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Deposit Insurance Is Doing The Job It Was Designed To Do: The Economics of Keyes Is Working. The New Deal Is Working.

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Each night as George Bush goes to bed he should say "Thank you President Franklin Delano Roosevelt", for it is Roosevelt's New Deal that is saving the Bush administration from the fate of the Hoover administration. It was Herbert Hoover's ill-fate to be President during an unconstrained debt deflation. It is George Bush's luck to be President when the New Deal's deposit insurance is containing the processes that lead to debt deflations. The result is that Bush is President of an ailing but not a collapsing economy.

A debt deflation is a process in which a rapid decline of output prices and wage rates takes place even as capital asset and financial asset prices fall even faster. Over the course of the great Hoover collapse (October 1929-March 1933) consumer prices fell by about 33% while the Standard and Poors stock price index fell by about 85%. This radical change in relative prices led to a collapse of gross investment. In the small government capitalism of the early 1930's this resulted in a sharp decline in gross business profits, what we now call cash flows. The fall in cash flows means that assets no longer perform: capital assets no longer yield profits and businesses cannot meet their commitments to pay interest and principle on both short and long term debts. Further falls in asset prices follow as businesses try to sell assets to raise funds to meet their payment commitments. The well nigh utter collapse of corporate retained funds leads into a collapse of investment spending.

During a debt deflation the movements of prices and quantities in one part of the economy in response to its own disequilibrium disrupts other markets in such a way that the feed back makes the initial disequilibrium worse. During a debt deflation the interactions among the interdependent markets for products, labor, investments, financial assets and capital assets are strongly such that one market's reaction to falling demand or prices leads to the worsening of demand and price conditions in other markets.

Ever since Adam Smith economic theory in general has argued that the working of interdependent "free" markets leads to an orderly and benevolent outcome. During a debt deflation the Smithian result does not hold: the outcome from the internal workings of interdependent "free" markets is seemingly chaotic. A deep and long lasting depression is the malevolent outcome of a debt deflation.

A crucial step in a debt deflation takes place when the fall in capital asset prices and the fall in business cash flows hit the asset side of financial institutions. The erosion and collapse of the value of assets in financial institution portfolios and the explosion of non performing assets in these portfolios means that the value of the liabilities of the financial institutions exceeds the value of their assets and their commitments to pay cash to satisfy their liabilities exceeds their cash receipts from their assets. In a free market banking and financial system a collapse of the values of financial institution assets and the failure of financial institution assets to perform is passed through the financial institution to the creditors of the institution, i.e. to depositors, policy holders and annuitants by the institution failing. Even though there may be recoverable values in the assets of the insolvent institutions for the time being the entire liability structure of the failed institution is frozen.

This pass through to depositors, policy holders and annuitants has a deep impact on the spending not only of those directly affected who may be forced to cut their consumption but also those who as yet have not been affected but begin to fear that they may be affected. Consumption, which has been the leader in pulling the economy out of our post world war 2 recessions, falls as people hoard to prepare for a "rainy day".

The dire events of a debt deflation are consequences of a prior euphoric state in which an investment boom, fueled by euphoric expectations of future cash flows and visions of a new age of permanent prosperity, takes place. The expectational climate is such that a very large portion of expected cash flows are pledged to debt payments: margins of safety in the excess of expected receipts over payment commitments are much compromised. Investments of all sorts take place in great quantities: airplanes, railway mileage, tanker capacity, office towers, shopping centers and even housing. Ill conceived schemes have little trouble finding financing. The market seems to work to generate prosperity and useful capital assets. In truth during this euphoric boom a massive misallocation of resources is taking place.

Since George Bush became President in 1989 a large scale deflation of the values of assets and a huge increase in non-performing assets in the portfolios of savings and loan associations, banks, pension funds and insurance companies. During these years the Deposit insurance agencies and the Federal Government have seen their contingent liability on the liabilities of banks become actual liabilities. By fulfilling its 1930's commitment, as extended by the legislation that increased deposit insurance and by the decisions by administrators that institutions can be too big to fail, the pass through from the collapse of values of assets, to deposit holders of banks and savings and loans has not taken place.

The objective of the legislation of the 1930's was partly reform and partly to prevent a debt deflation from ever happening again. This was done by having the government break the connection between non performing assets and the fulfillment of the protected institutions of their liabilities. This was done by making the deposit liabilities of these institutions, to a greater or lesser extent, the contingent commitment of the Federal Government. To date this device has been effective in cutting the connection between non performing assets of banks etc and the nonperformance of the non equity liabilities of these institutions. We are not in the midst of a sharp debt deflation now because deposit insurance has done the job it was put in place to do. So that when one hears moans about the cost to the tax payer of making good the governments contingent liability one should think of the alternative. What would it cost the United States and the rest of the world if the pass through from bank assets to bank liabilities were allowed to take place. Recall that GNP in 1933 was more or less 2/3 of GNP in 1929. A fall of even half that magnitude would be about $1,000 billions of dollars.

So far Deposit Insurance is doing the job. President Bush is the beneficiary of the effectiveness of deposit insurance.