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Washington, D.C. 20540

January 24, 1989

TO : Honorable Donald W. Riegle, Chairman
Senate Banking Committee

FROM : Bill Cox
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SUBJECT : FSLIC Bailout and the Economy

Rick
This is an important point. Like the methodology good.
W.F.

Senator Proxmire asked me to send you a copy of this CRS report by my colleague, Tom Woodward. Its message is that a bailout of the banks and thrifts, despite its potential size and political complications, would have no impact on economic activity, inflation or interest rates. This is because making good on Federal deposit insurance is analogous to Federal purchase of an existing asset held by the private sector. It should have as little economic impact as its opposite – sales of Federal assets to the private sector – which have been disallowed as deficit reductions under Gramm-Rudman-Hollings because they do not reduce the burden of Federal deficits on markets for credit and resources.

The deposit guarantee had its real economic impact as the institutions became increasingly insolvent by averting the contractionary effects on the economy of the losses that made them insolvent and, of course, of the bank runs that probably would have taken place in its absence. What averted this impact was the automatic substitution of a new asset – the Federal promise to pay – for assets lost via bad loans. A "bailout" now amounts to issuing a new Federal promise to pay – T-bills and bonds – in place of the earlier promise (the insurance obligation). Moreover, the Government is incurring interest obligations on this debt both before and after the bailout, because it is liable for the cost of interest paid to depositors by insolvent thrifts.

From the standpoint of economic activity, if the rate of deficit reduction scheduled under Gramm-Rudman-Hollings were increased to offset the impact on the budget deficit of an FSLIC bailout, then a more contractionary effect than previously intended would result from the GRH cuts.

I hope that this analysis is useful to you. If you have questions about it or want additional copies of this report, feel free to contact Tom Woodward on 707-7820 or me on 707-7842.