

THE HIGH COSTS OF THE BANKER BAIL-OUT: WHAT SHOULD BE DONE?

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Historical experience suggests that the choices made by the administration in financial resolution policies have not yielded the best outcomes for the economy. Compared to following a policy of prompt corrective action, policies such as forbearance have added substantially to fiscal costs. If the average losses in other countries from adopting these policies are experienced in the US, the society could lose 10% of the gross domestic product.

Forbearance (or not recognizing losses and forcing credit write-downs), repeated recapitalization (taking repeated equity stakes in companies), blanket guarantees, extensive liquidity support (providing plentiful liquidity to failing institutions) and other such policies have been regular features in the numerous systemic crises around the world over the last two decades. Sweden and Japan are certainly not the only recent cases of severe financial crises from which we can learn. Indeed, by some counts there have been over fifty in the last two decades. This indicates that there is substantial existing evidence available to analysts arising from these earlier crises on the impacts of various bailout policies. One of the most informative analyses is that undertaken by Patrick Honohan and Daniela Klingebiel of the World Bank in 2003. Using the experience of 40 episodes of systemic financial crisis, they find a wide range of costs, ranging from about 3% of GDP in the Swedish case to about 50% in the case of Indonesia. They undertake a careful collation of data from these cases to identify the cost of various policies, like those mentioned above, using the best available techniques to avoid statistical problems in interpreting their results. The major finding from their exercise is that having strict resolution policies (extending liquidity to those with the best collateral or closing down technically insolvent firms) resulted in substantially reduced costs and quicker recovery than otherwise.

The Administration's failure to undertake a program of nationalization and instead to implement policies of endless forbearance and recapitalization could—under reasonable assumptions and simulations—lead to an added fiscal cost of around 10% of GDP, or 1.5 trillion dollars (see Jayadev and Johnson, 2009). Note that this number is extremely large: 1.5 trillion dollars represents tremendous social opportunities that will forever be lost. For example, the International Energy Agency's *World Energy Outlook* (WEO) 2008 estimates around US\$ 550 billion needs to be invested in renewable energy and energy efficiency each year till 2030 in order to limit concentrations to 450ppm CO₂. While daunting, the US could undertake 3 years worth of global investment by itself if the fiscal costs of forbearance and recapitalization were used instead for this purpose. Other expenditures such as the total required to provide clean drinking water or housing to the entire world would be covered many times over by this amount. In the long term, given these trade-offs, the performance of this administration and other public and private officials will be evaluated by the manner in which they handled this crisis and whether they minimized social losses to the country and the world. At the moment, that judgment looks bleak.

What Can be Done Now?

First, an immediate and thorough accounting of all the government assistance is essential both for efficiency and transparency reasons. Second, a genuine examination of troubled institutions and a regime of prompt corrective action could still reduce the long term fiscal costs and avoid the problem of making the financial institutions too big to fail. The threat of public receivership should be made real. To the extent that these hard but necessary decisions are avoided, the US and the world will continue to pay dearly.

References

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Honohan, Patrick & Klingebiel, Daniela, 2003. “The fiscal cost implications of an accommodating approach to banking crises,” *Journal of Banking & Finance*, Elsevier, vol. 27(8), pages 1539-1560, August.