

Part I

A BRIEF HISTORY OF BAILOUTS



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Chapter 1

A Brief History of Bailouts

“The ultimate result of shielding men from the effects of folly is to fill the world with fools.”

—Herbert Spencer, English philosopher

America’s relationship with bailouts has been a complex and nuanced affair. It has evolved gradually, morphing through various phases over time. The United States has had several distinct bailout eras, and each has seen an incremental shift in the attitudes toward government rescues. Philosophically, the country has moved from finding the mere idea of a government intervention to any corporation abhorrent, to begrudgingly accepting interventions as a rare but necessary evil. Since the late 1990s, bailouts have been embraced around the world as a near-normal responsibility of government to save the financial markets from themselves. Most recently, a backlash has been building against bailouts as a reward for dumb and irresponsible behavior.

Let us consider an earlier period in U.S. history—the nineteenth century to the pre–Great Depression era. The popular attitude toward



both governments and corporations was very different at that time from today. Government was much smaller, and was not seen as a lender of last resort to either banks or industry. A general suspicion of corporate entities was commonplace among the populace, and there was a near-adversarial relationship between the government and the larger corporate interests.

The federal government's involvement in companies in the nineteenth century was more as an incubator than a rescuer. There wasn't much in the way of venture capital funding then, and a few start-ups sought and received modest amounts of government assistance. Railroad and telegraph firms were given easements and rights of passage, facilitating the government's desire for expansion into the West. Later on, telephone companies also enjoyed government largesse. Eminent domain was used to purchase properties for the benefit of companies as varied as mining, cattle ranches, railroads, and telegraph firms. In each of these early examples, the government's cash outlays were quite modest, and often facilitated a broad public good.

Rather than betting on any single company, the government found it to be in its own interest to jump-start a sector and then allow a brutal Darwinian competition to take place. Ultimately, that left standing only a few survivors as the rest of the industry fell by the wayside. Automobiles, computers, electronics—history is replete with examples of the U.S. government staying out of the way of a competitively developing industry. The government left these companies to follow their own natural life cycle via the mechanics of the free market. In *Pop! Why Bubbles Are Great for the Economy*, Dan Gross details the thousands of railroads, telegraph companies, automakers, and Internet companies that boomed and then eventually went bust.¹ In most industries, this process leaves behind a valuable infrastructure for subsequent companies to build upon. This was Joseph Schumpeter's "creative destruction" at work.

The groundwork for modern bailouts was laid in the early twentieth century, when in 1913, the Federal Reserve System was created. As we will see in a later chapter, this had major implications a century later. As originally envisioned, it was imbued with only modest monetary and fiscal powers. Eventually, these powers were expanded dramatically.

The next phase took place in the 1930s and 1940s, between the Great Depression and World War II. The widespread economic turmoil



and political discontent forced the government to engage in a series of economic stimuli designed to generate jobs, income, and economic activity. While some political historians have described this as a bailout, it was not directed toward any specific corporation or economic sector. The public works programs of the Depression era were designed to impact the entire economy, stimulate growth, and reduce the 25 percent unemployment rate.

The latter years of this second era preceded World War II. The U.S. steel industry had previously enjoyed a booming decade in the 1920s, but had collapsed during the economic crisis. The United States, anticipating the possibility of its entry into World War II, recognized the importance of a viable industrial manufacturing sector. Without a healthy steel industry, the country would've been hamstrung in its attempts to build ships, tanks, planes, and other tools of warfare. The munitions industry also received much of Uncle Sam's largesse, as did the metals companies and the rubber industry. Indeed, the ramp-up to World War II saw an enormous amount of government assistance to companies that were war-related.

Were these truly bailouts? It's hard to call any nation's national defense buildup in wartime a true bailout.

After World War II, the United States entered a long period of economic expansion. The building of suburbia, the automobile industry's enormous growth, the expansion of major cities, and the entire postwar baby boom led to salad days for corporate America. There was no further government involvement in corporate America until the rescue of Lockheed Aircraft Corporation in 1971.

What made the Lockheed bailout so pivotal was its status as the first public bailout of a major corporation—and only that corporation. The Lockheed rescue became the blueprint for most future bailouts over the next half century.

The rescue of Lockheed in 1971 (\$250 million) led to loan guarantees for Penn Central in 1974 (\$676.3 million in loan guarantees), which paved the way for the \$1.5 billion rescue of Chrysler in 1980 and then Continental Illinois Bank in 1984 (\$1.8 billion loss). This led to the original mother of all government insurance payouts—the savings and loan (S&L) crisis of the early 1990s (total taxpayer cost: \$178.56 billion), which led to the stock market rescue of 2000, and so on. Each bailout has



had negative consequences, and the repercussions have often led to the next bailout. Each negative impact seems to have the perverse effect of making future bailouts less surprising and more tolerable—and therefore more likely.

The Federal Reserve's attempted rescue of the credit markets in August 2007 ultimately led to the \$29 billion rescue of a single firm—the investment bank Bear Stearns in March 2008. The Fed not only was rescuing Bear Stearns but, indirectly, JPMorgan Chase, the largest derivatives counterparty of Bear Stearns. More important, the Fed was also protecting its original decision to rescue the credit markets. The housing bailout package of July 2008 rationalized the interest rate policies of the early 2000s, and led indirectly to the nationalization of Fannie Mae and Freddie Mac, which not only cost \$200 billion, but put more than \$5.5 trillion worth of debt back on the books of the U.S. government. Then came the takeover of AIG (\$173 billion and counting), the \$700 billion Troubled Assets Relief Program (TARP), which featured the forced injection of \$250 billion into the nation's largest banks. November 2008 brought another \$20 billion capital injection into Citigroup (total \$45 billion) and guarantees for \$250 billion of its toxic assets. Bank of America also saw its cash injection upped to \$45 billion and guarantees of \$306 billion on its toxic assets. There was \$30 billion for the automakers. 2009 saw a \$75 billion rescue for homeowners, and a \$770 billion dollar economic stimulus plan.

Perhaps it's best to stop calling these numbers “astronomical.” A better term might be “economic numbers”—dollar amounts so vast they dwarf time and space. When you are tossing around those kinds of numbers, what is another \$800 billion program for mortgage-backed securities and credit-related assets? And as long as we still have some checks left, we might as well do a government-engineered takeover by JPMorgan Chase of Washington Mutual. The government tried to do the same with Citigroup and Wachovia, but Wells Fargo swooped in with a higher offer, suggesting that even in Bailout Nation, private capital still has its place.

As a nation, we went from never bailing out anyone to somehow finding a seemingly inexhaustible supply of bailout candidates.

I can't wait to see what the hell is gonna happen next month.