Navigating Financial Crises: Role of Bail-Ins and Bail-Outs

FAIR Working Paper: SFB/B/2024

Muppana Ramitha

July 2024

NAVIGATING FINANCIAL CRISES:
ROLE OF BAIL-INS AND BAIL-OUTS

Muppana Ramitha[1]

INTRODUCTION

In the landscape of a thriving economy, sudden downturns can emerge unexpectedly, posing severe threats to financial stability. When such disruptions occur, banks—integral to the economy's functioning—often find their liquidity strained due to a variety of possible factors that trigger the situation, such as depositor panic, asset devaluation, interbank market freezes, central bank policies, and loss of confidence. If not addressed promptly, these factors can lead to potential insolvency crises and an eventual breakdown. Moreover, the collapse of even a single major bank can set off a domino effect, jeopardising the entire banking system and, by extension, the broader economy. Therefore, to navigate these turbulent waters, policymakers and financial authorities traditionally rely on two critical tools: bail-ins and bailouts.

Bailouts involve infusions of external support, typically from the government, to prop up struggling banks and restore confidence. This method, though effective in the short term, raises concerns about public debt and moral hazard alongside undermining market discipline. The 2008 financial crisis is a prime example, where massive government bailouts were employed to stabilise the banking sector but left a legacy of increased public debt and debate over the risk of encouraging reckless behaviour among banks. Conversely, bail-ins leverage the bank's internal resources by converting debt into equity or writing down liabilities, placing the burden on creditors and large depositors. The 2013 Cypriot financial crisis highlighted the use of bail-ins, which, while protecting taxpayers, resulted in significant economic disruptions and a loss of confidence in the banking system.

In this exploration, the effectiveness of these tools in addressing financial crises will be examined using the real-world crises from the past, along with their impact on the broader economy. Additionally, insights from Modern Monetary Theory (MMT) will be incorporated, offering a different perspective on the capabilities of sovereign currency issuers. By leveraging MMT, the aim is to provide a nuanced understanding of how bail-ins and bailouts can be strategically employed to safeguard economic stability.

GLOBAL FINANCIAL CRISIS OF 2008: BACKGROUND AND BAILOUTS

The 2008 financial crisis, triggered by the burst of the U.S. housing bubble and widespread issuance of subprime mortgages, led to a severe economic downturn. Financial

[1] The author is presently pursuing B.A. (Honours) Economics at the Madras School of Economics Chennai, Tamil Nadu. Email: ramithamuppana@gmail.com. The views expressed in this article are the author's own and not of institutions that the author is associated with.

institutions heavily invested in mortgage-backed securities faced massive losses as housing prices fell and defaults surged. Key events such as the collapse of Bear Stearns and the bankruptcy of Lehman Brothers caused a global credit crunch. The U.S. government responded with the $700 billion Troubled Asset Relief Program (TARP). Additional measures included bailouts for automakers and various Federal Reserve liquidity programs. Regulatory reforms, such as the Dodd-Frank Act, were implemented to prevent future crises. These actions aimed to stabilise the financial system and restore economic confidence.

- **BAILOUTS:** The Fed implemented several programs, including the Term Auction Facility (TAF), the Commercial Paper Funding Facility (CPFF), and the Term Asset-Backed Securities Loan Facility (TALF) along with TARP, a $700 billion program established in response to the financial crisis that includes purchasing toxic assets from banks and injecting capital into major banks by purchasing preferred shares, helping to recapitalize and restore confidence in the banking system.
- **FISCAL DEFICIT:** According to Lucas, the total direct cost of the crisis-related bailouts was about $498 billion, or 3.5% of the gross domestic product in 2009 which increased the government spending by a significant bulk. In FY 2009, actual total spending was $3.518 trillion. More than half of this spending was mandatory, including Social Security ($678 billion), Medicare ($425 billion), and Medicaid ($251 billion). Additionally, the interest on the federal debt amounted to $187 billion, making up 5% of total spending. These factors significantly contributed to the increased spending, alongside a notable rise in public debt. On the other hand, the Federal government received $2.105 trillion in revenue. This huge difference between spending and revenues created a massive increase in the deficit that brought the country close to breaching its debt ceiling, necessitating an increase in the limit. By the end of September 2009, the total national debt stood at $11.9 trillion. However, despite these measures, the recovery took time, and economic growth remained sluggish (Refer Figure 1).

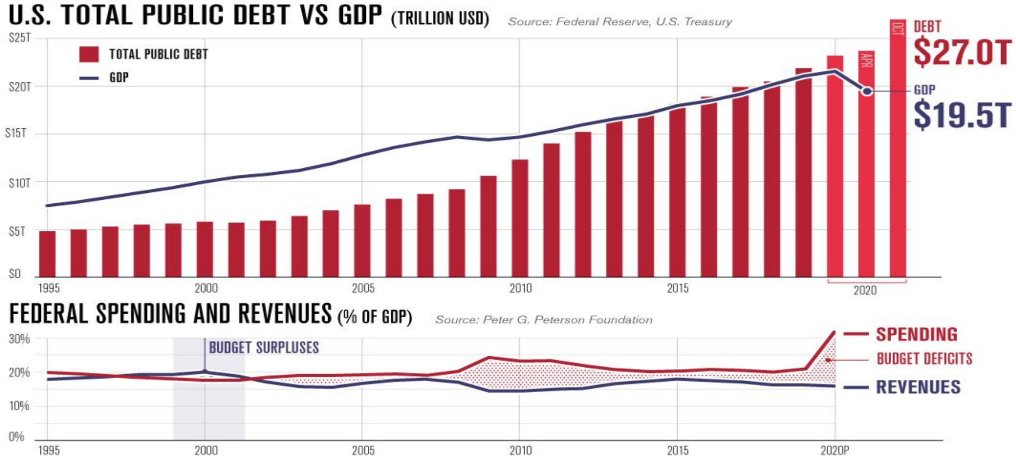

Figure 1

- **TAX BURDENS POST GFC:** There is a common myth that bailouts are ultimately paid for by taxpayers through future tax collections. However, the tax rates post-GFC remained fairly stable, debunking the notion that taxpayers directly shouldered the bailout costs. Additionally, it should be noted that taxes are just a way to drain liquidity from the system and fulfil inflation targets (Refer Figure 2).

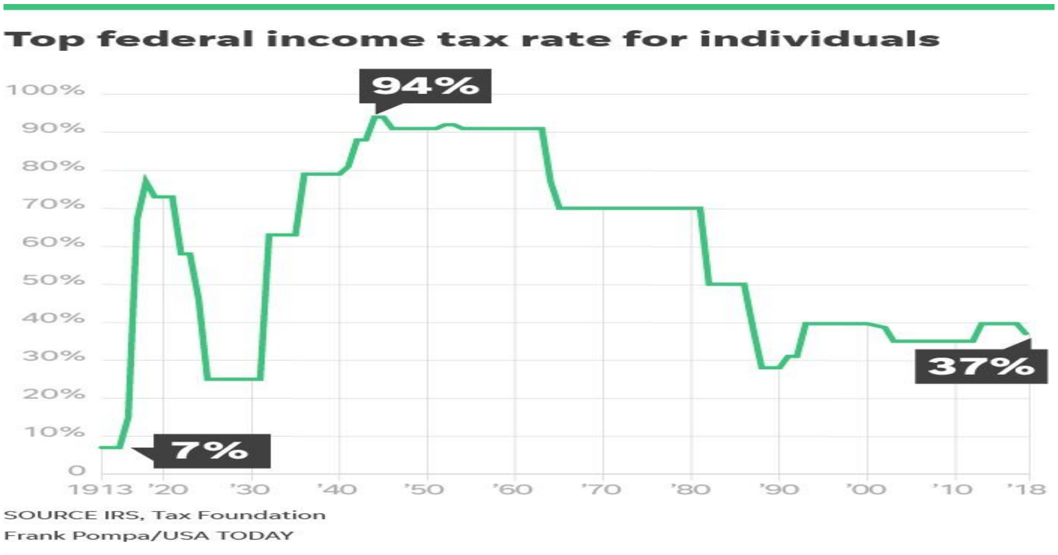

Figure 2

- **MODERN MONEY THEORY PERSPECTIVE**: According to MMT, bailouts can be structured to result in no change in fiscal deficit if desired. MMT posits that if capital is directly infused into the system, it increases reserves and potentially the money supply, which could lead to inflation. To manage this, the government can perform reverse repo transactions to absorb excess reserves and maintain inflation within the target range. In 2009, the issue of deflation rather than inflation was prevalent, which complicated the situation. The deflationary environment may have been a significant factor contributing to the increased fiscal deficit, since the usual MMT mechanisms to control inflation through reverse repos were less applicable. Also,the focus is not on the fiscal deficit or debt levels per se, but on the effectiveness of the spending in restoring economic stability and preventing a deeper recession. The capacity of the sovereign currency issuer to create money for such purposes is a central tenet of MMT, and these measures or programs align with this principle by using government spending, to stem economic meltdown and to address a critical issue.

AN UPDATED APPROACH: BAIL-INS

The traditional method of using public bailouts is being increasingly avoided, not only to prevent moral hazard but also due to concerns about the impact on heavily indebted nations. Although public debt is not worrisome from an MMT standpoint, media portrayal and worries about moral hazard have pushed for an alternative: the bail-in. This strategy makes creditors and depositors share the costs of bank failures, thereby reducing taxpayer burden and addressing fears associated with rising public debt. To better understand the approach, the analysis will now shift to the Cyprus crisis as a case study to illustrate the bail-in process.

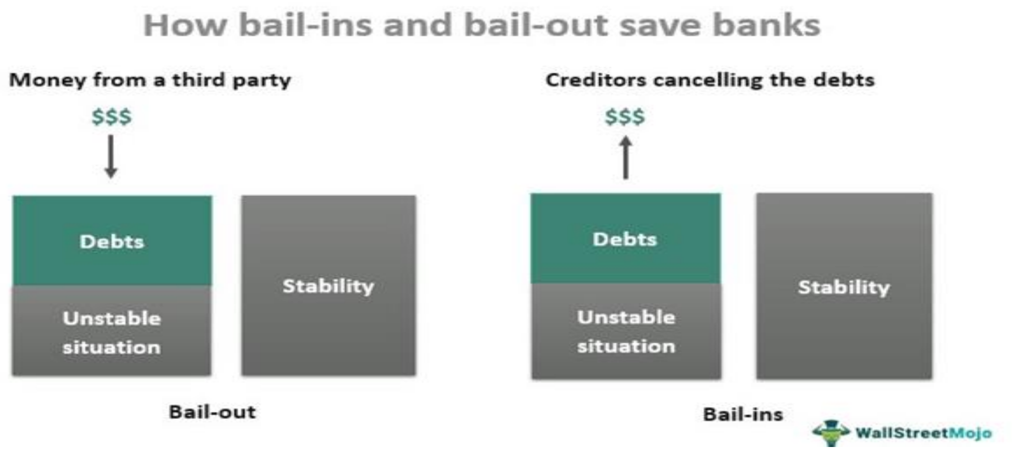

Figure 3

CYPRUS CRISIS: BAIL-IN STRATEGY

Before the onset of the crisis, Cyprus enjoyed a period of substantial economic growth, driven largely by an expansive financial sector. Cypriot banks, in pursuit of higher returns, heavily invested in Greek government bonds and other Greek assets. Similar to other economies at the time, Cyprus also experienced a real estate boom that eventually turned into a bubble. When this bubble burst, it left Cypriot banks saddled with a large number of non-performing loans (NPLs). Greek crisis, bundled with real estate bubble burst, rendered major Cypriot banks insolvent. From the MMT viewpoint, this highlights a critical issue: reliance on foreign-denominated debt and exposure to external economic conditions can severely undermine financial stability. Issuing a nation's own currency allows for greater control over economic policy, thereby reducing the risks associated with foreign debt exposure. However, as a Eurozone member, Cyprus did not have sovereign control over its currency, the euro, which limited its ability to respond to the growing crisis effectively.

- **RESPONSE TO CRISIS**: In March 2013, Cyprus reached a €10 billion bailout agreement with the European Union (EU) and the International Monetary Fund (IMF). This bailout came with strict austerity measures and conditions, including a controversial "bail-in" where losses were imposed on the banks' depositors and creditors. Deposits in the two largest banks, Bank of Cyprus and Laiki Bank, faced significant losses. While deposits in Laiki Bank were largely wiped out, those in Bank of Cyprus were converted into equity. On the other hand, Laiki Bank was shut down, and its viable assets were transferred to Bank of Cyprus, which underwent restructuring.

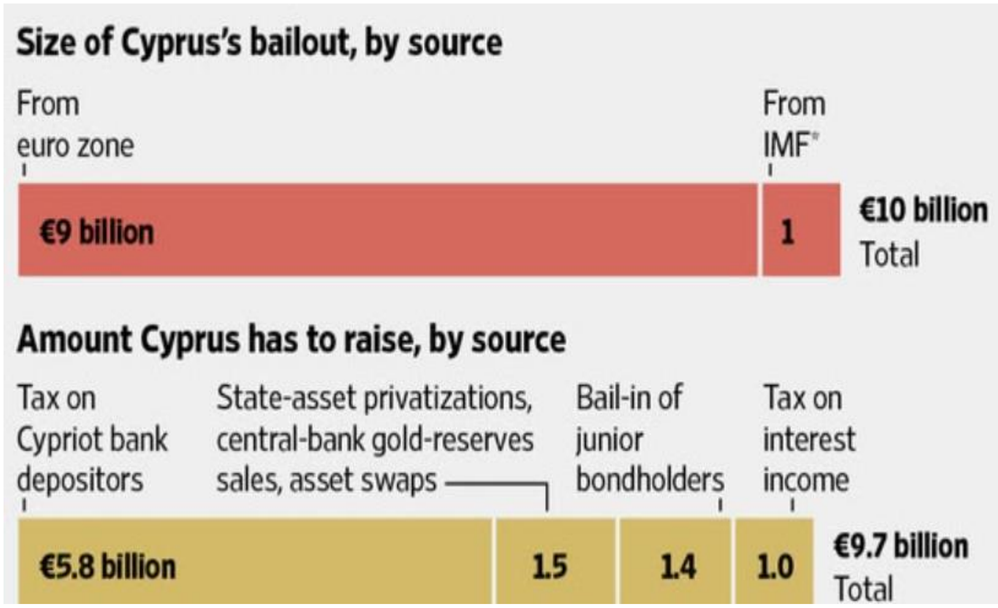

Figure 4

- **A BROADER PERSPECTIVE ACKNOWLEDGING MMT'S INSIGHTS:** Imposing losses on depositors through bail-in measures is not a well-suited substitute for bail-outs if the government has the ability to issue its own currency to cover these losses. By doing so, the government can protect depositors and maintain economic stability. It is often advocated for direct government intervention to stabilise the banking sector, preventing the severe consequences of bank closures on the broader economy. In essence, a government with sovereign currency control can act as a financial backstop for its banking system, using its fiscal and monetary capabilities to ensure liquidity and solvency. This approach helps avoid austerity measures and protects the economy from the negative feedback loop of reduced spending and increased financial instability. Additionally, MMT highlights the fallacy of composition in the belief that individual depositors, unlike the government, cannot create currency. This leads them to fall into debt traps when faced with significant losses. By leveraging its sovereign currency, the government can provide the necessary financial support to banks, ensuring their continued operation and thereby fostering a more stable and resilient economic environment.

CONCLUSION

The analysis of the Global Financial Crisis and the Cyprus crisis underscores the intricate balance between ensuring financial stability and maintaining economic confidence. Both bailouts and bail-ins serve as critical tools for policymakers to navigate the treacherous waters of economic downturns. The former provides immediate liquidity but risks moral hazard and increased public debt, while the latter imposes a burden on creditors and depositors, mitigating taxpayer impact but potentially undermining confidence.

In essence, while traditional economic strategies offer immediate remedies, MMT provides a broader framework that emphasises the proactive role of government in sustaining economic stability. This perspective not only addresses immediate financial challenges but also fosters a resilient economic environment, ensuring long-term stability and confidence. Moreover, MMT encourages thinking beyond conventional approaches, offering opportunities to develop more innovative strategies to solve real-world problems effectively.

REFERENCES:

https://www.cbo.gov/sites/default/files/111th-congress-2009-2010/reports/01-07-outlook.pdf

https://www.wallstreetmojo.com/bail-in/

https://www.pgpf.org/analysis/summary-of-the-2009-financial-report-of-the-us

https://research.stlouisfed.org/publications/economic-synopses/2012/01/06/fiscal-policy-in-the-great-recession-and-lessons-from-the-past/

https://www.federalreservehistory.org/essays/great-recession-and-its-aftermath

https://mitsloan.mit.edu/ideas-made-to-matter/heres-how-much-2008-bailouts-really-cost

https://academic.oup.com/jfr/article/1/1/3/2357875?login=false

https://www.thebalancemoney.com/fy-2009-u-s-federal-budget-and-spending-3306311

https://www.theatlantic.com/business/archive/2013/03/everything-you-need-to-know-about-the-cyprus-bank-disaster/274096/

https://www.cyprusprofile.com/articles/cyprus-banking-crisis-causes-and-consequences-bailout