems due to the crisis, not inevitable bankruptcy.Doug Arner, *Financial Stability, Economic Growth, and the Role of Law* (New York: Cambridge University Press, 2007), 139–140. **Bailouts**, *by contrast, restore the losses suffered by one or more economic agents, usually with taxpayer money*. The restoration can come in the form of outright grants or the purchase of equity but often takes the form of subsidized or government-guaranteed loans. Unsurprisingly, bailouts are often politically controversial because they can appear to be unfair and because they increase moral hazard, or risk-taking on the part of entities that expect to be bailed out if they encounter difficulties. *Nevertheless, if the lender of last resort cannot stop the formation of a negative bubble or massive de-leveraging, bailouts can be an effective way of mitigating further declines in economic activity*.

During the Great Depression, for example, the federal government used $500 million of taxpayer money to capitalize the Reconstruction Finance Corporation (RFC). In its initial phase, the RFC made some $2 billion in low-interest loans to troubled banks, railroads, and other businesses. *Though at first deprecated as welfare for the rich, the RFC, most observers now concede, helped the economy to recover by keeping important companies afloat*. Also during the depression, the Home Owners Loan Corporation (HOLC), seeded with $200 million of taxpayer dollars, bailed out homeowners, many of whom had **negative equity** in their homes, by refinancing mortgages on terms favorable to the borrowers.

In a resolution, by contrast, a government agency, like the Federal Deposit Insurance Corporation (FDIC), disposes of a failed bank's assets (one at a time or in bulk to an acquiring institution) and uses the proceeds to repay the bank's creditors and owners according to their seniority, a predetermined order depending on their class (depositor, bondholder, stockholder). The line between resolutions and bailouts sometimes blurs. In the aftermath of the Savings and Loan Crisis, for example, the Resolution Trust Corporation (RTC) closed 747 thrifts with total assets of almost $400 billion. The RTC cost taxpayers only $125 billion while staving off a more severe systemic crisis.

Stop and Think Box

The 1979 bailout of automaker Chrysler, which entailed a government guarantee of its debt, saved the troubled corporation from bankruptcy. It quickly paid off its debt, and the U.S. Treasury, and hence taxpayers, were actually the richer for it. Was this bailout successful?

At the time, many observers thought so. Chrysler creditors, who received 30 cents for every dollar the troubled automaker owed them, did not think so, however, arguing that they had been fleeced to protect Chrysler stockholders. Workers who lost their jobs or were forced to accept reductions in pay and benefits were also skeptical. Now that Chrysler and the other U.S. carmakers are again in serious financial trouble, some scholars are suggesting that the bailout was a disaster in the long term because it fooled Detroit execs into thinking they could continue business as usual. In retrospect, it may have been better to allow Chrysler to fail and a new, leaner, meaner company to emerge like a Phoenix from its ashes.

KEY TAKEAWAYS

- Bailouts usually occur after the actions of a lender of last resort, such as a central bank, have proven inadequate to stop negative effects on the real economy.
- Unlike resolutions, where assets are sold off to compensate creditors and owners according to their seniority, bailouts usually entail restoring losses to one or more economic agents using taxpayer funds.
- Although politically controversial, bailouts can stop negative bubbles from leading to excessive de-leveraging, debt deflation, and economic depression.

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