Bailouts

Mauro F. Guillén
Issues

- Jobs: direct & indirect.
- Communities.
- Consumers.
- Taxpayers.
- Moral hazards.
- Global stability: Contagion.
Robert Reich vs. Laura Tyson

• Reich: Ownership does not matter; the issue is *where* jobs are created.

• Tyson: Ownership matters for both strategic and practical reasons.
Tyson vs. Guillén
Four Cases

- AEG-Telefunken.
- British Leyland.
- Toyo Kogyo (Mazda Corporation).
- Chrysler.

Bailout Methods

- Chapter 11 vs. Chapter 7.
- Debtor-in-possession bankruptcy.
- Loan guarantees.
- Unloading liabilities (e.g. pension funds).
- Unloading ‘toxic’ assets.
- Capital injections.
- Nationalization.
January 1980
Common Patterns

- Highly successful in the past.
- Rapid expansion.
- Difficulties digesting growth.
- Vulnerable to forces beyond their control.
- Lack of transparency.
- Major regional employers: Niedersachsen, Midlands, Hiroshima, Great Lakes.
- Shortage of cash as the trigger.
- Bailouts take years to implement.

Contextual Factors

- Overall state of the economy.
- Bank ownership of equity.
- Fragmentation of debt holding.
- Strength and type of labor unions.
- Collective bargaining: fragmented or central?
- Policymaking apparatus.
- Party in power (?)

Solutions

• Bank-led or government-led bailout.
• Liquidation (AEG-Telefunken).
• Reorganization & restructuring.
• Layoffs vs. redeployment of labor.
• Extent of shrinkage.
• Ideological debates: SPD vs. Liberals; Conservatives vs. Labour (but remember Thatcher expanded the bailout of BL).
  – Often, sharp departures from party ideology and rhetoric.

Update

• **AEG:**
  – 1990s: GE, Siemens & Electrolux acquired bits & pieces of AEG.

• **Mazda:**
  – 1979: Ford acquired a controlling stake (presently 33%), of which it wants to sell 20% in order to raise cash.

• **Chrysler:**
  – 1990: Kirk Kerkorian acquired 10% for $272 mn.
  – 1998: “Merger” with Daimler-Benz, valued at $37 bn. (Eaton got $70 mn; Schrempp: “I never thought I was so close to the poverty line.”)
  – 2007: Daimler sold to Cerberus for $7.4 bn, which presently owns 80%.

• **British Leyland:**
  – 1994: BMW acquired Rover from BAe (Honda also interested).
  – 2000: Ford acquired Land Rover for $2.7 bn (BMW kept brand until ‘06).
  – 2007: Tata acquired Jaguar & Land Rover for $2.3 bn.
## U.S. Automobile Market Shares (%)

<table>
<thead>
<tr>
<th>Company</th>
<th>Cars</th>
<th>Light Trucks</th>
</tr>
</thead>
<tbody>
<tr>
<td>GM</td>
<td>35.6</td>
<td>20.2</td>
</tr>
<tr>
<td>Toyota</td>
<td>8.4</td>
<td>19.2</td>
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<tr>
<td>Honda</td>
<td>9.2</td>
<td>11.2</td>
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<tr>
<td>Ford</td>
<td>20.9</td>
<td>10.8</td>
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<tr>
<td>Chrysler</td>
<td>9.3</td>
<td>8.4</td>
</tr>
<tr>
<td>Nissan</td>
<td>4.8</td>
<td>8.1</td>
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<tr>
<td>Hyundai-KIA</td>
<td>…</td>
<td>5.8</td>
</tr>
</tbody>
</table>
Figure 4.1

Figure 4.5

Table 4.2
Automation by region and plant area (all figures weighted by volume).*

<table>
<thead>
<tr>
<th>Percentage of all direct production steps that are automated</th>
<th>US</th>
<th>Japan</th>
<th>Europe</th>
<th>New entrants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Welding area</td>
<td>41.0%</td>
<td>39.6%</td>
<td>36.1%</td>
<td>27.7%</td>
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<tr>
<td>Paint shop</td>
<td>94.0%</td>
<td>92.5%</td>
<td>79.6%</td>
<td>65.2%</td>
</tr>
<tr>
<td>Assembly area</td>
<td>58.7%</td>
<td>56.0%</td>
<td>52.1%</td>
<td>31.9%</td>
</tr>
<tr>
<td>Robotic index (robots per vehicle per hour)</td>
<td>1.5%</td>
<td>2.1%</td>
<td>3.0%</td>
<td>2.8%</td>
</tr>
<tr>
<td>Body shop welding flexibility*</td>
<td>5.0</td>
<td>6.8</td>
<td>5.2</td>
<td>5.6</td>
</tr>
</tbody>
</table>

*Early versions of these metrics were developed by J. Krafck (A Comparative Analysis of Assembly Automation, International Motor Vehicle Program, MIT, 1989). For a detailed discussion of automation from the 1980s through the mid-1990s, see J. MacDuffie and F. Pil, “From fixed to flexible,” in Transforming Automobile Assembly, ed. K. Shimokawa et al. (Springer-Verlag, 1997).

a. Percentage of welds by worker or robot, as opposed to inflexible “hard” automation.

*Data for 1994 from J. MacDuffie and F. Pil, “High-involvement work practices and human resource policies,” in Evolving Employment Practices in the World Auto Industry, ed. T. Kochan et al. (Cornell University Press, 1997), and from Pil and MacDuffie, “Organizational and environmental factors influencing the use of high-involvement work practices,” in Employment Strategies, ed. P. Cappelli (Oxford University Press, 1999). Fraction of workforce in teams is based only on plants with teams. The extent of job rotation is scored on a 1–5 scale, and the rotation policies are ordered as follows: 1. workers are trained to do one job and do not rotate to other jobs; 2. Workers are capable of doing other work tasks in their work group (or teams if teams are present), but generally do not rotate jobs; 3. Workers rotate jobs frequently within their group, but not outside their group; 4. Workers rotate jobs within their work groups and across work groups in the same department (body, paint, and assembly), but not across departments, and 5. Workers rotate jobs within the work group, across work groups, and across departments. Responsibility for Quality control looks at 4 areas of responsibility: incoming parts, work-in-progress, finished products, and charting SPC data. At one end of the spectrum, quality control staff can undertake these activities. At the other end of the spectrum, production workers can do them (or no one). Other options include skilled trades, first line supervisors, and engineering staff.
CONGRATULATIONS! WE FINALLY HAVE A PLAN FOR SUCCESS!

A DIVISION OF TOYOTA
The Financial Crisis

• *Don’t panic!* Between 1970 and 2007 we’ve seen:
  – 124 systemic banking crises.
  – 208 currency crises.
  – 63 sovereign debt defaults.

• But: they are expensive to solve.

• I do not believe a ‘new’ global financial architecture (à la Bretton Woods) is needed.

• Need to distinguish between containment & resolution of the crisis.

• We need better (not necessarily more) regulation, and more *supervision*.

• Any financial bailout needs to address:
  – Conflicts of interest.
  – Transparency problems.
  – Moral hazards.
## Selected Banking Crises

<table>
<thead>
<tr>
<th>Country</th>
<th>Initial Year</th>
<th>% Nonperforming Loans at Peak</th>
<th>Gross Fiscal Cost (% GDP)</th>
<th>4-Year Output Loss (% GDP)</th>
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</thead>
<tbody>
<tr>
<td>Spain</td>
<td>1977</td>
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<td>Chile</td>
<td>1981</td>
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<td>Senegal</td>
<td>1988</td>
<td>50.0</td>
<td>17.0</td>
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<td>USA</td>
<td>1988</td>
<td>4.1</td>
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<td>Sweden</td>
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<td>India</td>
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<td>Japan</td>
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<td>Korea</td>
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<td>China</td>
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### Frequency of Financial Crises

Twin crisis = banking + currency.

Triple crisis = banking + currency + sovereign debt.


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<tr>
<th>Year</th>
<th>Banking crisis (number)</th>
<th>Currency crisis (number)</th>
<th>Sovereign debt crisis (number)</th>
<th>Twin crisis (number)</th>
<th>Triple crisis (number)</th>
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<tr>
<td><strong>Total</strong></td>
<td>124</td>
<td>208</td>
<td>63</td>
<td>42</td>
<td>10</td>
</tr>
</tbody>
</table>
Sample: N = 66.

Sources: Bordo et al. (2001), Caprio et al. (2005), Kaminsky and Reinhart (1999), Obstfeld and Taylor (2004), and these authors.

Notes: As with external debt crises, sample size includes all countries, out of a total of sixty six listed in Table 1 that were independent states in the given year. On the right scale, we updated our favorite index of capital mobility, admittedly arbitrary, but a concise summary of complicated forces. The smooth red line shows the judgmental index of the extent of capital mobility given by Obstfeld and Taylor (2003), backcast from 1800 to 1859 using their same design principle.

Sovereign External Debt: 1800-2006

Percent of Countries in Default or Restructuring

Growing Importance of Finance

Money machine
Finance industry profits and gross value added
As % of US corporate total

Note: Financial services and insurance accounted for 7.8% of U.S. GDP in 2006.
$3.0 trillion

Mortgage-backed securities issued

Mr. Mudd becomes chief executive

Daniel Mudd joins Fannie Mae

44%

34%

22%

33%

Fannie's share of the total market

Fannie Mae

Sources: Inside Mortgage Finance; Fannie Mae company reports
Subprime Defaults

Souring dough
Monthly defaults on subprime loans*
as % of outstanding balance

Source: Fitch Ratings
*By date of origination
Mortgage Defaults by Country

Source: Analistas Financieros Internacionales, based on OECD data.
Defaults in the U.S.

Residential Real Estate, Commercial banks
(Delinquency & charge-off rate, SA, %)

Commercial Real Estate, commercial banks
(Delinquency & charge-off rate, SA, %)

Corporate Defaults

U.S. High Yield Default Rate Vs. GDP and Corporate Profit Growth

High Yield Default Rates
Real GDP
Corporate Profit Growth

Consumer Credit & Consumption

U.S. High Yield Default Rate Vs. Consumer Credit and Consumption

Leverage
Financial Times, 16 de septiembre de 2008 – The last gasp of the broker-dealer
‘Dynamic Provisioning’: Spain

“Since 2000 the Bank of Spain has had something called a ‘dynamic provisioning’ regime, where bank provisions go up when lending is growing quickly. The scheme is based on the difference between banks’ specific provisions for identified losses in any given year and a ‘statistical’ provisioning amount that reflects average losses on assets over the whole business cycle. Over the cycle the effect is neutral, but the timing of the provisioning should make the troughs less deep and the peaks less vertiginous. ‘There is a gap between when risks are taken and when they materialise which needs to be bridged,’ says Mr Roldán [head of bank supervision at the Bank of Spain].”

Possible Actions: Containment

- Suspension of convertibility of deposits.
- Regulatory capital forbearance.
- Emergency liquidity support.
- Government guarantee of depositors.

Possible Actions: Resolution

• Workouts of bad loans and/or debt forgiveness.
• Government insurance of bad debt.
• Transfer of bad debts to a government asset management company.
• Sales of financial institutions to new owners.
• Government intervention and recapitalization of banks:
  – e.g. Spain ’77, Sweden ’91, Mexico ‘94 Japan ‘97, Korea ‘97, China ’98, Turkey ‘00.

• Bank liquidations:
  – e.g. Spain ‘77, Egypt ’80, Chile ’81, Senegal ‘88, USA ‘88, Sweden ‘91, Japan ’97, Korea ’97, Russia ’98, Turkey ‘00.

I’m Not Optimistic about Congress…

- Spy Magazine: What should we be doing to stop the ethnic cleansing in Freedonia?
- Nick Smith (R.-Mich.): “My impression is we’ve got to be very careful, that moving through the United Nations effort has a great deal of merit.”
- James Talent (R.-Miss.): “I think anything we can do to use the good offices of the United States government to assist stopping the killing over there, we should do.”
- Jay Inslee (D.-Wash.): “I’m not familiar with that proposal, urn, but it’s coming to the point now that turning a blind eye to it for the next ten years is not the answer.”

Nota bene: Freedonia, Marx Brothers fans will recall, was the country in which the movie “Duck Soup” was set.

A Gently Reminder: How Does the Market Work?

• First, by *rewarding* those who are innovative, creative, and efficient.
• Second, by *punishing* those that are not.
• Both are necessary for the market economy to work.
• Let’s avoid interfering with these two mechanisms, or else…

Source: Mauro F. Guillén, Lauder Institute & Wharton School.
SO AS AN EXPERT WITNESS, YOU BELIEVE A FEDERAL BAILOUT OF DETROIT IS A MISTAKE?

THAT'S CORRECT, SENATOR.
Exacerbating the Problem

- U.S. policymakers have hesitated and flip-flopped:
  - Summer & fall 2007: Cutting rates and injecting liquidity.
  - Feb 17, 2008: Britain nationalizes of Northern Rock.
  - July 11: Federal regulators seize IndyMac.
  - Sept 7: Freddie Mac and Fannie Mae brought under government conservatorship.
  - Sept 15: Lehman is let go bankrupt.
  - Sept 15: Lifeline for AIG established.
  - Sept 14: Bank of America acquires Merrill Lynch.
  - Sept 26: JP Morgan acquires WaMu.
  - Sept 28: Britain nationalizes Bradford & Bingley, then sells it to Banco Santander.
  - Sept 29: Citigroup agrees to acquire Wachovia.
  - Oct 2: Congress passes the $700-billion asset relief bailout.
  - Oct 3: Wells Fargo ends up acquiring Wachovia.
  - Oct 13: Britain announces recapitalization plan.
  - Oct 13: Recapitalization: Citibank ($25 billion), JPMorgan Chase (25), Bank of America (20), Wells Fargo (20), Goldman Sachs (10), and Morgan Stanley (10).
  - Nov 10: Partial nationalization of AIG.
  - Nov 12: Paulson shifts emphasis from asset relief to consumer relief.
  - Nov 23: Citigroup is bailed out in an asset-relief package worth $306 billion, and a further $20 billion recapitalization (on top of an earlier $25 billion).