Real World Graduation: Question 10

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Question 10

A Savings-and-Loan bank crisis in the 1980's and 1990's required a government bailout. Major automobile companies (Chrysler and General Motors) have sometimes required government bailouts. In the most recent bailout (2007-2009), many banks (Washington Mutual, Indy Mac), mortgage companies (Fannie Mae, Freddie Mac), and financial institutions (Bear Stearns, American International Group) required government bailouts.

"Fannie Mae" and "Freddie Mac" are nicknames for two government-sponsored entities (GSE) that buy residential mortgages; the goal being to stimulate home-buying. In the latest bailout, the losses to the taxpayers for bailing out these two organizations will range between $221 billion and $363 billion [1].

Bear Stearns, a long-standing investment bank specializing in mortgage securitization, was sold to JP Morgan Chase in an emergency sale to avoid a formal bankruptcy that would negatively affect the rest of the economy. The New York Federal Reserve bought $30 billion of Baer Stearns' "assets" to get them off the balance sheet, then lent $29 billion to JP Morgan to finance the purchase of Stearns [2].

American International Group, an insurer of mortgage contracts, borrowed $182 billion in bailouts from the Federal Reserve, with the taxpayers liable if they fail to pay it back [3].

Morgan Stanley and Goldman Sachs converted to bank holding companies in order to obtain access to emergency funding from the Federal Reserve to stay afloat and avoid collapse [4]. Goldman Sachs required loans totaling $67 billion, while Morgan Stanley required loans of $96 billion.

How can one predict in advance which segment of the economy will require a bailout?
a) The ones with the highest CEO pay will require the bailout, because the CEO takes all the money out of the company.
b) All companies who operate in accordance with for-profit capitalism.
c) Only foreign companies require bailouts, because they borrow too much American money and fail to pay it back on time.
d) They are not really bailouts because the government pays for it.
e) All of the above.

[1] Phil Angelides, Chairman, The Financial Crisis Inquiry Report, New York: Public Affairs, 2001, p. 322
[2] ibid., pp. 290, 291
[3] ibid., p. 350
[4] ibid., p. 362, 363

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Answer to Question 10

This is trick question. All of the choices are wrong.

Answer a) is wrong because none of the bailouts were correlated to CEO pay (although many of the CEOs of companies requiring bailouts made hundreds of millions of dollars).

Answer b) is wrong because without a profit motive, there would be no industry or economic activity above bare subsistence. Do you expect to work for free, or do you expect to be paid so that you can enjoy the benefits of your expenditure of time and talent? Your wages are the "profit" from your work: and that same attitude throughout the economy had led to the establishment of civilization that we enjoy.

Answer c) is wrong because it is the U. S. that is borrowing from foreigners, which we add onto our "national debt".

Answer d) is wrong because the government only has what it can get from taxpayers; if a government loan or bailout goes bad, the government will raise your taxes to pay for it (or add it to the national debt for your descendants to pay).

The correct answer is: there are three categories of businesses that are guaranteed bailouts: a) those that are highly regulated by the government and can show that their failure is a result of bad government policies; b) those whose failure will lead to a large number of angry Democratic party voters who may be willing to change to voting Republican; and c) politically well-connected companies and industries who ignore risk, confident that their friends in Washington will save them from incompetence and/or corruption.

Those in the first category usually require bailouts because they engaged in business decisions that were not rational; they were not rational because the chief regulator (Congress) actively encouraged or mandated that they engage in non-rational business practices. But for a time, business was good, and great profits were being made, and the Securities and Exchange Commission (SEC) regulators and Congress looked the other way. An example of this category is the Savings-and-Loan (S & L) collapse of the 1980's and 1990's. The S & L's were small private banks that accepted deposits and mostly lent money on mortgages. Throughout the 1950's and 1960's, these S & L's financed many residential mortgages at fairly low interest rates. The capital to finance the mortgages came from deposits from members, for which the S & L's paid interest. Interest on savings accounts was not regulated until 1966, when Congress decided to limit the amount that could be paid on savings accounts. This affected the S & L's more than commercial banks, since the commercial banks always had access to the Federal Reserve for contingencies. The S & L's did not have this luxury. The 1970's were a bad period economically: high energy prices, slow growth, and high interest rates. The high interest rates meant that S & L depositors withdrew their money to make more profitable investments. But the S & L's could not compete because the interest they were allowed to pay was fixed. The income from the long-term mortgages previously issued at low interest rates combined with an inability to attract depositors led to a financial problem. Rather than correct the error that Congress made in 1966, Congress initially ignored the problem. But because so many mortgages were financed by S & L's there was considerable pressure to keep the S & L's in business. The federal insurance company that was to pay off depositors in case an S & L failed (FSLIC) was under-financed, so allowing the S & L's to go out of business was not attractive, since it would prove that Congress was derelict in it's duty to fulfill guarantees it had made. So, in 1980, Congress de-regulated the S & L's, meaning the regulators could now allow the S & L's to engage in higher-risk investments with their depositor's money. The hope was that they could earn enough in these higher-risk, higher-reward ventures to cover the losses elsewhere (from the long-term mortgages made in the 1950's and 1960's). The S & L's made high-risk real estate investments that failed, and the raising of in-

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terest rates in the early 1980's to correct the Federal Reserve's previous error of undue expansion put the S & L's into serious financial problems. Many of them were facing failure from the mid-1980's to the mid-1990's. The government then had to bail them out at a cost of about $130 billion of taxpayer's money. Here we mostly see bad government polices and some high-risk behavior by the S & L's.

Examples of the second category include the large automobile manufacturers: Chrysler bailout in 1979 and the "structured bankruptcies" of both Chrysler and General Motors in 2008 and 2009. Chrysler's problems in the 1970's were mostly due to Chrysler's unwillingness to respond to the public demand for more fuel-efficient vehicles, given the rise in gas prices throughout the 1970's. Chrysler also decided not to try and raise capital from the public, relying instead on its own resources; this led to a debt financing problem. Chrysler was saved because many of its workers and those of its suppliers were union members, and Chrysler's failure would be a political problem for the Democratic Party. Hence it was bailed out with a loan $1.5 billion of taxpayer's money. Fortunately, Chrysler did make some significant changes, revamped its lineup, cut costs, improved sales, and was able to repay the federal government early. Overall, the government made a profit of about $500 million on this transaction.

The causes of the 2008 bailouts of General Motors and Chrysler are similar: high debt, falling sales owing to production of vehicles the public did not want, and high cost union labor. This again was clearly a political problem, since most of the workers are union members. The first $17.4 billion bailout was authorized 19 Dec 2008. There a series of additional bailouts between Feb 2009 and Jun 200; the total "invested" using taxpayer money was about $80 billion. In the end, GM ended up being 60% owned by the U. S. Treasury and 40% by private investors; Chrysler became jointly owned by the Italian carmaker Fiat and the United Autoworkers Union. Chrysler paid off its portion of the bailout in 2011; GM repaid part of its bailout but the U. S. government wrote off $14 billion in losses.

An example of the third category is the bailout of financial institutions in 2007 through 2009. The main causes were: a) government-mandated mortgages granted to people who could not afford them ("called subprime"); b) a considerable amount of undetected corruption in the writing of those mortgages; c) willing and knowing suspension of risk assessment by large financial institutions; d) creation and sale of poorly-understood bundled securities known as "collateral debt obligations" and "credit default swaps"; and e) assumption on the part of the financial institutions (who should know better) that the housing boom of 2002-2006 would continue indefinitely, which led to undue assumption of risk. These financial institutions had to be bailed out because their collapse would affect the rest of the economy (so we are told), but actually they were bailed out because of close political connections and the fact that part of the problem was itself a result of unwise government policies regarding home ownership rates. On 3 Oct 2008, bailouts totaling $700 billion was authorized, but this was later reduced to $475 billion. Of the $475 billion authorized, $426 billion was actually "invested" in loans and other guarantees. In the end, $441 billion was repaid by these institutions, resulting in a profit of $15 billion; however other ancillary programs related to the bailouts will result in a $38 billion loss.

To summarize, bailouts occur when bad government policies lead to bad financial outcomes, or when a political party risks losing votes, or when political insiders come to believe they are so big and important that their friends in high places will never allow them to fail. This is "crony capitalism": in good times, the corporations keep all their profits; in bad times, the losses are covered by the taxpayers. A good indicator of which industries and firms will eligible for bailouts when necessary is to examine political contributions to members of certain Committees in the Congress, and contributions to their favorite Political Action Committees. The most important committees for implementing and managing large-scale bailouts in the House are the Budget and Financial Services; in the U. S. Senate, the Banking, Housing and Urban Affairs, Budget, and Finance Committees.

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But the main thing to recall here is that no small business will ever get a bailout; they simply do not matter to the political elite. Only the companies that are so incompetent and so large that their failure would negatively impact the general economy can get a bailout. So long as they have the right political and personal connections, they will continue in business, even at taxpayer expense. Raises and promotions all around; the penthouses, champagne, limousines, and fancy parties continue as always.

Disregard any talk you hear from socialists and progressives that the U. S. economy is too "capitalist", and requires more regulation. If the economy were truly capitalist, there would be no bailouts, and these incompetent and/or corrupt companies would get the "reward" they deserve: to be out of business.

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