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# **Bailouts Done Right: Learning from the 1980 Chrysler Loan Guarantee**

Presented at AEI's

## **The Theory and Practice of Bailouts**

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## **Bailouts can be done right, but they require a credible policy framework**

- We have had eight years of government economic policy based on the flimsiest of analytical frameworks, known in the economics profession as “Neanderthal Economics” i.e. “Market good! Government bad!”
- Now events have gotten ahead of ideology, and panic over the feared consequences of a meltdown of the financial markets has triumphed over dogma.
- The most free market of administrations did a complete about face over the course of a weekend, and that administration, which came to office eight years ago as “social conservatives,” is leaving office as “conservative socialists,” proposing a massive government intervention in the private market.



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## **The Administration's Proposal Was Criticized By All Sides:**

- Because the administration lacked a policy framework with in which to structure an intervention, the proposal they offered was a nonstarter.
- The administration proposed making the Secretary of the Treasury the dictator of the economy and giving him the authority to spend \$700 billion without any accountability, oversight, risk of legal review, or conditionality.
- The administration's original proposal was met with incredulity.

## **Nevertheless, It Is Possible To Structure An Effective And Responsible Government Intervention In Response To A Crisis**

- A well structured government intervention requires a policy framework
- A successful government intervention must have well understood principles that are critical for success.



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## **The 1980 Chrysler Loan Guarantee Is the Premier Example of Successful Government Intervention**

- The Chrysler Loan Guarantee Program was structured well from the start.
- The Chrysler Loan Guarantee Program was carefully designed to succeed
- The Chrysler Loan Guarantee Program included the kind of accountability, conditionality, oversight, and responsibility everyone should expect from the exercise of government authority in a democracy.



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## **The Chrysler Loan Guarantee Program Embodied Seven Key Principles That Are Essential For Effective And Responsible Government Intervention**

- 1. Establish a clear public policy objective and design the program to achieve that objective.**
  - Following the second energy crisis in 1979, demand for 4-cylinder fuel efficient cars far outstripped supply; the loan guarantee allowed Chrysler to launch the annual production capacity for over 800,000 such vehicles.
- 2. Vest decision making authority in a strong and independent board.**
  - Decisions were made by an independent board made up of three high level officials: the Secretary of the Treasury, the Chairman of the Federal Reserve Board, and the Comptroller General of the United States. A Board vote was necessary for all decisions which assured that those decisions would be made on the basis of documented facts and analyses.



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### **3. Use government funds solely to achieve the clear public policy objective.**

- Government funds were not permitted to flow through the Chrysler Corporation as windfall benefits for constituent interest groups. Everyone who stood to gain from Chrysler's success had to contribute to the turnaround; including workers, creditors, suppliers, dealers, and investors. The government's Chrysler Corporation Loan Guarantee board had to approve all material Chrysler expenditures and contracts.

### **4. Use government resources sparingly.**

- Built into the loan guarantee statute was a requirement that I call the fiscal judo provision: for every \$1 of federally guaranteed funds received by Chrysler there had to be \$2 in contributions from interested parties. Significant contributions came from creditors, workers, states and localities in which Chrysler had plants. Iacocca worked for one dollar a year, but what galled him most was that Chrysler was forced to sell off Iacocca's Gulfstream corporate jet.



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**5. There should be a reasonable assurance of repayment of government guaranteed funds.**

- Chrysler could receive the guaranteed funds only if the Chrysler Loan Guarantee Board determined that there was a reasonable assurance of repayment. This decision was based on credible operating and financing plans demonstrating how the company would succeed. And, the federal government took a priority security interest in every asset of the company (worth more than \$2.5 billion) to make sure that the taxpayers would not be left in the lurch.

**6. Limit the program's time frame and scope.**

- Chrysler was offered a maximum of \$1.5 billion of federally guaranteed loans for a maximum of 10 years subject to stringent conditions. No permanent government agency or enduring corporate entitlement was created.



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## **7. The government should share in the upside of success.**

- In return for the loan guarantees the federal government received expense reimbursements, commitment and guarantee fees, and warrants. When the loans were paid off, the government netted over \$300 million from the sale of the warrants. With this final measure, the taxpayers were compensated for the risks the government had taken on with the loan guarantees.

**When it comes to government intervention, the success of the Chrysler Loan Guarantee demonstrates that we know how to do it right and there is no reason why we cannot do it right again.**



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Allan I. Mendelowitz has served on the Board of Directors of the Federal Housing Finance Board (FHFB) since 2000.

Dr. Mendelowitz, who was born and raised in Middletown, Connecticut, was the Executive Director of the U.S. Trade Deficit Review Commission, a congressionally appointed, bi-partisan panel, from October of 1999 until his appointment as chairman of the Federal Housing Finance Board. Previously he served as the Executive Vice President of the Export-Import Bank of the United States where he was responsible for overseeing all Export-Import Bank programs and operations. Prior to that position, he was Managing Director for International Trade, Finance and Economic Competitiveness at the U.S. GAO, during which time he directed a large number of studies of the nation's international trade and finance programs and policies, and testified numerous times before committees of the Congress of the United States. Dr. Mendelowitz spent 1980 as the senior economist and representative of the Comptroller General with the Chrysler Corporation Loan Guarantee Board negotiating the terms of the Federal loan guarantee. Prior to joining the GAO he was an Economic Policy Fellow at the Brookings Institution and on the faculty of the Department of Economics of Rutgers University where he taught courses in urban and regional economics and international trade and finance.

Articles by Dr. Mendelowitz have appeared in the Journal of Business, the National Tax Journal, the Journal of Policy Analysis and Management, the Financial Times, and various conference proceedings' volumes.

Dr. Mendelowitz received an A.B. degree from Columbia University, and M.A. and Ph.D. degrees from Northwestern University. Dr. Mendelowitz and his wife, Shereen, currently reside in Rockville, Maryland, and have two adult children.