# BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF RESEARCH AND STATISTICS

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**Date:** May 10, 2010

**To:** Federal Open Market Committee

**From:** Larry Slifman

**Subject:** Economic effects of loan write-offs and forgiveness

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At the last FOMC meeting, President Lacker asked about the economic effects of loan write-offs and forgiveness of consumer loans. Starting with the treatment in the national income and product accounts: According to the BEA, the System of National Accounts recommends that a distinction be drawn between loan forgiveness, which would be treated as a capital transfer from the lender to the borrower, and write-offs of bad debt, which would not be treated in the income accounts, but instead affect the balance sheet through the "other changes in assets" account. In practice, however, the BEA only tracks loan forgiveness as capital transfers for certain debts owed to the federal government. For private loans, the BEA simply excludes all write-offs and loan forgiveness from the calculation of corporate profits. The BEA is considering looking into government programs that call for modification of loans or loan forgiveness to see whether there are data available that would allow for the capital transfer treatment.

Measurement aside, in terms of possible economic effects it is probably easiest to think of the owners of lending institutions as suffering a reduction in their wealth (because of the reduction in the net worth of the lending institution) and the borrowers as gaining an increase in their cash flow. Roy Webb (FRB Richmond) estimates that charge offs for consumer credit card lending at the largest banks totaled $40 billion in the first quarter, or $160 billion for the year if write-offs continue at the same pace. Combining the $160 billion figure with a typical estimate of the marginal propensity to consume (MPC) out of wealth of .05, suggests that the owners of lending institutions would reduce their consumption by $8 billion. For borrowers, their cash flow

would increase by the product of the reduction in the outstanding loan amount times the interest rate on the loan.[1] Assuming, for convenience, a round number like 15 percent as the average interest rate on consumer loans by banks would yield an increase in the cash flow of borrowers of roughly $24 billion for the year. These borrowers are likely to be liquidity constrained and have an MPC of 1. Accordingly, the net effect of the charge offs would be $16 billion ($24 billion minus $8 billion), or a little less than 0.2 percent of the level of nominal PCE.

[1] Cash flow also would be affected slightly by the amount of foregone periodic payments for reduction in the outstanding principle.