Bloomberg Businessweek

Big Ideas to Save the Economy, From Bailouts to Super Chapter 11

Peter Coy

March 25, 2020

In economics, there is no Hippocratic oath: First, do no harm. If there were, world leaders would be in serious violation of it. With the noble purpose of saving lives, they are deliberately throttling the global economy. The plan is to put economic activity in a state of suspended animation for weeks or months, get past the worst of the Covid-19 pandemic, and then resuscitate the patient. Necessary? Probably. Dangerous? Undoubtedly.

Because this has never been done before at this scale, there are no white-haired elders to guide us. We are going to have to invent the plan as we go, recalibrating as facts emerge. Just as overwhelmed doctors must choose which patients to save and which to let go, we will need to decide which sectors, which companies, and which workers are most in need of and most deserving of a rescue.

And eventually we'll need to make agonizing trade-offs between saving lives and saving livings. The more people are saved from the coronavirus through draconian shutdowns, the more livelihoods will be broken, in some cases irreparably. President Trump said on March 24 that he would like the U.S. economy "opened up and just raring to go by Easter," which is April 12. However, the more we ease up on quarantines and social distancing to allow the economy to breathe, the more patients will have their breath stolen by this frightening lung disease. Martin Eichenbaum of Northwestern University and others calculate in a new working paper that the U.S. could save 500,000 lives through serious containment measures vs. the base case of doing nothing—but at the cost of knocking 10% off economic output in 2020. No doubt, it's going to be ugly.

Here is one principle for policymakers to consider as they make decisions on our behalf: If you must do harm to the economy, please make it reversible. Hurt, but don't kill. Bend it, but do not break it.

The sudden stop could cause hundreds of thousands of small and medium-size enterprises to go out of business—to break. Some will quickly reemerge, which is fine. But in many cases the loss will be permanent. High-functioning teams that have taken years to assemble will break up. Synergies will be lost. Workers who thrived in a particular niche will flounder, seeking jobs from new employers who don't understand who they are or what they can do.

"Much of the information in our society is embedded within corporations. The bankruptcy of an enterprise leads to the loss of organizational and informational capital—a negative shock to the

economy," the Nobel Prize-winning economist Joseph Stiglitz said in 2014 in a meeting of the International Economic Association by the Dead Sea in Jordan, where he gave the presidential address.

The answer, of course: Keep companies intact as much as possible. Restarting the economy after Covid-19 recedes will be easier if the enterprises that make and sell things are ready to go. It's also a kindness: "Losing a business to failure—especially one that has been built up over time—is a devastating blow to the owners and their families, who are often involved," economist David Levy, himself the chairman of a family business, the Jerome Levy Forecasting Center in Mount Kisco, N.Y., writes in an email. "Dreams destroyed, fortunes destroyed, lives destroyed."

So what are we to do? Well, one elegant way to keep companies afloat is Germany's Kurzarbeit, or short work time, in which the government subsidizes the salaries of workers who would otherwise be laid off. Kurzarbeit helped Germany snap back from the financial crisis faster than any other European country, says Markus Brunnermeier, a German-born economist at Princeton. Several Scandinavian countries have followed Germany's lead, and the United Kingdom announced a similar program on March 20.

An alternative is to lend money to businesses freely and cheaply until the crisis passes. The Federal Reserve is all over that when it comes to big companies, financing their commercial paper and announcing on March 23 that it will even buy corporate bonds directly—a major departure for the central bank. ("Wow, just wow," George Rusnak, co-head of fixed income strategy at Wells Fargo Investment Institute, said on Bloomberg Television.)

Getting help to smaller companies, which rely on banks rather than the markets to raise money, is a tougher problem. The Fed signaled on March 23 that it would soon introduce a Main Street Business Lending Program, complementing the efforts of the Small Business Administration. Another idea, from Brunnermeier, is for the Fed to charge banks a negative interest rate—that is, pay them, via the discount window—for rolling over their loans to small and medium enterprises.

In an ordinary recession, encouraging banks to "evergreen" their loans—give new money to debtors so they can pay interest on their old loans—would be considered malpractice. It would be viewed as wasting precious capital on propping up zombies instead of directing it to new, job-creating investment. But this is not an ordinary recession. The companies that need help are not zombies. Keeping them afloat is not sinful but essential. "It's a 180-degree change in mindset," Brunnermeier says.

Stiglitz, the Nobel laureate, who teaches at Columbia, advocates a "super Chapter 11" that would avert mass insolvency. In a 2010 paper, he and the University of Warwick's Marcus Miller wrote that the bankruptcy code "is essentially designed for idiosyncratic events in which assets may be disposed of at going market prices," which is emphatically not the case in a crisis in which no one wants to catch a falling knife. Under a super Chapter 11, they wrote, a government-sponsored institution "would consolidate the troubled businesses and decide simultaneously—and this is the key—how all of them would be resolved in a common procedure." That procedure could involve, for example, swapping debt for shares across the board.

Deborah Lucas of the Massachusetts Institute of Technology has spent most of her career studying the federal government as a financial institution. She was chief economist of the

Congressional Budget Office and now directs the Golub Center for Finance and Policy at the MIT Sloan School of Management. “You don’t want to blow up viable, going concerns, and that’s the biggest risk in the current situation,” she says. “It’s worth paying a lot to avoid that.”

Companies should not get direct aid such as grants, she says, because any company will take cash that’s offered, even if the managers know their situation is unsustainable. Loans work better—managers won’t usually take a loan they don’t expect to pay back, because a default could land them in bankruptcy court. Based on her experience in the financial crisis, Lucas says it’s a mistake to put conditions on loans, such as requiring that employers retain workers. Many managers would rather pass up the money than tie their hands, she predicts.

Bailouts aren’t popular. When I touched on this theme in an earlier article, I got reactions on Twitter such as, “A morally bankrupt money grab for the investor class.” The Left wants help for workers, not capitalists. And there’s a segment of the libertarian Right, including many economists, that says the free market does a fine job of redeploying resources—workers, machines, patents, trademarks, etc.—to their highest and best use when a company fails. In the financial crisis, “instead of bailing out banks, U.S. policymakers should have allowed the standard process of bankruptcy to operate,” Harvard economist Jeffrey Miron wrote in the libertarian Cato Journal in 2009.

So, yes, individuals need help, too. Beefing up unemployment benefits and extending their duration is a no-brainer. Forbearance on debt repayment also makes sense. It’s not only companies, after all, but households that should be kept from breaking. Meanwhile, the process of rescuing companies can go horribly astray. Ben Hunt, co-founder and chief investment officer of Second Foundation Partners, calculates that stock buybacks by the four biggest airlines exceeded their free cash flow from 2014 through 2019—enriching executives and shareholders but leaving the companies unprepared for a crisis. “The raccoons and high-functioning sociopaths are out in force on this, looking to get their private losses socialized and their private gains locked in,” Hunt wrote on March 19 on his website, Epsilon Theory.

It’s reasonable to impose conditions on the aid companies get. Hunt would put tight caps on executive compensation; fire and replace board chairs; require the companies to raise money by selling shares, even at today’s unfavorable prices; and prohibit buybacks and dividends until the government loans are repaid. Taking part ownership in companies in return for emergency aid—as Treasury Secretary Steven Mnuchin said on March 23 he’s considering—would give taxpayers some of the upside, at the cost of edging the U.S. a tad closer to Bernie Sanders-style socialism. It’s also reasonable to pick and choose which industries to rescue. Airlines may be vital infrastructure, but casinos and cruise lines are not.

In keeping with the philosophy of bend-don’t-break, aid should be concentrated on the most breakable kinds of companies, which tend to be ones that are light on physical assets. Once the employees of asset-light companies disperse, there is little or no value left. Small businesses, which employ almost half of the U.S. workforce, are more likely than big ones to be asset-light. Companies with valuable physical assets can bounce back relatively easily. The failure of a shale-oil producer does no harm to the hydrocarbons still in the ground. Cruise lines still have their ships, airlines have their jets, and casinos still have their glitzy gambling halls, which can quickly resume operation once the virus all-clear sounds.

Politics should play as little role as possible in bailout decisions. Easy to say, hard to enforce. In 2008-09, when the Bush and Obama administrations were trying to rescue General Motors Corp. and Chrysler LLC, "we worked to fend off attempts by stakeholders on all sides of the issue to meddle in granular decisions over which dealerships to close or which plants to shut down," Brian Deese, Steven Shafran, and Dan Jester, who concocted the plans, wrote in a chapter of First Responders, a new book written and edited by financial crisis insiders. The lobbyists are once again out in force, representing everyone from pig farmers to theater owners to exercise-clothing manufacturers. On March 24, House Speaker Nancy Pelosi said the Trump administration had agreed to independent oversight of a fund to support companies as part of a roughly $2 trillion stimulus bill that was before the Senate.

Bailouts of companies and aid to individuals will be fantastically expensive. There's a good chance that the stimulus plan that was under negotiation on Capitol Hill on March 24 will have to be followed by more. But that's because the need has never been greater. Think of the government-ordered shutdown of the economy as a heart attack—or to use a more timely metaphor, severe acute respiratory syndrome. Treatment must be aggressive to succeed. Halfway measures and economizing don't cut it.

Whatever is done needs to be done soon. Layoffs have already begun. The more damage businesses suffer, the harder it will be for them to bounce back. As Trump's March 24 statement goes to show, the political pressure to resume normal economic activity is beginning to intensify. The surest way to maintain support for the restrictions that protect the public from Covid-19 is to alleviate the damage that those restrictions do to the economy.