

# **Chapter 17: Executive Summary**

## **Where Should the Bailout Stop?**

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### **Background**

The massive US Government bailout originally intended for the financial industry has now spread to the non-financial sector, and the government is considering bailing out car manufacturers. This is partly the fault of the financial bailout itself, which was poorly designed and too generous to the financial industry. Unfortunately, history and political economy have taught us that ad hoc government interventions to bail out industries are a recipe for long-run economic stagnation. This does not mean, however, that the government should stay on the sidelines. We propose a set of principles for efficient interventions, and we show how these principles apply in the case of General Motors.

### **The Issues**

The main issues are as follows:

1. Which principles should guide government interventions?
2. Should the financial industry be the only industry to receive public support?
3. Should the government offer support to automakers? If yes, how?

We argue that government interventions should be based on a consistent set of principles because interventions without principles are almost guaranteed to be captured by interest groups, to become excessively politicized, and to be inefficient in the long run. We present four broad principles:

1. The market failure must be identified
2. The intervention should use efficient tools
3. The costs for the taxpayers should be minimized
4. Government intervention should not create moral hazard

### **Case Study - How to Help GM**

Based on these principles, there is indeed a case for government intervention in favor of GM, but this intervention should not be a give-away bailout.

The market failure that we identify is the disappearance of the debtor-in-possession (DIP) market because of the financial crisis. This provides a rationale for government intervention (*first principle*). To be efficient, the reorganization

should be thorough, and therefore lengthy. This is why it should take place under Chapter 11 of the Bankruptcy Code (*second principle*). To minimize the costs to the taxpayers, the government should provide DIP financing (directly or through private financial institutions) because DIP loans are well protected (*third principle*). Finally, reorganization in bankruptcy does not reward bad management and therefore minimizes moral hazard (*fourth principle*).

We advocate a massive DIP loan to GM in bankruptcy. The current bailout plan would offer less of a breathing space to GM and imply more job cuts in the short run than our proposed bankruptcy/DIP financing plan. The DIP loan would allow the restructuring to take place over 18 to 24 months while the bailout would be barely sufficient to avoid liquidation in 2009. To further limit the ripple effects of GM's bankruptcy, the government should also consider backstopping warranties and spare parts availability, even if the reorganization fails.

### Policy Recommendations

1. Reorganization under Chapter 11 of the bankruptcy code is an efficient process and should always be the default option.
2. Current Chapter 11 procedures cannot deal with the failure of large, complex financial institutions because financial crises unfold too quickly. We therefore advocate the creation of specific bankruptcy procedures to deal with such cases.
3. Car manufacturers should be allowed to reorganize under the protection of the bankruptcy code, and the government should step in to provide DIP financing if necessary.

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