History of and Rationales for the Reconstruction Finance Corporation

by Walker F. Todd

Walker F. Todd is an assistant general counsel and research officer at the Federal Reserve Bank of Cleveland. An earlier version of this paper was presented to a conference on financial crises sponsored by the Jerome Levy Economics Institute at Bard College, Annandale-on-Hudson, New York, on November 22, 1991.

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[I]t became apparent almost immediately, to many Congressmen and Senators, that here was a device [RFC] which would enable them to provide for activities that they favored for which government funds would be required, but without any apparent increase in appropriations, and without passing an appropriations bill of any kind to accomplish its purposes. After they had done that, there need be no more appropriations and its activities could be enlarged indefinitely, as they were almost to fantastic proportions.

Chester Morrill, former Secretary, Board of Governors, on the RFC (cited in Olson [1988], p. 43)

Introduction

The creation of the Resolution Trust Corporation (RTC) in 1989, the evolution of a "too-big-to-fail" doctrine within the bank regulatory community in the 1980s, and more recent recommendations that means of regular government intervention be created to support some financial institutions all recall the history of the Reconstruction Finance Corporation (RFC) during the Great Depression. This paper explores the lessons learned from our nation's previous large-scale effort to rescue financial institutions and discusses their current relevance.[1]

Then faced with the worst financial crisis in a century, U.S. policymakers of the 1930s deliberately enacted a set of reforms that included central bank restructuring, bank regulatory reforms, federal deposit insurance, and a *separate, politically accountable*, publicly funded rescue mechanism, the RFC. Those policymakers paid careful attention to statutory and institutional structures that separated the fiscal policy operations of the debt rescue mechanism, the RFC, from the monetary policy operations of the central bank, which then were dominated by the Federal Reserve's discount window.

In contrast to most recent proposals for increased levels of government intervention to fund the capital structures of financial institutions directly, the RFC had a clearly defined network of checks and balances with respect to both the activities in which it was authorized to engage

1 As used in this paper, "debt rescue," "rescue," and "bailout" are used interchangeably and might properly be defined as the government's payment or assumption of a person's debts owed to third parties, without adequate security for that payment or assumption to ensure that the government will recover its outlays in full in the near term (currently, under two years).

and the sources of its funding. Yet, despite these checks and balances, and despite the comparatively competent management of the agency for 13 years, the RFC's lending and capital support operations still became politicized over time. After the 1946 elections, congressional Republicans made it one of their first orders of business to begin the dismantling of the RFC. It would be difficult to argue that they were wrong to do so (Sprinkel [1952]). Recent commenters on the RFC have focused primarily on the desirability and efficiency of government intervention in financial markets (Keeton [1992]), rather than on the merits or demerits of particular institutional structures for such intervention, the historic causes of intervention, or the monetary policy aspects of the 1930s reforms.[2]

Today, in the search for a governmentally sponsored financial rescue mechanism, it would be helpful to review the lessons of history that bear upon the legal, economic, and political factors that contributed to the creation and ultimate demise of the RFC. Particular consideration should be given to the rationale for the institutional barriers of the 1930s that separated the RFC's solvency support or capital replacement mechanisms from both the central banking functions (the Reserve Banks) and federal deposit insurance (the Federal Deposit Insurance Corporation [FDIC] and, later, the Federal Savings and Loan Insurance Corporation [FSLIC]).

Modern advocates of RFC-like schemes either have ignored or have passed lightly over the rhetorical inconsistency between advocacy of free markets on the one hand, and publicly funded bailouts of large financial firms on the other. One specific plan reminiscent of the RFC, prepared by a group of advisors to New York Governor Mario Cuomo, was presented to President-elect Clinton in November 1992 and was described as follows:

> [T]he report urged the Federal Reserve to play a far more aggressive role in spurring the economy, saying it should pump $20 billion in capital into the nation's banks to make it easier for them to lend money. But Mr. [Robert] Rubin [Chairman of Goldman Sachs and a member of the Cuomo Commission] dissented from that proposal, saying it would be undue Government interference in business. (Greenhouse [1992])

Such a proposal would be tantamount to requiring the Federal Reserve today to play the role of the RFC during the Great Depression in supporting the solvency or capital structure of financial institutions. It would also extend the Federal Reserve's monetary policy function well beyond its normal roles of ensuring a steady supply of liquidity to the aggregate economy and stabilizing the domestic price level.

Even if it were decided to have the federal government intervene to such an extent in the private economy, the institutional structure and legal form of the intervention still would matter a great deal (see, for example, Sprinkel [1952], Todd [1988], and Schwartz [1992]). Perhaps the best argument in favor of a revived RFC is that keeping the bailout lending device (the RFC) separate from the monetary policy device (the Fed and, to a lesser extent, the FDIC) would both enable monetary policy to be conducted independent of the bailout function and increase the political accountability to taxpayers for any publicly funded debt rescue.

An understanding of the RFC's history and institutional structure should assist policymakers in decisions regarding the desirability and efficiency of rescuing segments of the financial services industry. Also, knowledge of the history of the RFC should predispose policymakers toward keeping government-funded debt rescue operations separate from the Federal Reserve's monetary policy operations.

I. History of the RFC

Although government intervention in business operations has a long and involved history, the classically liberal political philosophy of most U.S. administrations prior to Herbert Hoover limited their market interference to relatively few peacetime interventions until the RFC. The actual prototype of the RFC was the War Finance Corporation (WFC), chartered in 1918 to enable the federal government to centralize, coordinate, and fund the procurement and supply operations that accompanied formal U.S. entry into World War I in April 1917.[3]

The WFC was loosely modeled on methods used by J.P. Morgan & Company to coordinate and fund the British Treasury's purchases of U.S. war supplies between January 1915 and April 1917. The WFC's operations, in turn, were guided by an Advisory Commission and were

■ 2 See, for example, Phillips (1992), Calomiris (1992), and Butkiewicz (1992).

■ 3 See text of War Finance Corporation Act at *Federal Reserve Bulletin*, vol. 4 (February 1918), pp. 95–98 (proposed bill), and ibid. (April 1918), pp. 300–06 (bill as enacted). See also Olson (1988), pp. 10–14, Dos Passos (1962), pp. 219–27, and Clarkson (1924).

BOX 1

Herbert Hoover's Intentions for the RFC

Hoover's message to Congress (January 1932) proposed that RFC funds be used for the following purposes:

(a) to establish and finance a system of agricultural credit banks ... [ancestors of the Farmers Home Administration];

(b) to make loans to the existing [Federal] Intermediate Credit Banks ... [part of the Farm Credit Administration];

(c) to make loans to building and loan associations, savings banks, insurance companies, and other real estate mortgage agencies so as to enable them to postpone foreclosures [ancestor of the Federal National Mortgage Association];

(d) **to make loans to banks and financial institutions "which cannot otherwise secure credit where such advances will protect the credit structure and stimulate employment"** [emphasis added];

(e) to make loans to the railways to prevent receiverships [this was in fact the most significant use of the RFC during its first year of existence and relieved some of the biggest banks of some of their most problematic assets—railroad bonds];

(f) to finance exports that would aid the farmers and the unemployed [ancestor of the Export–Import Bank];

(g) to finance modernization and construction of industrial plants and utilities so as to increase employment and plant efficiency [ancestor of the Defense Plant Corporation of World War II and of the Defense Production Act of 1950]; [and]

(h) **to make loans to closed banks upon their sound assets so as to enable them at least partially to pay out deposits to a multitude of families and small businesses who were in distress because their deposits were tied up pending liquidation or reorganization of these banks** [emphasis added] [ancestor of the FDIC's powers under the original FDIC Act (1933) to speed up payment of liquidation proceeds to holders of "frozen" bank deposits]. (Hoover [1952], p. 98)

subject to "preference lists" issued by the War Industries Board.[4]

In fall 1931, the onset of the worst part of the Great Depression, President Hoover proposed to the Federal Reserve System's Federal Advisory Council (FAC) the formation of a $500 million credit pool, to be funded entirely by commercial banks and to have the authority to borrow another $1 billion, if necessary, for the purpose of refinancing assets on the books of distressed banks. Prior to 1932, the Federal Reserve Banks were not authorized to make advances against assets other than "real bills" or government securities, and they could not lend for longer than 15 days on the government securities owned by member banks. The proposed credit pool, called the National Credit Corporation (NCC), was to make extraordinary advances until the December 1931–March 1932 session of Congress could act upon Hoover's recommendation to authorize Reserve Banks' emergency advances for up to 120 days collateralized by government securities or any other satisfactory assets. Hoover also proposed to the FAC "... [i]f necessity requires, to recreate the [WFC] ... with available funds sufficient for any emergency in our credit system."[5] The NCC was organized in October 1931, but was superseded when the RFC Act was signed into law on January 22, 1932.[6]

Describing his abandonment of free-market principles to bail out the commercial banking system, Hoover wrote:

> [When I met with a group of Congressional leaders on October 6, 1931,] I presented a program for Congressional action if the bankers' movement [NCC] did not suffice. I hoped those present would approve my program in order to restore confidence which was rapidly degenerating into panic. The group seemed stunned. Only [Speaker of the House John Nance] Garner and [Senate Majority (Republican) Leader William] Borah reserved approval. The others seemed shocked at the revelation that our government for the first time in peacetime history might have to intervene to support private enterprise [in this case, by creating the RFC]. (Hoover [1952], p. 98)

Although this was hardly the first time that the U.S. government had supported private enterprise through protection, subsidies, or bailouts, it certainly was the first time that it had done so on a grand scale in peacetime.

4 The WFC was easily the largest-scale effort at central planning in U.S. history before 1932. See Tansill (1938), pp. 79–81, 90–113, Chernow (1990), pp. 186–91, Dos Passos (1962), pp. 219–27, Pusey (1974), p. 216, Clarkson (1924), and *Federal Reserve Bulletin*, vol. 4 (1918), pp. 931–34.

5 Hoover (1952), pp. 84–98, quotation at p. 98. See also Pusey (1974), pp. 216–17, and Friedman and Schwartz (1971), p. 320.

6 Hoover (1952), pp. 84–98, Friedman and Schwartz (1971), p. 320, Pusey (1974), pp. 217–19, and Butkiewicz (1992). The official text of Hoover's statement on the creation of the NCC, together with Federal Reserve Bank of New York Governor (President) George Harrison's reply, is at *Federal Reserve Bulletin*, vol. 17 (October 1931), pp. 551–53. A statement by the organizers of the NCC is at ibid., pp. 555–57. President Hoover's statement on the RFC and the text of the RFC Act are at *Federal Reserve Bulletin*, vol. 18 (February 1932), pp. 89–90, 94–99.

The original RFC was given a Treasury capital contribution of $500 million, with initial authority to borrow up to $1.5 billion more "from either the Treasury or private sources."[7] Hoover initially asked for $3 billion of RFC borrowing authority, but that increased amount was not granted until July 21, 1932, when the Emergency Relief and Construction Act raised the ceiling to $3.3 billion, of which $300 million was set aside for unemployment relief (Friedman and Schwartz [1971], p. 320; *Federal Reserve Bulletin*, vol. 18 [1931], pp. 473–74).

Although the original RFC Act was altered substantially in subsequent years, its main elements were in place from the beginning, either in Hoover's original plan or in the modifications made during the next year. Bailout loans were to be made not by the central bank (Federal Reserve), but instead by this new, separately chartered, government-sponsored enterprise, the RFC.

To ensure further structural separation between the governmental bailout (fiscal) and central banking (monetary) functions, Section 9 of the RFC Act provided explicitly that obligations of the RFC "shall not be eligible for discount or purchase by any Federal Reserve Bank" (*Federal Reserve Bulletin*, vol. 18 [1932], p. 97). RFC obligations were issued in the public debt market and counted both in federal budget receipts and expenditures and in limitations on federal debt outstanding.

The inauguration of the Roosevelt Administration on March 4, 1933, finally enabled a major change in the RFC's formal powers to occur: The preferred stock purchasing power was added. The vehicle for that change was the Emergency Banking Act, enacted March 9, 1933. The procedures for passage of that bill were extraordinary; among other things, the House of Representatives had no copy of it.

> The Speaker recited the text from the one available draft, which bore last-minute corrections scribbled in pencil.... With a unanimous shout, the House passed the bill, sight unseen, after only thirty-eight minutes of debate.... The Senate, over the objections of a small band of progressives [Senators Lafollette, Borah, Case, Dale, Nye, and Shipstead, together with Senator Costigan, the lone Democrat voting no], approved the bill unamended 73–7 at 7:30 that evening and at 8:36 that same night it received the President's [Roosevelt's] signature. (Leuchtenberg [1963], pp. 43–44; *Federal Reserve Bulletin*, vol. 19 [1933], p. 115–18 [text of Act])

President Hoover's advisors played a principal role in preparing the legislation, but the primary draftsman of the final version was Walter Wyatt, then general counsel of the Federal Reserve Board (Jones [1951], pp. 21–22; Olson [1988], pp. 37–40). Eugene Meyer, still Governor of the Federal Reserve Board but no longer Chairman of the RFC at the time, and Treasury Secretary Ogden Mills were the principal Hoover advisors in this effort (Pusey [1974], pp. 232–38).

Under Section 304 of the Emergency Banking Act, the RFC was authorized to purchase preferred stock of banks "in need of funds for capital purposes either in connection with the organization or reorganization of such [banks]" (*Federal Reserve Bulletin*, vol. 19 [1933], p. 117). Wyatt was familiar with the issue and could have given the Reserve Banks a capital replacement or solvency support role in the draft statute if he had chosen to do so. But in fact, he gave that role to the RFC, not to the Reserve Banks.[8]

When the Roosevelt Administration took over in March 1933, the leadership and scope of the RFC also changed. Jesse Jones, a prominent Houston businessman, was appointed chairman (Federal Loan Administrator). He already had served one year as a member of the RFC's board of directors, participated in the first big bank rescue operation of the Depression (the Central Republic Bank of Chicago borrowed $90 million from the RFC in June 1932), and managed to weather the political storm that erupted when the list of the RFC's borrowers was made public in August 1932. Jones remained as chairman of the RFC until January 1945.[9]

Under Jones, the RFC spent about $50 billion of the public's money, of which more than $22

■ 7 Olson (1988), pp. 37–40

■ 8 Olson (1988), pp. 38–39, notes that the idea of RFC investment in the preferred stock of troubled banks was promoted during the spring and summer of 1932 by, among others, Federal Reserve Bank of New York Governor (President) George Harrison and director Owen D. Young "because so many banks had capital as well as liquidity problems." By December 1932, Governor (Chairman) Eugene Meyer of the Federal Reserve Board, who understood the fiscal/monetary policy distinction less well than the New York Reserve Bank officials, "began arguing that either the RFC or Federal Reserve Banks [should] invest in [banks'] preferred stock."

■ 9 Jones (1951), pp. 72–83. See generally Olson (1988), Pusey (1974), pp. 216–26, and Butkiewicz (1992) Morgan (1985), p. 743, describes the reasons for Jones's termination as follows:

> By the end [of 1944], President Roosevelt decided to fire ... [Jones] largely because Jones had opposed the third term (1940) and fairly openly supported Dewey (1944). As a consolation prize, FDR offered to fire Marriner Eccles and to let Jones have the chairmanship of the Federal Reserve

See also Jones (1951), pp. 255–311.

billion fueled World War II procurement and production. About $10.5 billion went for the fight against the Great Depression "without loss to the taxpayers," if the time value of money were ignored. The rest of the RFC's funds were channeled to foreign aid, domestic relief, and postwar reconstruction and conversion loans to industry. These were significant amounts at the time because, in 1933, gross national product was only about $56 billion (the initial appropriation for the RFC was about 1 percent of GNP, equivalent to $65 billion today) (Jones [1951], p. 4).[10]

Jones was both a populistic and a parsimonious man. In the words of Hyman Minsky, "He spent the public's money as though it were his own."[11] His overall aim for RFC interventions in the economy was not to increase central planning or corporatist control, as some New Dealers understood and intended to practice those concepts, but rather to exercise his own judgment in producing outcomes roughly analogous to those that would have been expected had the markets been left alone. Thus, bankers were required to reduce their salaries and sometimes to change managements in exchange for RFC capital assistance; dividends on common shares could not be paid until preferred shareholders' dividends (including those of the RFC) were paid; and bankers were required to post reasonably good collateral and eventually to repay borrowings, typically over 10 years. There was no hint that the government was making a permanent capital injection into the banks or was making a market in their common shares (Jones [1951], pp. 25–37; Olson [1988], pp. 47–62, 78–83, 124–127), as some of Jones's New Deal contemporaries and some current theorists and politicians have advocated.[12]

The high points of RFC operations affecting the banking industry occurred during 1932 and just after the bank holiday of March 1933. Of the 17,000 commercial banks in existence going into the holiday, only 12,000 survived, and half of those were borrowing some or as much as all of their capital from the RFC under the preferred stock provisions of the Emergency Banking Act. Federal deposit insurance (added in June 1933 as part of the Glass–Steagall Act) did not yet exist. Almost all large banks, in addition to the 5,000 conservatorships, receiverships, and assisted mergers, funded themselves through the RFC. With bailout loans to other industries included, ranging from insurance companies and savings and loans to real estate and steel mills, the RFC became a principal influence on credit availability in the U.S. economy.[13]

Over time, the RFC became corrupted by politics, as Jones came to control enormous patronage. Between 1947 and 1953, the prevailing opinion in Washington, particularly among congressional Republicans, was that central-planning-style interventions in the economy were inefficient and harmful, and the RFC was phased out. Its formal operations ceased in 1953, with the final accounts settled in 1957 (U.S. Treasury [1959], Sprinkel [1952]). Some of its operations survived as independent new agencies, like the Export–Import Bank and the Federal National Mortgage Association, or as part of ongoing Cabinet-level departments.

The bailout lending, preferred stock purchasing, and direct or industrial lending powers of the RFC were not transferred anywhere else—certainly not to the Federal Reserve, or to the FDIC prior to 1982—and should be presumed to have died with the RFC in 1957. No serious effort was made to revive those powers in Congress until the borrower-specific federal loan guarantee programs were enacted for Lockheed, New York City, and Chrysler Corporation during the 1970s. In those cases, the only role played by any federal department or agency other than the Treasury Department, which provided the guarantees, was the role of fiscal agent explicitly

■ **10** Schiming (1992) notes that, for perspective, the Mercury and Apollo space program outlays of the 1960s should be compared with RFC outlays. In the period 1961–1969, total "space research" program outlays in the federal budget summaries appearing in *Federal Reserve Bulletins* were $34.1 billion, about 3 percent of the final year (1969) GNP. Peak-year outlays were $5.93 billion in 1966, about 4.5 percent of federal budget outlays, but still slightly less than 1.0 percent of nominal GNP. Thus, proportionately, initial-year outlays for the RFC (about 1.0 percent of GNP) exceeded even peak-year outlays for the Mercury–Apollo space programs.

■ **11** Author's conversation with Hyman Minsky, November 22, 1991. See Buchanan and Tullock (1965), Buchanan (1968), Buchanan and Wagner (1977), Kane (1989), pp. 95–114, Kane (1990), pp. 760–61, and Greider (1992b) for varying explanations of the rarity of efficient management of public funds.

■ **12** See Olson (1988), pp. 111–114, 173, Greider (1992a), Rohatyn and Cutler (1991), Willoughby (1992), and Cummins (1992). In contrast to the kinds of measures that Jones required of bankers receiving RFC assistance, the Treasury Department during 1992 requested repeal of analogous provisions regarding salaries and management changes enacted as part of recent banking legislation (see Rehm [1992], Greider [1992b], and Willoughby [1992]). A 1992 federal housing assistance bill passed by Congress and expected to be signed by President Bush "toned down a provision [of the FDIC Improvement Act of 1991] requiring regulators to issue guidelines for executive compensation. Now guidelines need be issued only to cover unsound institutions." (Garsson [1992b]).

■ **13** See Penning (1968), Upham and Lamke (1934), Jones (1951), Sprinkel (1952), Olson (1988), and Keeton (1992).

assigned to the Federal Reserve Banks for the Lockheed loan guarantee in 1971.[14]

II. Six Lessons Learned from the RFC

The RFC embodied six key features that are relevant to how one might use such an agency today and, by inference, how one should *not* use a central bank.

First, the RFC was explicitly prohibited by law from funding itself via the Reserve Banks, either directly or indirectly. This prohibition was intended to avoid potential conflicts between the Reserve Banks' central banking (monetary policy) operations and politically driven bailout loan requests, which are fiscal policy operations in the classic models of political economy.[15]

Second, the RFC also was prohibited from extending credit to new enterprises trying to enter a market. Typically, the RFC made loans only to established enterprises initiated, set on foot, or undertaken "prior to the adoption of th[e RFC] act." (RFC Act, section 5, in *Federal Reserve Bulletin,* vol. 17 [1932], p. 96.) Thus, from a normal, free-market, procompetitive perspective, the RFC was interventionist and anticompetitive, providing subsidized credit to existing businesses that was unavailable to new entrants into those lines of business.

Third, through direct purchases of preferred stock after March 1933 (Emergency Banking Act, section 304, in *Federal Reserve Bulletin,* vol. 18 [1933], p. 117), the RFC could provide governmental recapitalization of the banking industry in a way that would be undesirable if undertaken by a central bank.[16] The RFC's preferred stock purchases were one step short of nationalizing the banking system (see, for example, Phillips [1992] and Wyatt [1933]). Governmental recapitalization of the banking industry would amount to de facto nationalization if there were insufficient collateral for the government's loans or if there were no credible schedule for repayment in full of the government's assistance within a reasonable time, such as five years (the longest term of Federal Reserve advances ever explicitly authorized by statute) or 10 years (the longest statutory term of RFC assistance).

Fourth, no small part of the success of the RFC may be due to its leader, Jesse Jones. Changed times and changed personalities might make it difficult to appoint anyone comparable to him today. A czar of banking recapitalization today would face conflicting choices between fiscal prudence (reducing spending on the debt rescue) and fiscal imprudence (increasing spending on the debt rescue). Either choice would alienate one set of political constituencies while pleasing the other set. If enough constituents were alienated by such choices, and if reappointment accordingly began to appear politically impossible, then one would have to view even the initial appointment of another Jones as highly improbable.[17]

■ 14 See Todd (1988) and Schwartz (1992) regarding the evolution of RFC-like intervention schemes into federal loan guarantees, particularly after 1942. See also Hackley (1973), pp. 133–61. The 1970s' federal emergency loan guarantee statutory references are Lockheed Corporation, Public Law No. 92-70 (1971); New York City (first rescue), Public Law No. 94-143 (1975); New York City (second rescue), Public Law No. 95-339 (1978); and Chrysler Corporation, Public Law No. 96-185 (1979). In addition, the Defense Production Act of 1950, 50 U.S.C. Appendix Sections 2061 et seq., reenacted in 1992, continues authorization for V-loans, a form of reimbursable loan guarantee program administered by the Reserve Banks for the Treasury since 1942.

■ 15 See Greenspan (1991), pp. 435–36; but see, against his views, Greenhouse (1992). Chairman Greenspan's views on Federal Reserve funding of the Treasury's or a deposit insurance fund's obligations are particularly instructive. Addressing the Bush Administration's early 1991 proposal, with which some members of Congress seemed sympathetic, to have the Reserve Banks lend up to $25 billion directly to the FDIC's Bank Insurance Fund (BIF), Chairman Greenspan's remarks were as follows (source cited):

> [A]n element of the Treasury's proposal that has troubled the Board is the use of the Federal Reserve Banks as the source of these loans. To prevent such loans from affecting monetary policy, the loans would need to be matched by sales from the Federal Reserve's portfolio of Treasury securities.... Not only would use of the Reserve Banks for funding the BIF serve no apparent economic purpose, it could create potential problems of precedent and perception for the Federal Reserve. In particular, the proposal involves the Federal Reserve directly funding the government. The Congress has always severely limited and, more recently, has forbidden the direct placement of Treasury debt with the Federal Reserve, apparently out of concern that such a practice could compromise the independent conduct of monetary policy and would allow the Treasury to escape the discipline of selling its debt directly to the market. Implementation of the proposal could create perceptions, both in the United States and abroad, that the nature or function of our central bank had been altered. In addition, if implementation of the proposal created a precedent for further loans to the BIF or to other entities, the liquidity of the Federal Reserve's portfolio could be reduced sufficiently to create concerns about the ability of the Federal Reserve to control the supply of reserves and, thereby, to achieve its monetary policy objectives.

■ 16 The point that it is theoretically improper for a central bank to provide capital replacement or solvency support for the banking industry is made explicitly in the report of a conference of South American central bankers that appears in *Federal Reserve Bulletin,* vol. 17 (January 1932), p. 45. The conference report, prepared largely by and under the influence of Federal Reserve Bank of New York officials, including future president Allan Sproul, stated that central banks must not in any way supply capital on a permanent basis either to member banks or to the public, which may lack it for the conduct of their business.

■ 17 See, for example, Buchanan and Tullock (1965), Buchanan (1968), and Buchanan and Wagner (1977)—all on "public choice" analysis as it might apply to this issue—and Greider (1992a, b), Kane (1989), pp. 95–114, and Kane (1990), pp. 760–61, on the "principal–agent" conflict as applied specifically to the bank supervision/bank recapitalization problem in the thrift industry. See also a reference to what now would be called the "principal–agent" conflict, applied to the RFC, in Olson (1988), p. 43 (quoting Chester Morrill, former secretary of the Board) [prefatory quotation for this paper].

Fifth, for more than one year (January 1932–March 1933), the RFC operated in an environment in which there was no deposit insurance and Federal Reserve notes were convertible into gold. The FDIC, authorized in June 1933, did not begin operations until January 1934. Neither of these conditions—an externally constrained central bank and no deposit insurance—prevails today. The simple vision of federal deposit insurance in the early and mid-1930s was the role of a liquidator primed with cash, not the more extensive role of bank supervisor and engineer of reorganizations of open banks that the FDIC plays today (see Penning [1968] and Todd [1991], pp. 85–90). The actual experience of the 1930s suggests that the optimal use of an RFC would be to compensate for the deficiencies of deposit insurance, where it was deemed desirable to do so, and to lend in cases (such as to insolvent banks) that would be dangerous for lending by an externally constrained Reserve Bank (for example, under a gold standard) (see Todd [1988, 1991]; compare with Epstein and Ferguson [1984]).

Sixth, because the RFC's finances were externally constrained, its operations were directly and politically accountable (initially, through the office of the Federal Loan Administrator; later, through the Department of Commerce, whose chief officer, the Secretary of Commerce, is a full member of the President's Cabinet). The external constraint arose from the RFC's incapacity to fund itself off-budget or for a very long time.[18]

In summary, the principal danger posed by governmental bailout mechanisms, or by a Federal Reserve that undertakes RFC-like operations, is that, from public choice theory, we know that it is difficult for the government to extend credit directly to selected businesses (already established ones, at that) and simultaneously to avoid political pressures to distribute the loans or investments in a partisan manner or to selectively favored constituencies (see Olson [1988], p. 67, and Buchanan and Tullock [1965], especially pp. 265–95). In current discussions, a useful distinction could be made between an RFC that primarily protected existing firms (an RFC with a notably corporatist tinge) and an RFC implementing an industrial policy that attempted to identify, protect, and subsidize emerging industries (Schiming [1992]). It would be better to do neither and to let market forces select winners and losers and encourage promising new industries.

III. Forbearance, the Too-Big-to-Fail Doctrine, and the RTC: Comparisons between the Rescue Structures of the 1930s and Those of the 1980s

The crises that emerged in the thrift and banking industries in the 1980s prompted a variety of governmental attempts to either buy time to allow market-driven corrective forces to work out a positive solution or prevent further loss of depositors' confidence that their deposits would be repaid at par value. Initially, *forbearance* seemed to be the mechanism of choice, with the former FSLIC and the FDIC being authorized in 1982 to issue income maintenance certificates and net worth certificates to keep insured institutions open, even if technically insolvent.[19]

The too-big-to-fail doctrine had precursors in regulatory discussions of the 1970s, but gradually became fully articulated in the early 1980s. The doctrine was brought into public debate with the 1984 decisions by both insurance funds to treat their largest insured institutions as "too big to fail" because of the generalized loss of depositors' confidence that might be engendered by a closing without repayment of deposits at par: The FSLIC preserved American Savings Bank of Stockton, California ($34 billion total assets), its largest insured thrift. The FDIC, with funding provided temporarily by the Federal Reserve, preserved Continental Illinois of Chicago ($41 billion total assets), the tenth-largest FDIC-insured institution. Both were rescued even though only small shares of their funding were provided by their own, retail, insured deposits (Mayer [1992], pp. 108–15, 254–56; Todd and Thomson [1990]).

In the case of Continental, the shareholders of the parent holding company were offered a settlement initially valued at 20 percent of the shareholders' equity in the remaining bank, plus stock options and a contingent claim on recoveries from liquidations of presumptively

■ **18** The RFC initially was authorized to issue obligations not in excess of three times its subscribed capital (originally $500 million) and to borrow for not in excess of five years. Its obligations were explicitly guaranteed by the full faith and credit of the United States (RFC Act, sections 2 and 9, in *Federal Reserve Bulletin*, vol. 18 [February 1932], pp. 94, 97). Similarly, obligations of the modern Resolution Trust Corporation (RTC) explicitly carry the full faith and credit of the United States when the principal amount and maturity date are stated. 12 U.S.C. Section 1441a (j)(3) (1992).

■ **19** See, for example, Eichler (1989), Kane (1989), Mayer (1992), pp. 57–89, and Woodward (1992). Woodward provides a good working definition of "forbearance": the policy of permitting capital-deficient institutions to operate under the protection of federal deposit insurance.

bad assets (Sprague [1986], pp. 186–88, 209–10). These rescues, which preserved large, insolvent institutions, were analogous to the role of the RFC in the 1930s, but they were not done as efficiently or as cheaply as the RFC could have done them after March 1933, when the preferred stock purchase plan began. In any case, although there was limited statutory authority for the FDIC to provide open-bank assistance to prevent immediate loss to the fund after 1982, there was no comparable, explicit statutory authority for other too-big-to-fail actions undertaken by the commercial banking regulators in the 1980s. In contrast, the Emergency Banking Act of 1933 explicitly authorized the RFC to recapitalize insolvent or marginally solvent banks. The RFC's power to fund receiverships existed since 1932, and the comparable power to fund conservatorships was added by the Emergency Banking Act.

Eventually, in 1989, the thrift crisis of the 1980s led to the creation of the Resolution Trust Corporation (RTC) as a passive liquidator of insolvent institutions formerly insured by the FSLIC. Although it appears that the sponsors of the RTC had a rough model of the RFC in mind, especially its operations in 1932, the RTC proved to be quite different from the RFC of 1933 and after.

Also, the federal bank regulators' concepts of too big to fail and systemic risk have continued to evolve since the RTC was created in 1989. In this context, "systemic risk" has the meaning attributed to it in the FDIC Improvement Act of 1991 (FDICIA) [Section 141 (a)(1)(G)]: a regulatory determination that failure to repay uninsured claims on insured institutions at par "would have serious adverse effects on economic conditions or financial stability." The following section evaluates the effectiveness of the RTC and the continued evolution of the too-big-to-fail/systemic risk doctrines in light of the lessons learned from the experiences of the RFC in the 1930s.

Forbearance and the Too-Big-to-Fail Doctrine

During the 1980s, and particularly after 1982, thrift industry regulators found themselves in a situation in which they required a large amount of new funds to deal with weak institutions in the traditional manner (closing and liquidating or assisting with the required mergers of such institutions). However, neither Congress nor the Executive Branch was willing to provide the necessary funds to the FSLIC before 1986, and the amount finally provided in 1987 ($10.8 billion) proved inadequate (Mayer [1992], pp. 230–42). Thus, the thrift regulators were forced to forbear, that is, to defer events that would force the accounting recognition of the economic losses already accrued to the FSLIC (Kane [1989], pp. 70–114). The forbearance devices actually used took several forms, ranging from decreased frequency and intensity of examinations to lower capital requirements and approval of accounting regimes designed to make embedded losses in asset portfolios appear to be increases in regulatory capital instead (Mayer [1992], pp. 57–115).

Writing on the importance of supervisory forbearance as a cause of the thrift industry's collapse in the 1980s, Kane (1989), p. 78, notes:

> [C]apital forbearance — which has to an important extent been forced on FSLIC by Congress, both in its unwillingness to increase FSLIC's human or capital resources to handle the surge in client [S&L] economic insolvencies and in formal limitations on closure powers enacted in the Competitive Equality Banking Act of 1987 — served to bifurcate the industry into the living and the living dead. While many of the living have been able to strengthen their capital position, the zombies have been getting worse.

Kane also notes the cumulative impact of the FSLIC's forbearance policies: Between 1982 and 1987, the number of insolvent *open* institutions rose from 237 to 515, and the number of insolvencies resolved by the FSLIC fell from 247 in 1982 to only 36 in 1984 (Kane [1989], p. 26).

The FDIC and other federal regulators were simultaneously developing and expanding the concept of banks "too big to fail," with Continental Illinois serving as the principal catalyst in 1984. The collapse of nearly all large bank holding companies in Texas from 1986 until 1989 and of a few large ones in the Middle Atlantic region and New England after 1989 gave rise to further refinements of large-bank failure resolution procedures under the systemic risk doctrine (Todd and Thomson [1990] and Kaufman [1992]).

The relevance of these developments to analysis of the RTC depends on the assumptions that one is prepared to make about the efficacy of and motives for supervisory behavior during the 1980s. If, as the authorities cited argue, the regulatory process had lost its way prior to the enactment of FDICIA, then too many weak or failing thrifts and banks were being kept open instead of being closed down and liquidated. The decisive factor in the political process was that it was apparently cheaper in the short term to ignore failing bank cases in a fiscal environment

that simply would not have provided sufficient, on-budget funding to close weak institutions directly (see, for example, Kane [1989], pp. 18–22, and Mayer [1992], pp. 90–115). In hindsight, it appears that a full-fledged RFC with the capacity to either recapitalize weak and marginally insolvent banks or provide the funding to pay off depositors and general creditors would have proved quite helpful (see Keeton [1992]). But instead, the eventual government-funded liquidator, the RTC, was created in 1989 with all of the liabilities but comparatively few of the asset and funding powers of the old RFC.

The RTC and the RFC

In August 1989, the RTC was chartered for seven years to deal with the wave of thrift institution failures in the late 1980s.[20] Like the RFC, the RTC was intended as a temporary expedient only, with its authority to administer new cases to expire in September 1993 and its charter to expire in 1996. But although the RFC became an active solvency-support provider after March 1933, the RTC's role has been restricted to passive liquidation only—an important distinction between the roles of these two rescue agencies.

Funding the RTC has been problematic. The initial vehicle was the Resolution Funding Corporation, an entity whose acronym (RFC) evokes memories of the original rescue agency of the 1930s. Like the original RFC, the modern RTC has borrowed funds to enable it to repay depositors of failed thrifts initially and then has had to administer assets until resale. The RTC also has obtained funds through additional, direct appropriations and through borrowings for liquidity purposes through the Federal Financing Bank. The ultimate cost to taxpayers backing RTC obligations is the difference between the amounts initially disbursed to repay depositors and the amounts realized upon eventual resale of seized assets, adjusted for ongoing costs of administration of those assets.

The funding sources of the modern RTC are more varied, but its cash flow is more constrained than that of the old RFC. Both entities share a common funding restraint: Neither could borrow at the Federal Reserve Banks.

The 1930s' RFC was authorized to issue its own debt instruments into the public debt market (the Federal Financing Bank did not exist until 1973) and had a substantial amount of positive cash flow. After all, the RFC did not lend to significantly insolvent firms, most of its loans were short term, and loan repayments and scheduled preferred stock redemptions provided the cash flow. The RTC, on the other hand, is required to fund depositor payoffs for even grossly insolvent thrifts and has, by definition, a large portfolio of nonperforming, difficult-to-sell assets. The RTC's cash flow, other than from asset sales, has been minimal for several months at this writing. In fact, it is because of these funding constraints that some proponents have advocated a role for the Federal Reserve in any new or expanded bank or thrift rescue operations (see Greenhouse [1992] and Rohatyn and Cutler [1991]).

Although most of the RTC's funding is on-budget, and although its funding corporation has issued off-budget bonds (which still count as part of gross public debt) with maturities as long as 40 years, the RTC exhausted its available cash for thrift failure resolutions in March 1992, and Congress still has not appropriated new funds. Worse yet, as Kane (1990), p. 756, has noted, there are political and bureaucratic pressures at work that tend to increase the eventual, final, taxpayers' cost of the RTC's operations, such as the "counterproductive layers of go-slow administrative restraints [at the RTC]." (See also Pike and Thomson [1991].)

Two principal lines of argument have emerged regarding the disposition of RTC assets. One line argues that the RTC should liquidate its entire portfolio as quickly as possible, even if that means initially absorbing large losses from the face value of its assets, because the losses embedded in the RTC's portfolio generally will not improve under government management (Eichler [1989], Kane [1990], and Pike and Thomson [1991]). Also, the carrying costs (the accrual of interest on borrowed funds, maintenance costs regarding real property, and administrative expenses for a large bureaucracy) are sufficiently large that the total cost of the RTC after five or seven years probably would be less than if the alternate path were followed.

The second line of argument is that the RTC's affairs should be managed so as to minimize nominal losses from face value upon resale of the properties. This would entail a readiness to expend necessary sums for maintenance and improvements, because borrowing costs currently are low and because bureaucratic and administrative expenses should not prove significantly greater in the near term than those required for a sales force to liquidate all the properties. Initially, proponents of this second view argued that the RTC could become the government's general

■ 20 Financial Institutions Reform, Recovery, and Enforcement Act of August 9, 1989, Section 501; 12 U.S.C. Section 1441a (1992), as amended (FIRREA).

manager for all rescue operations, including rescues of nonbank, nonfinancial firms, thereby more fully mimicking the original RFC (see Mayer [1992], pp. 260–325, especially pp. 315–18).

In general, this second view, omitting the proposed role of the RTC as general manager of all governmental rescues, has dominated RTC operations thus far, largely because of fears in regions like Texas and New England that massive sales of foreclosed real property would further depress an already depressed real estate market. Proponents of the first view argue that liquidation sales would clear the market and establish a bottom value for real estate upon which a sustainable recovery of prices could be founded—something that cannot occur as long as there is a substantial amount of real estate in government hands that overhangs the market and eventually has to be sold anyway (Mayer [1992], pp. 260–86, 308–10; compare with Eichler [1989], pp. 143–46).

Similar matters were argued at great length during the RFC's operations in the 1930s, with the central planning/corporate state factions of the New Deal (such as Rexford G. Tugwell and Adolf A. Berle) arguing for permanent management of assets in the RFC's hands (Schlesinger [1959], pp. 432–33, and Olson [1988], pp. 111–14, 173). Jones eventually aligned himself with the fiscal conservatives (including Senator Carter Glass, Budget Director Lewis Douglas, and Postmaster General James Farley), who wanted to return RFC assets to private hands as soon as possible and eventually to dismantle the RFC.[21]

Cost estimates regarding the modern RTC's operations vary. The original RFC broke even, ignoring the time value of money (Jones [1951], p. 4). But the combined cost of the RTC and FSLIC resolutions (deadweight loss) is expected to be about $200 billion at present value, largely reflecting the difference between failed thrifts' liabilities paid off at par today and the RTC's recoveries on assets sold in the future.[22] This loss represents nearly $2,000 for every individual income tax return.

It still is generally expected that nearly 900 thrifts (almost one-third of the industry in 1987) holding more than $400 billion in assets will fail and be managed by the RTC before its intervention authority expires in September 1993. At the end of March 1992, when the RTC's available cash was exhausted, it had disposed of 640 closed institutions holding $311 billion of total assets, for which it obtained $202 billion at book value (Resolution Trust Corporation [1992]).[23] The Bush Administration estimates that an additional $42 billion of funding, beyond the $80 billion already appropriated in 1989 and 1991, would be necessary to complete the RTC's operations, in addition to funding the Southwest Plan deals (see note 22), with a further $8 billion funding request for initial capitalization of the Savings Association Insurance Fund, the successor of the FSLIC, after 1992.

The Central Bank's Role

A tendency to use central bank resources to fund a bailout increasingly politicizes the bank's monetary policy functions, which risks causing it to resemble the way in which national development agencies are used and often abused in developing countries (providing assistance from public funds to the most powerful and politically well-connected entities in the state).[24] Generally, industrial-economy central banks are somewhat insulated from political requests to fund specific rescue operations. For example, during 1992, Sweden, Norway, and Finland, all industrial economies, decided to bail out their banking systems, but they established new governmental agencies outside their central banks (RFC analogues) to do so.[25]

Some industrial-economy nations, however, do use their central banks to fund rescue operations. The French bankers' association has

21 See Olson (1988), pp. 36–37, 84–103, 173, 193; Browder and Smith (1986), pp. 110–16; and Schlesinger (1960), pp. 515–23.

22 This $200 billion estimate of loss is divided between $135 billion for RTC resolutions and $65 billion for so-called "Southwest Plan" resolutions committed by FSLIC before FIRREA was enacted in 1989. See Mayer (1992), pp. 249–59, on the Southwest Plan. The $135 billion portion of the $200 billion estimate is likely to rise again (and the $65 billion portion to fall somewhat) if short-term interest rates increase. The Congressional Budget Office also currently estimates the RTC's portion of this cost at $135 billion, reduced from its $155 billion estimate in late 1991, attributing the reduction primarily to lower-than-expected interest rates during the past year. See Garsson (1992a). At this writing, in early December 1992, the Federal Reserve discount rate is 3.0 percent, as is the federal funds target rate that the market perceives.

23 Using June 30, 1992 data provided by RTC regional sales offices, the Southern Finance Project calculated that the RTC was recovering about 55 percent of the book value of commercial real estate assets sold (Schmidt [1992], Thomas [1992], and Southern Finance Project [1992]).

24 See, for example, the case of the Central Bank of the Philippines, which assumed the foreign debt of its government's state-sponsored enterprises in the early 1980s and consequently lost $13 billion on its income statement during 1991, with even greater losses expected during 1992 (LDC Debt Report [1992]). See also Schwartz (1992), Todd (1988, 1991), and Epstein and Ferguson (1984).

25 See Brown-Humes (1992), Corrigan (1992), Fossli (1992), and Taylor (1992).

officially asked the French government for assistance with about $15 billion of nonperforming property loans on the books of the nation's banks, including "one option proposed ... for cheap refinancing of troubled loans through the Bank of France" (Dawkins [1992a, b]). Japan also has been studying methods for relieving its banking system of nonperforming real estate loans without using taxpayers' funds but has not yet settled upon a final plan (Chandler [1992]). Some Japanese bankers have requested central bank assistance in this plan, but the government has not yet committed such resources to the effort.

In the case of the Federal Reserve Banks, it is official Federal Reserve policy that Reserve Banks' advances should not be used to substitute for the capital of depository institutions and that Federal Reserve resources should not be used so as to enable the Treasury to avoid the discipline of selling its debt instruments into the open market.[26]

IV. Conclusions

This paper reviews some of the important lessons to be learned from the experience of the original RFC, which was the principal government-funded bailout agency for both banks and nonbanks from 1932 to 1947. Having tried forbearance and seen it fail to deal adequately with the thrift industry's problems after 1982, Congress created the RTC, which it apparently hoped would resolve those problems much as the RFC had done in the 1930s. Unfortunately, the RTC has proved to be a much weaker entity, and it has had no new appropriations for failure resolutions since March 1992, with its mandate to deal with new cases set to expire in September 1993.

When capital replacement problems analogous to those of the thrift industry began to emerge in the banking industry in the mid-1980s, regulators initially responded by adopting forbearance policies regarding certain classes of loans (developing-country debt, agricultural loans, and commercial real estate) and by articulating and elaborating on the too-big-to-fail doctrine, which also produced an offshoot called the systemic risk doctrine. Since the debate began on FDICIA in 1991, increased attention has been paid to RFC-like solutions for the banking industry's problems as well.

Although some authorities still advocate creation of a new RFC, or the conferral of RFC-like powers on the Federal Reserve, others oppose such a measure and express doubt that it would, in fact, be needed. In retrospect, recreating the RFC probably would have been a better solution to both thrift and banking industry problems in the mid-1980s than what actually was done in 1989 and afterward. However, even the original RFC with a second Jesse Jones in charge would have been hard-pressed to function effectively in the 1980s, when a large number of the institutions to be rescued were grossly insolvent, not just marginally insolvent or undercapitalized, and when Congress refused for long periods to appropriate necessary operating funds for the eventual rescues.

Remembering the RFC and Jesse Jones fondly in hindsight tends to cloud the issues that need to be resolved in any debate about creating a new RFC or assigning its functions to the Federal Reserve. Even with a comparably capable man like Jones running it, the original RFC was not immune from well-founded charges of political favoritism, corruption, and abuse.

An RFC certainly might prove useful today. As Keeton (1992) has shown, an RFC can be an effective way for the government to preserve financial institutions that otherwise would fail, but it is doubtful in the present environment that the government could undertake such rescues in a way that would maximize long-term efficiency and minimize short-term political considerations. Having the Federal Reserve Banks provide the funds for such a rescue operation would only muddy the waters further by reducing the customary measure of direct political accountability for such rescue decisions that currently is obtained through forcing periodic congressional appropriations of new operating funds.

The ultimate objection to RFC-like rescue operations, and even more to having Reserve Banks (repositories of the society's common fund of monetary reserves) fund such rescues, arises from the incidence of the costs to society from such operations. Bailouts entail social costs because they misallocate scarce resources in the direction of activities that the market, by refusing to fund at previous levels, already has rejected, regardless of whether the Fed or a new RFC steps in.

Any revived RFC should be established only as a temporary rescue device. If it lingers indefinitely, it risks becoming a tool for corporatist management of the industrial and financial economies. Jones, for example, saw the RFC as

■ 26 Federal Reserve Regulation A, governing use of the Reserve Banks' discount windows, has provided for nearly 20 years that "Federal Reserve credit is not a substitute for capital and ordinarily is not available for extended periods." 12 C.F.R. Section 201.5 (a)(1992). All words in this paragraph of the regulation following "capital" have been omitted since 1980. See Greenspan (1991), pp. 434–36, partially quoted in note 15.

a temporary rescue device to save capitalism. Still, a new RFC is an idea (albeit an inherently bad one) worth discussing if the only alternative permitted by the political process is central-bank-funded rescues of politically designated target firms. Any new RFC should be separately chartered with a fixed expiration date for its activities and a comparable deadline for the maturity of its funding instruments. The RFC should be funded on-budget and through regular appropriations. The Federal Reserve should be precluded explicitly from funding the RFC, directly or indirectly, to ensure that institutional checks and balances remain in place.

Overall, in thinking about ideas for particular bailouts and bailout devices like the RFC, it is useful to recall the following wisdom extracted from 19th-century experiences with the problem of social cost:

> [Policymakers came to understand that] efficiency and equity required that public subsidies to private persons be openly assessed, and not accomplished by inattention or concealment.... [W]e had to learn that the incidence of cost was socially as important as the fact that cost existed. (Hurst [1956], p. 105)

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