

Federal Credit Programs

--the Issues They Raise

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Even in the relatively narrow context of a discussion on Federal debt management, the term "Federal agencies" covers a broad and diverse range of debt instruments. At one end of the spectrum one finds the direct obligations of government-owned agencies such as the Export-Import Bank, TVA, and the Postal Service — obligations that are virtually indistinguishable in credit standing from direct obligations of the U.S. Government itself. At the other end are the notes of private issuers, such as SBICs that are guaranteed by a government agency, in this case the Small Business Administration. In between fall every sort and description of instrument, distinguished by differing degrees of access to the Treasury in case of default, of insurance coverage as to interest and principal, of marketability based on size of issue, minimum denomination, etc., and differing degrees of explicitness in the extent to which the obligations are guaranteed, if at all.

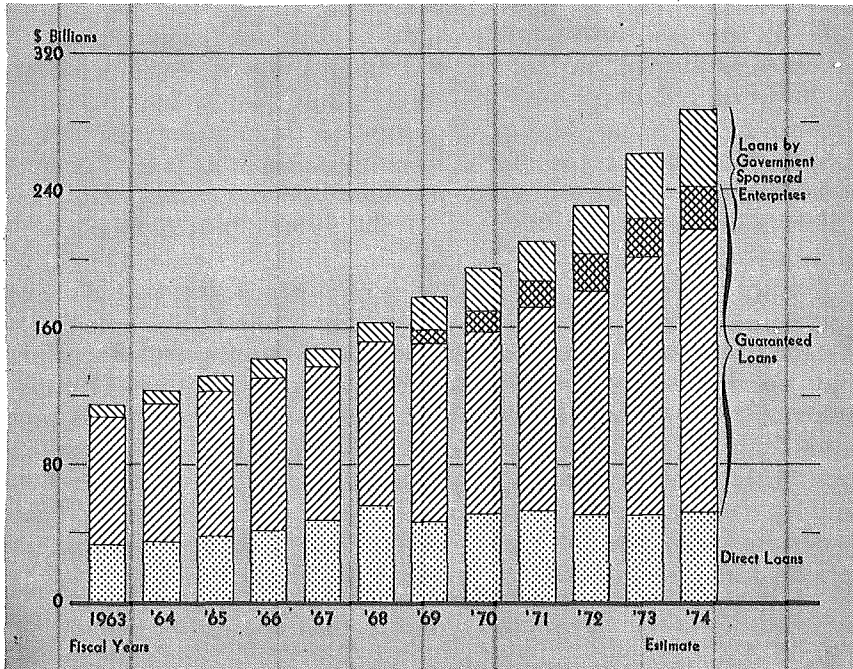
Despite this great diversity, most market people think of the term "Federal agencies" as encompassing primarily the obligations of the so-called federally sponsored agencies that are privately owned and that operate outside the budget: the Federal National Mortgage Association, the Farm Credit System, and the Federal Home Loan Bank System. This narrower use of the term reflects both the size and the activity of these particular borrowers in the credit markets, and the fact that their obligations are sold in the open market and traded actively. Other agency issues are generally smaller, less actively traded, or tailored to specific types of investors.

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To focus on agency issues as such, by whatever definition, however, is to miss the broader context of the Federal government's involvement in the credit markets more generally. Before the off-budget agencies became so large, the Federal government through regular budget agencies had long been in the business of extending direct loans in support of a wide variety of programs. In addition, of course, the government had long been in the business of guaranteeing the debt of private parties, most notably through the mortgage insurance programs of the FHA and VA. Thus, while for some purposes it is sufficient to look at the role and implications of government agency securities, defined as bond-type instruments sold and traded in the open market, for other purposes it is more relevant to look at the broader aspects of the government's function as a credit-granting and credit-guaranteeing entity.

Expansion of Federal Credit Programs

Starting from the broader perspective of the government's role in credit markets generally, it is not hard to document the very rapid rates of growth in federally assisted credit in recent years, both in absolute terms and in relation to credit flows in the capital markets. The accompanying chart, taken from Special Analysis E of the 1974



Budget, depicts graphically the accelerating trend in amounts of Federal and federally assisted credit outstanding over the last decade. As shown in the chart, total borrowing under Federal auspices is expected to reach \$287 billion in 1974, a two-year increase of \$55 billion and 24 percent over the 1972 level.

Another indication of the growing importance of Federal credit assistance is the increased proportion of funds raised in the credit markets that benefit from some form of Federal assistance:

FEDERALLY ASSISTED BORROWING

(Billions of \$ or %)

	Amount		Percent	
	FY 1962	FY 1972e.	FY 1962	FY 1972e.
Federally Guaranteed	5	25	8	18
Sponsored Agency	<u>1</u>	<u>4</u>	<u>2</u>	<u>3</u>
Total	\$6	\$29	10%	21%

*Change in amount outstanding

Source: Adapted from Treasury material accompanying submission of bill to establish a Federal Financing Bank, Dec. 9, 1971.

As a proportion of funds raised, the federally assisted portion has doubled to about 20 percent over the last decade. Nor do these figures include the impact on credit markets of the increase in direct government debt issued to finance budget deficits.

As is obvious from the chart, the entire growth in federally assisted credit in recent years has taken the form of guarantees and loans by government-sponsored agencies. In fact, the volume of outstanding direct loans extended by budget departments has not increased at all on balance since 1967.

The expansion of federally assisted credit has occurred not only in aggregate amounts outstanding, but also in the proliferation of departments, programs, and off-budget agencies making use of this sort of assistance. A list of Federal, federally guaranteed, and federally sponsored agencies borrowing from the public was attached to the Treasury's proposal in December 1971 to create a Federal Financing Bank (to be discussed below), and is reproduced here. Section IV of the list shows proposals for new borrowing agencies and new guarantee programs before Congress at that time. Since then, the guaranteed Washington METRO Bonds have been authorized and issued, the Farmers Home Administration has been granted broad new authority to finance rural development credit, and the Environmental Financing Authority and the National Student Loan Association have been enacted and will probably be in operation by nex

**FEDERAL, FEDERALLY-GUARANTEED, AND
FEDERALLY-SPONSORED AGENCY BORROWING
FROM THE PUBLIC¹**

- I. Federal agencies regularly issuing in the securities market direct obligations of a type which will be eligible for sale to the Federal Financing Bank:

Credit agencies:

Export-Import Bank
Federal Housing Administration
Rural Telephone Bank

Other agencies:

Tennessee Valley Authority
U.S. Postal Service

- II. Federal agencies issuing guarantees of a type for which the submission of budget plans will be required by the Federal Financing Bank Act:

- A. Guaranteed obligations regularly financed in the securities market:²

Agriculture:

Farmers Home Administration (asset sales)

Commerce:

Maritime Administration (merchant marine bonds)

Health, Education, and Welfare:

Academic facility bonds (debt service subsidies)
Hospital facilities (asset sales)

Housing and Urban Development

College housing bonds (debt service subsidies)
GNMA mortgage-backed securities³
New community debentures
Public housing bonds and notes (debt service subsidies)
Urban renewal notes (debt service subsidies)

Transportation

Railroad (Amtrak, etc.)

Export-Import Bank (PEFCO, etc.)

General Services Administration (asset sales)

Small Business Administration (SBIC debentures)

Funds appropriated to the President:

International security assistance
International development assistance
Overseas Private Investment Corporation

¹Excludes minor programs and programs in liquidation.

²Guaranteed borrowing includes sales of Federal loan assets on a guaranteed basis and borrowings partly guaranteed by means of debt service subsidies.

³Includes GNMA guarantees of mortgage-backed bonds issued by FNMA and FHLMC.

B. Other guaranteed obligations:

Commerce:

Economic Development Administration
Trade adjustment assistance

Defense:

Defense production

Health, Education, and Welfare:

Health manpower training facilities
Nurse training facilities
Student loans

Housing and Urban Development:

Federal Housing Administration

Export-Import Bank

Small Business Administration

Veterans Administration

III. Federal sponsored agencies whose obligations will not be eligible for sale to the Federal Financing Bank:

Farm credit agencies:

Banks for cooperatives
Federal intermediate credit banks
Federal land banks

Federal Home Loan Banks

Federal Home Loan Mortgage Corporation

Federal National Mortgage Association

IV. Major proposals before Congress:

A. New borrowing agencies:

Environmental Financing Authority
National Student Loan Association
U.S. International Development Corporation
National Development Bank
Urban Development Bank
National Credit Union Bank
Rural Development Bank

B. New guaranteed borrowings:

Farmers Home Administration farm operating loans (asset sales)
Transportation Department equipment trust certificates
Washington Metropolitan Area Transit Authority
District of Columbia government borrowing (debt service subsidies)
Taxable municipal bonds for rural development (debt service subsidies)

Office of the Secretary of the Treasury
Office of Debt Analysis

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year. Just since 1969 when I started my assignment at the Treasury, various other new agencies and programs have come into existence, including: the Rural Telephone Bank, the U.S. Postal Service, GNMA mortgage-backed securities, new communities debentures, Amtrak, Pefco, Overseas Private Investment Corporation. Indeed, it would be rather surprising if the pressure to provide credit assistance *outside* the budget did not result in a wave of new programs and financing vehicles, each with its own constituency and special characteristics.

Another dimension to the growth in Federal credit assistance is the tendency to "upgrade" the form of instrument issued or guaranteed so that it will be more readily marketable and presumably carry a lower interest cost. This upgrading can be seen most easily in the transformation of guaranteed mortgages into guaranteed bonds through issuance of GNMA mortgage-backed securities.¹ It is also evident in the efforts to "perfect" the guarantees on various types of securities, e.g., SBIC debentures and Merchant Marine bonds, to obtain a cleaner and faster tap on the Treasury in case of default, to increase the ratio of guarantee from 90 percent to 100 percent etc.

While there is nothing inherently wrong in trying to devise characteristics for securities that will make them more marketable, the rub comes when the ultimate objective is to create securities that are indistinguishable from direct government debt, and yet still preserve some rationale for not counting the issues as a means of financing budget deficits or against the Federal debt ceiling — a clear case of trying to have one's cake and eat it too.

Why the Growth in Federal Credit Programs and Agency Securities?

If the fact of rapid expansion in Federal credit programs is self-evident, the factors stimulating this growth are more complex. The most basic question to be asked, I suppose, is why the Federal government should be involved in credit programs at all. There are a variety of answers.

First, credit assistance, just like expenditures on goods and services and transfer payments, may be used to alter in a socially desirable way (it is assumed) the allocation of resources in the economy. And indeed, it is a fact that programmatic objectives can be achieved either through cash grants or credit assistance within a considerable range of overlap.

¹From none in 1970, such securities jumped to \$6.8 billion outstanding in 1972, and are expected to reach \$15.6 billion in 1974.

Second, a case is made for Federal involvement in the credit markets (e.g., through guarantees) as a means of overcoming market imperfections. This is perhaps the purest case, where assistance is "temporary", i.e., until the market itself fills in the gaps. In practice, many of the federally assisted credit programs contain a proviso requiring the lending agency to find that private financing is not available on reasonable terms.

But the Congress has gone well beyond the "market imperfections" rationale, to provide very substantial elements of subsidy in the form of debt service grants, below market interest rates, etc. not on a temporary but on a continuing basis. The intent, of course, is again to influence the allocation of resources, but to do so in a way that leverages the Federal budget dollar. It can be argued, for example, that many worthwhile (i.e., benefits > costs) projects in the private sector would not be undertaken if the full cost of the investment had to be financed out of the investor's stream of current income. By analogy, there are presumably many worthwhile investments that could be made by the Federal government (forgetting that in an accounting sense the government has no capital budget as such) either in bricks and mortar (e.g., waste treatment plants) or education (college tuition assistance) that would not be made if the full cost had to be funded through current tax receipts whereas the stream of benefits will accrue over a long period of years.

But this argument simply makes the case for borrowing to finance a certain type of federally desired outlay. It says nothing about *who* should borrow, the government itself or the party(ies) to be assisted. As the growth in credit programs outside the budget shows, however, this is a more theoretical than a practical question. In practice, a budget dollar has a much greater scarcity value to Congress and the Administration than a dollar borrowed from the private sector — borrowed with Federal assistance maybe, but not direct Federal debt!

Indeed, there is little doubt that the single most important factor that explains the growth and proliferation of Federal credit assistance is the desire to see programs funded with a minimum use of scarce budget dollars. An early example of the effort to conserve budget dollars yet carry on programs was the ingenious development of the so-called Participation Certificate in 1966. By carefully tailoring the provisions of this instrument, the Administration sought to issue "participations" in a pool of financial assets (the claims arising out of previous direct loans) and count the transactions as sales of assets (i.e., negative expenditures) rather than as a means of financing

the deficit. This particular device gave rise to heated political debate, and the accounting practices were changed to preclude (or at least make more difficult) such practices thereafter. But the budget pressures that spawned initiatives of this sort continued, and so did the efforts to escape the budget constraints with new and different credit programs.

In 1967, the Report of the President's Commission on Budget Concepts said that "one of the most difficult questions the Commission has faced is how Federal loan outlays should be reflected appropriately in the budget." In the end, the Commission recommended, and the Administration agreed, to include direct loans within a unified budget (rather than deleting direct loan transactions from the budget as proposed by some). Prophetically, the Commission said:

Highlighting of direct loan programs — and strict control of almost all of them within the budget — could create incentives to redirect Federal loan programs to some extent into government guarantee or insurance of private loans. These may have much the same effect on resource allocation and on economic impact as direct loans, even though Federal funds are not directly involved, and even though such guarantee and insurance programs are not reflected in the budget except for administrative expenses and defaults, and occasional provision of secondary market support.

The Commission also recommended that government-sponsored enterprises, such as FNMA, the Federal Land Banks and the Federal Home Loan Banks, which had previously been omitted from the (administrative) budget even though they were owned in part by the government, be omitted from the (unified) budget accounts when such enterprises were completely privately owned.²

As we have seen, since direct loans were not removed from the unified budget, they stopped growing entirely, and all of the growth in federally assisted credit took the form of loan guarantees, or loans by sponsored agencies which are practically invisible in the budget documents. In addition, the trend toward "debudgeting" of credit agencies accelerated. Not only were the Bank for Cooperatives and the Federal Intermediate Credit Banks "privatized" (i.e., government capital replaced by private capital, thus qualifying them as "100 percent privately owned" and by this criterion out of the budget), but the Federal National Mortgage Association also joined the parade.

²Though the volume of outstanding loans of such excluded enterprises should be shown as a prominent memorandum item.

At about the same time, and partly in consequence, the functions of the housing-oriented agencies — FNMA and FHLB — expanded from so-called secondary market operation (or in the case of FHLB, rediscounting) designed to assure liquidity to mortgages and mortgage lenders over the business cycle, to the provision of funds for the housing sector on a more or less continuing basis. Obviously, this change in purpose implied a continued tapping of the bond markets to provide the funds.

More recently, we have seen a less subtle example of debudgetization. Since there was little hope of turning the Export-Import Bank into a “private” institution, Congress took the bull by the horns and simply declared in legislation that Ex-Im’s lending would be excluded from the budget totals beginning August 17, 1971. It is not just coincidental that Ex-Im’s lending is expected to jump from \$250 million in FY ’72 to \$1.6 billion in FY ’74.

Having set this precedent, one should not be surprised at the May 1973 enactment of a bill that likewise removed the REA 2 percent loans from the budget, and at the same time provided REA with broad new guarantee authority. A similar bill is now pending to debudget the AID 2-3 percent development-loan program.

In essence, the growth and proliferation of credit programs have been a consequence of the increasing scarcity of budget vs. non-budget dollars, and the vagaries of the definitions of what is included and excluded from the budget totals. Related to the scarcity of budget dollars were the massive capital expenditure programs that the Federal government sought to stimulate (if not fund) in the areas of urban renewal, public housing, mass transit, waste treatment, etc. — programs that in the private sector would indeed be funded by borrowing rather than financed out of current income.

Another spur to the expansion of Federal credit assistance has been the two bouts of very tight credit conditions that have occurred in recent years, the credit crunch of 1966, and its even tougher successor in 1969-70. Congressional concern with the impact of these periods of credit tightness on particular sectors of the economy, most notably housing, stimulated a search for ways to mitigate the impact through preferential credit facilities. Out of this search, for example, came the development of mortgage-backed securities, together with a much more active role for the housing agencies.

Increased budget pressures have thus given rise to something like a typical life cycle in which outright grants, say for construction, were replaced by direct loans, on grounds that the government was only providing temporary financing that would eventually be repaid — a

budget saving not in the short run, but certainly in the long run. The second step was to transform the direct loans into guarantee of private credits, thus costing the budget only a fraction of the total outlay and effecting the saving immediately. To be sure that the projects in fact got the necessary funding without the government having to put up much of the money, Congress authorized varying amounts of subsidies to accompany the guarantee programs, e.g., payment of all but 1 percent of interest on Section 235-236 guaranteed loans for low income housing.

Similarly, in the area of higher education, the government previously had made 3 percent direct loans to colleges for the construction of academic facilities and college housing. In 1970, this program was phased out and instead the government agreed to provide to private lenders interest-subsidy payments of all interest above 3 percent so that the cost to the colleges would not be increased.

Implications of Expanded Federal Credit Programs

The more or less unfettered expansion of Federal credit programs and the accompanying deluge of agency direct and guaranteed securities to be financed in the credit markets has undoubtedly permitted Congress and the Administration to claim that wonder of wonders – something for nothing, or almost nothing. But as with all such sleight-of-hand feats, the truth is somewhat different.

The fact is that the growth and proliferation of Federal credit programs has created, or at least exacerbated, problems on a number of fronts. Some of these problems are of interest primarily to managers of the public debt. Others have ramifications well beyond that limited concern, touching on:

- 1) the control of Federal expenditures generally,
- 2) the ability to measure the impact on the economy of “the budget”
- 3) the functioning of credit markets as allocators of resources.

The uncomfortable truth is that there is very little agreement on the net impact on resource allocation of the government’s growing role in the credit markets.³

To take the debt management concerns first, the basic point is that the growth in federally assisted debt in recent years has significantly outpaced the growth in direct Federal debt. Simply in terms

³See note by John Kareken and Neil Wallace in Appendix.

of size of issues, frequency of financings and anticipating cash flow problems, the task of "managing" individual agency financing now requires the same expertise that has been built up in the Treasury to manage the national debt. Even if that expertise can be acquired — as it has been in a number of instances — it involves an inefficient duplication of talent and extra administrative costs.

Similarly, there are extra costs associated with 1) introducing new agencies to the market, 2) selling issues that are smaller than some minimum efficiently tradeable size, 3) selling securities that only in varying degree approximate the characteristics of direct government debt in terms of perfection of guarantee, flexibility of timing and maturities, "cleanness" of instrument, etc. As a result of such considerations, the market normally charges a premium over the interest cost on direct government debt of comparable maturity ranging from $\frac{1}{4}$ percent on the well-known federally sponsored agencies such as FNMA, to more than $\frac{1}{2}$ percent on such exotics as SBIC debentures, New Community Bonds, etc. In some cases (e.g., SBA guarantees of loans to small businesses) this premium reflects actual services rendered by the private sector, such as origination and/or servicing of loans, co-insurance, credit appraisal, etc. More often, however, the premium on guaranteed obligations far more than compensates for such services. In general, if cost of financing were the only consideration, it would be most efficient to have the Treasury itself provide the financing for direct loans by issuing government debt in the market.⁴

Efficiency of financing is not the only debt-management cost of the proliferation of agency issues. Since the market views the various kinds of agency and guaranteed issues as falling generally in a single category — Federal debt — it makes little sense to have one agency preparing an issue right on top of another, or the Treasury itself. The role of traffic cop in terms of timing and maturity distribution of potentially competing issues is important to the government in minimizing costs, and important to the smooth functioning of the debt market itself. The Treasury has long played this role, in some cases by legislative mandate, in other cases by custom. But it is not hard to understand that the problem of coordination has become more complex as the number of issuing entities has increased along

⁴Efficiency, however is not the only criterion. To put all the credit programs back in "the budget" without distinguishing more clearly than at present between an "income account" (i.e., the stream of expenditures) and "balance-sheet transactions" (i.e., exchanges of assets/liabilities) might exacerbate the problems of interpreting the economic impact of "the budget", as discussed below.

with the size of their issues, and as they have asserted a greater degree of "independence" commensurate with their status "outside the budget". Paul Volcker, Undersecretary of the Treasury for Monetary Affairs, made the point effectively in a 1971 talk when he said: "We are already at the point where some Federal financing is coming to market at least three out of every five business days."

Off-budget financing of a growing number of Federal programs through use of federally assisted credit has almost certainly weakened administrative control over these programs in the Congress and in the Administration. While it would be hard to prove this point, common sense and personal experience argue strongly in its favor. Since contingent liabilities under guarantees are inevitably obscured in the complexities of the budget documents and departmental presentations, only administrative costs of such programs, and provision for defaults, are at all prominent in the review of departmental programs involving guarantees. The same is true *a fortiori* for the sponsored agencies. As a result, there is little awareness of, or interest in, the growth, in some cases explosive growth, of such programs. Nor is there any interest in the additional costs to the government over the longer run of financing loans via guarantees of private debt rather than through Treasury issues.

In welcome contrast, some members of Congress have become concerned about the cost of subsidies buried obscurely in a wide range of Federal programs, credit programs among them. As a result, I assume, Special Analysis E in the budget now presents a discussion of the subsidy element in Federal credit programs, both direct loans and guarantees. On commitments undertaken in FY 1972, the *annual* interest subsidy (i.e., the difference between the lending rate and assumed borrowing cost of 8 percent) worked out to about \$880 million. The present value of this subsidy over the average life of the loans, also discounted at 8 percent, was some \$7 billion. Because the President suspended new commitments under a number of the HUD programs, e.g., for urban renewal, low-rent public housing, subsidized mortgage insurance, etc., the budget shows declining subsidies over the next two years in the credit program area, *measured in terms of new commitments*. No attempt was made to value the subsidy element in outstanding loans! Perhaps, just perhaps, one of the reasons for the re-evaluation of some of these credit programs was because their true cost came to light for the first time. In general, however, I would wager that credit programs with their leveraged budget dollars will continue to escape the close scrutiny accorded direct budget outlays.

Another sort of potential "economic cost" that stems from the growth and proliferation of Federal credit programs is the homogenization of debt coming into financial markets. One function that credit markets are supposed to perform is that of distinguishing differing credit risks and assigning appropriate risk premia. For all of the criticisms leveled against the techniques and practices of the bond rating agencies and investment bankers, no one denies the usefulness — to the markets and to the economy — of evaluating the relative economic viability of different financial undertakings, and pricing issues accordingly. Indeed, this is the essence of the ultimate resource-allocation function of credit markets.

As an increasing proportion of issues coming to the credit markets bears the guarantee of Uncle Sam, the scope for the market to differentiate credit risks inevitably diminishes. With the big Federal umbrella covering a growing portion of funds moving through the credit markets, these markets become simply vehicles for mobilizing private savings, and their role in assessing credit risks is displaced or forgotten. Theoretically, the Federal agencies issuing or guaranteeing debt could perform this role, charging as costs of the programs differing rates of insurance premia. In practice, all of the pressures are against such differential pricing of risks, even if the technical expertise were available. As a result, the potential exists for reduced efficiency in resource allocation in the economy, as Federal credit programs spread.

Admittedly, it is impossible to measure the actual costs of this potential resource misallocation. Moreover, against any such costs must be set the possibility that financial markets, left to their own devices (i.e., without the Federal programs), do an even worse job than the government in channelling funds to borrowers with the highest *social* priorities. The net effect of this "homogenization" argument therefore is unfortunately in doubt. But the expansion of credit programs in particular areas should at least take explicit account of these offsetting social and economic costs. (Or more accurately, differing degrees of externalities.)

Finally, the most difficult economic question raised by the growth of Federal credit programs is the extent to which they distort assessments of the economic impact of the Federal budget on the economy. On the one hand, financial transactions are for the most part excluded from the National Income Accounts budget on grounds that such transactions simply represent exchanges of assets/liabilities and do not themselves generate income/expenditures. And the National Income Budget is generally taken to be the most useful set of accounts for analyzing the economic impact of the Federal government.

On the other hand, there are a lot of Congressmen who have been seriously deluding themselves and their constituents if the substitution of credit program assistance for outright grants, and the subsequent expansion of these credit programs, has not in fact meant increasing federally assisted claims on real resources.

Apart from this fundamental conundrum, there is the further complication of changing definitions. It would be difficult enough if we were dealing simply with changing magnitudes relative to the economy and to each other — of loans and expenditures in a consistently defined “budget”. But as we have seen, major credit agencies have been “debudgeted” in recent years, so that whatever the economic impact of their programs (which can certainly be taken as greater than zero), this impact has been lost sight of by those analyzing “the budget”. The same “disappearance” applies to programs that were once funded through direct loans but are now funded by guarantees of private credit. If these changes were small, they could be ignored. But in practice they amount to several billions of dollars from one year to the next.

There is by now a fair literature on the economic impact of Federal credit programs — most notably in the Staff Papers of the President’s Commission on Budget Concepts — but still very little agreement on theoretical grounds and almost no valid policy guides, such as we have with the full-employment budget. Credit programs, in essence, continue to fall between the cracks — confronted directly neither by the fiscal-policy advocates nor the monetarists.

Theoretically, the monetarists could argue that there is very little to be debated here. If the monetary authorities simply stuck to their knitting and provided a steady increase in the monetary base (or some other magnitude), there would be allocation effects as the government-assisted borrowers bid away financial resources from the rest of the market, but there would be no risk of excessive credit creation overall, since this is ruled out by definition. In practice, I find this “solution” no solution at all, because the real world doesn’t work in the way postulated.

A point of current interest — much attention is focused at the moment on Congress’ efforts to impose on itself a more rational mechanism for controlling aggregate Federal expenditures. This is one of the more hopeful initiatives taken by that body. It would be too bad if the opportunity is missed to incorporate at the same time an overall review of federally assisted credit programs into the new budget review process.

In summary, the costs of uncontrolled expansion of Federal credit programs, and related Federal agency issues, may be thought of as

falling into two categories: debt-management costs and economic costs, with some overlap. In the first category may be listed:

- 1) duplication of financial expertise at various agencies
- 2) higher costs of marketing agency issues than for direct Federal debt, because of
 - a) unfamiliarity of issues to buyers
 - b) small size of individual issues
 - c) varying degrees of "guarantee"
 - d) inflexibility of maturities and other terms
- 3) greater risk of market congestion from uncoordinated issuing dates and terms.

The economic costs include:

- 1) less close scrutiny by Congress and the Administration of loan and guarantee programs than expenditure outlays
- 2) great possibilities for hidden subsidies
- 3) dilution of resource allocation function of credit markets by homogenization of credit risks
- 4) difficulty of measuring economic impact of growing Federal credit programs.

*The Federal Financing Bank – A Proposal to Mitigate
Some of These Problems*

The problems cited above are not new. But the continued rapid growth of Federal credit programs and agency issues makes the search for some solutions more pressing.

In December 1971, the Treasury on behalf of the Administration submitted a bill to Congress to establish a Federal Financing Bank. Recognizing that it was not realistic, and perhaps not even desirable, to try to turn back the clock and route a greater portion of federally assisted credit through direct loans financed out of current receipts or direct government borrowing⁵, the Treasury proposed the creation of what is essentially a financing shell. The "bank" would be authorized to buy any obligation "issued, sold, or guaranteed" by a Federal agency, and in turn finance such purchases through sale of its own securities, which would be obligations of the United States. This financing arrangement is obviously designed to consolidate under one roof the issues of many different agencies. It would achieve hopefully economies of scale, better coordination of issues, and lower program costs for the agencies concerned.

⁵E.g., for *unsubsidized* guaranteed issues, it may in fact be preferable to have the borrower pay the higher cost associated with partially guaranteed agency issues than get the "subsidy" of the government's own credit costs.

Apart from the potential benefits the bank might effect as a debt management device, another provision of the bill is designed to encourage better coordination of credit programs through more rigorous control. Specifically, agencies issuing or guaranteeing securities in the market would be required to submit financing plans in advance to the Treasury. (A second, and potentially more important control, i.e., that no Federal agency would be permitted to guarantee issues "except in accordance with a budget program submitted to the President," was deleted from the 1973 version of the bill.)

The consolidation of issues should focus attention more widely on the scope and growth of credit programs and agency issues, and hopefully permit the informed public to relate anticipated demands of federally assisted credit on the flows of funds available — just as is now done in relating Federal expenditures to resource availability in the economy.

APPENDIX

TO: Bruce K. MacLaury, President
Federal Reserve Bank of Minneapolis

FROM: John Kareken and Neil Wallace

SUBJECT: Federal Credit Programs and Desired Investment

1. You indicated that you wanted us to take up the question “What are the macroeconomic effects of Federal credit programs?” But as you probably know, this is not a question to which one can turn to the economic literature for a satisfactory answer. We have had to make up our own. It is by no means complete. It holds only for wealth-maximizing economic units — for firms and households, that is, but probably not for nonprofit institutions such as universities and colleges. Moreover, it may be wrong. That is a possibility you will want to keep in mind when drafting your talk.
2. There being various Federal credit programs, our answer is in several parts:
 - (a) Financial intermediation by the Federal government has a macroeconomic effect. More particularly, an increase in the Federal government’s portfolio of private loans or equities, financed by an increase in, say, the stock of Treasury securities outstanding, is expansionary. An increase in desired investment results.
 - (b) Direct lending by the Federal government has a macroeconomic effect. And there is an effect when the government guarantees private-sector debts. But what these effects are is not clear. *A priori*, it is impossible to say what happens to desired investment (or, therefore, aggregate demand) when the stock of direct Federal loans or federally guaranteed debt is increased.
 - (c) There are various possible Federal interest-subsidy programs and they are not all the same in their macroeconomic effects. If the Federal government subsidizes firms by giving them sums of money that are proportional to their respective outstanding debts, then desired investment increases. If the subsidy rate is the difference between the market rate of interest and some stated rate (perhaps the Federal government’s own rate), then desired investment changes. But depending on circumstances, it may increase or decrease.

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Financial Intermediation

3. It is not difficult to show, using the type of analysis developed by Professor Tobin, that financial intermediation by the Federal government is expansionary.¹ And why is easily explained. The Federal government increases the supply of Treasury securities and, by the same amount, its demand for private-sector loans.² Inducing the private sector to shift from loans to Treasury securities requires a higher rate on Treasury securities, however, and a lower rate on private loans. Consequently, the equilibrium rate on private-sector loans decreases and the equilibrium rate on Treasury securities increases. And, what is most important, the equilibrium "supply price of capital" — as Tobin has defined it, the ratio of the price of a unit of existing physical capital to the price (reproduction cost) of a unit of new capital — also increases.³ But an increase in the supply price of capital is expansionary, for the higher it is the greater is the incentive to produce new capital.
4. There are some of us, however, who are not overly fond of explanations that involve the supply price of capital (or models in which this variable appears). For one thing, if there is a market-determined supply price, then presumably there is a market in which existing capital can be bought and sold. How does the supply price change, except by being bid up or down in a market? But it is surely inappropriate to assume that there are markets for all kinds of existing capital.
5. Fortunately, it is possible to tell a story about financial intermediation by the Federal government without mentioning the supply price of capital. To make it short, we assume that what the government does is buy equities. It finances its purchases by increasing the supply of Treasury securities. With a government purchase of equities, the supply available to the private sector

¹See the recent paper by Craig Swan, "A General Equilibrium Model of FNMA and FHLB Actions" (Federal Home Loan Bank Board, February 1973).

²Professor Swan considers an increase in the supply of agency securities, matched by an increase in the demand for private-sector loans, but that is because he is specifically interested in the macroeconomic effects of the operation of particular institutions. Whichever supply is increased, whether the supply of Treasury securities or the supply of agency securities, the result is (qualitatively) the same.

³The increase in the supply price of capital is not, strictly speaking, necessary. But if a certain reasonable condition (what would seem to be a stability condition) is satisfied, then Tobin's supply price does increase.

decreases. And on the most reasonable assumptions about portfolio behavior, the price of equities increases. In other words, the rate of return on equities (the earnings-price ratio) decreases. But a decrease in this rate is expansionary. As the rate on equities decreases, there is an increase in the number of investment projects that can be undertaken with no dilution of earnings per share.

6. Thus, whether the rate of return on equities or the supply price of capital is taken as the crucial variable, straight-forward application of portfolio theory produces the conclusion that an increase in financial intermediation by the Federal government increases desired investment and is therefore expansionary.⁴ Of course, only a *ceteris paribus* increase in such financial intermediation is expansionary. If an increase in such intermediation is accompanied by, say, an appropriate change in the money stock, then only a reallocation of resources will result. There will be more investment in industries favored by Federal financial intermediation and less in others.

Direct Lending and Guarantees

7. We turn now to the Federal government's direct lending and its guaranteeing of private-sector liabilities. It suffices to analyze one or the other of these activities. For whether the Federal government lends directly to a firm or guarantees its liabilities, perhaps up to some limit, the effect is the same: the firm's interest cost is decreased. Further, since the guaranteed liabilities of a private firm are just like the liabilities of the Federal government, the changes in the stocks of debt outstanding are the same; whether the Federal government makes direct loans or guarantees private-sector liabilities, there is an increase in the supply of Treasury (that is, risk-free) securities.
8. With a decrease in a firm's interest cost, current and expected dividends increase. So the price of the firm's equities increases. Since this increase results from the change in the dividend stream, there is, however, no decrease in the rate of return on equities. Nor therefore is there any increase in the number of investment projects that can be undertaken with no dilution of equity. Direct lending does not then result in an increase in desired investment.

⁴This conclusion requires that private-sector units view the government as an institution apart and not, as it were, simply a mutual fund holding a part of their portfolios.

9. We have said that when the stock of Federal direct loans outstanding increases, the (expected) dividend stream and the price of equities also increase. Tax payments must also increase, however, for with more direct loans outstanding there are increased loan losses. So there is no increase in private-sector income (or, alternatively, wealth). And there is no increase in desired consumption spending. Unless, of course, the Federal government deliberately decreases its surplus. What is expansionary then is not a *ceteris paribus* increase in the stock of direct loans outstanding, but an increase that is accompanied by a decrease in the Federal budget surplus.⁵

An Alternative Analysis of Direct Lending

10. The conclusion of paragraph 8 — that direct lending does not change desired investment — was obtained, however, using portfolio theory. We suspect, however, that there is an important effect of Federal direct lending, an effect on the situation of equity owners, that cannot be taken account of within the confines of portfolio theory, and that therefore this conclusion may well be wrong.
11. We begin our alternative analysis by assuming, not unreasonably, that there is a range of future states (outcomes) for some arbitrarily selected firm. In some of these states, the so-called bankruptcy states, this equity value is zero. In all others, it is positive.
12. Suppose now that there is some investment project which is characterized by a distribution of payoffs, there being a specific payoff for each future state. The problem of the firm is of course to decide whether to undertake this project. If it has no direct loans from the Federal government on its books, then in so doing it will “value” all the payoffs, even those of bankruptcy states. This because bankruptcy-state payoffs are valuable to private-sector creditors. And if the firm undertakes this project, then the risk of default will decrease, allowing it to refinance its initial debt at a lower interest cost and thereby increase the return to equity owners.

⁵It might be that those who receive the extra dividends have a higher propensity to spend than those who pay the taxes to cover the government's loan losses. But it might also be that they have a lower propensity to spend. The point is that if the distribution of income is allowed to intrude, then anything can happen.

13. And if all of the firm's debt is in the form of direct loans from the Federal government? Then, since it is borrowing at the lowest possible rate, the bankruptcy-state payoffs are worth noting.
14. So it is easy to imagine two firms – one that has no direct loans from the Federal government and one that has only direct loans – deciding differently about any particular investment project. Consider a project that pays off only in bankruptcy states. The firm with no direct loans may undertake it. The firm with only direct loans will not. Or consider a project that pays off only in nonbankruptcy states. The firm with no direct loans may not want to undertake this project. Even so, the firm with all direct loans may.
15. The conclusion is therefore that direct lending by the Federal government (or a Federal guarantee program) may increase or decrease desired investment. Without specifying in detail the payoff distributions of all the various investment projects, it is not possible to say whether such lending is expansionary or contractionary.
16. Our inclination is to accept the conclusion that direct lending is indeterminate in its effect on desired investment and to reject the conclusion of paragraph 8 (that direct lending leaves desired investment unchanged). For as we have indicated, we are not all that sure about using portfolio theory to get at the macro-economic effects of Federal direct lending and loan-guarantee programs. The conclusion of paragraphs 3 and 5 – that financial intermediation by the Federal government increases desired investment and is therefore expansionary – was obtained using portfolio theory. So we should perhaps be suspicious of it. We are rather confident though, that we can get this conclusion by analyzing how governmental financial intermediation alters the situation of equity owners and evaluations of investment projects.⁶

Interest Subsidies

17. We consider two kinds of Federal interest-subsidy programs. The first, our fixed-subsidy program, involves a subsidy that is independent of the rate at which the subsidized firm or household borrows in the market. Whatever this rate may be, the

⁶We should note that although the FHLB can be regarded as a governmental intermediary, the FNMA, being privately owned, cannot. It has to be regarded as part of the Federal government's loan guarantee program.

subsidized unit receives a certain number of dollars per unit of debt. The second type of program, the variable-subsidy program, involves payments that depend on the market rate of interest paid by the subsidized unit. The government pays the difference between this rate and some stated rate (which may be the same as or greater or less than the government's borrowing rate).

18. The fixed-subsidy program is in a sense expansionary. The introduction or extension of the coverage of such a program increases desired investment. With or without a fixed subsidy, the subsidized unit values all investment project payoffs, including those of bankruptcy states. But if there is a fixed subsidy, then there is additional revenue or payoff in every state. In effect, all investment projects cost less than they otherwise would.
19. If, however, a variable-subsidy program is introduced or extended to more firms and/or households, then desired investment does not necessarily increase. This type of program can be regarded as a combination of a direct or guaranteed-loan program and a fixed subsidy program, with the amount of the fixed subsidy depending on the rate that is stated or used in calculating the subsidy. If this rate is the government's borrowing rate, so that under the variable-subsidy program it pays the difference between private borrowing rates and the government rate, then this program is a direct or guaranteed-loan program. There is no (additional) fixed subsidy involved. And as we have already indicated, the introduction of a direct loan program has an indeterminate effect on desired investment.
20. Under a variable-subsidy program, however, the government may pay the difference between the subsidized units borrowing rate and a rate that is greater or less than its own rate. If it does, then there is some fixed-subsidy effect on desired investment — in addition, that is, to a direct or guaranteed-loan effect. Even so, the introduction or extension of the coverage of a variable-subsidy program that has a stated rate below the government rate does not guarantee an increase in desired investment. But it would seem to follow from what we have said that a decrease in the stated rate of a variable-subsidy program (the rate used to calculate the subsidy) is expansionary. The lower is this rate, the greater is desired investment.

DISCUSSION

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President MacLaury's statement does four things. It documents the rapid expansion in the *volume* of federally assisted *credit* and the *number* of Federal credit *programs*. It presents three major reasons for their growth and states a number of major objections to this growth on pages 214-219. Finally it proposes a Federal Financing Bank to mitigate against some of what I shall call congestion or marketing problems and to provide some better control over the overall level and over the composition of the credit activities undertaken by each agency or activity.

In my role as discussant I find myself in a rather difficult position. Better coordination of the sale of issues and reductions in borrowing costs through the issuance of standardized securities of various maturities and in a volume that creates fairly efficient secondary markets are hard ideas to oppose. Better control over the overall level of Federal credit subsidy or insurance granting is also hard to fault. On the other hand, MacLaury is quite knowledgeable about the dimension of these problems, and therefore it is not possible for me to outdo him with a more dramatic statement of the problem. My difficulty seems to be that of trying to find a way to say that the problem is either not as severe as he says, or that its solution does not lie in the direction of a Federal Financing Bank which coordinates or orchestrates issues and which either exercises control or helps Congress exercise control over agency activities. That is the task I have taken on. Rather than see the growth in Federal credit as an explosion reflecting a lack of Congressional control, I would like to try to make the case that, in the Federal credit programs, we have seen the Congress exercising as much continuing and careful control as one can reasonably expect and that the programs are adapting to meet the new directives of such legislative activities. Moreover, rather than creating devious devices to avoid the "discipline of the budget" when dealing with these problems, the Congress with its Federal

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credit activities is dealing with these problems in the ways long proposed by economists and by such groups as the Commission on Money and Credit and the Hunt Commission. Finally, as I will try to make clear, it is not obvious to me, academic that I am, that the problem of congestion and debt management are as severe as they are made out to be.

First to the issue of control. According to the budget figures referred to by President MacLaury, about 53 percent of the Federal and federally-assisted credit outstanding in 1973 arises from guarantees. About 80 percent or \$116 billion originates in the FHA/VA mortgage insurance program. Approximately \$13 billion of this seems to belong to subsidized housing programs and \$103 billion is under the regular unsubsidized insurance program. Now, rather than growing uncontrollably, FHA/VA insurance is not growing even as fast as its market. In 1951 mortgages guaranteed by FHA/VA amounted to 32.2 percent of all private mortgages. By 1968 this figure was 30.9 percent and by 1971 25.8 percent. This does not seem to imply a program out of control. Moreover, the recent addition of the low-income subsidized housing program to FHA and the inclusion of these activities in HUD, the subsequent problems with the low income subsidy program and the recent hearings in April before the Senate Subcommittee on Housing and Urban Affairs all give witness to the close and continuing interest Congress takes in this program. These facts also seem inconsistent with the notion of an uncontrolled program.

Finally, FHA/VA mortgage insurance is likely to confront significant new competition in the near future — private mortgage insurance companies. In 1961, about \$.5 million of private mortgage insurance was in force. By 1968, this had grown to \$5.8 billion. During 1972, \$9 billion more was written and by the end of 1972 \$19 billion was outstanding. It is estimated that private mortgage insurance will rise by \$13 billion in 1973 and continue to grow at a 20 percent annual rate through 1977. This would make the annual growth in 1977 about \$27 billion and the stock outstanding in 1977 about \$100 billion. These projections of the growth of private mortgage insurance mean that by 1977 there may be a volume of private mortgage insurance about equal to the currently existing amount of FHA/VA insurance.

Sources of Potential Expansion

There are several factors which have created this potential boom in private mortgage insurance.

The Emergency Home Financing Act of 1970 empowered FNMA and FHLMC to buy loans with loan-to-value ratios above 75 percent if they were insured by private insurers and the originator retained a 15 percent interest. In 1971, Federal and state authorities allowed S&Ls to increase their loan-to-value ratios to 95 percent if private insurance were used or loss reserves were set aside. So private mortgage insurance is growing fast. Its plan seems to be to invade the conventional market first rather than compete directly with FHA/VA. However, it will certainly pose a threat to at least a part of the FHA/VA business.

In sum, rather than see the 53 percent of the federally assisted credit which is FHA/VA mortgage insurance as uncontrolled or unthreatened by competition, a more accurate image may be that it has experienced lagging growth relative to its market, is under continuous scrutiny by Congress, and faces major new private competition. In addition, anyone who wishes to slow the growth of FHA/VA guarantees even further may be wise to try to further the development of private mortgage insurance or try to influence the Senate Subcommittee on Housing and Urban Affairs rather than create a new bureaucracy in a Federal Financing Bank.

Let me turn now to the agencies outside the budget. They have credit outstanding of \$65 billion in 1973 — or about one-fourth of the Federal and federally assisted credit. About 60 percent of the credit they supply is issued by the FHLBB and FNMA with a very small portion by FHLMC. These agencies deal with the mortgage market directly through their secondary-market activities or indirectly by providing finance to S&Ls. The need for a secondary mortgage market has long been recognized by economists. The Commission on Money and Credit advocated the creation of a private secondary mortgage market. Nothing came of this and by the middle of 1960s, FNMA began to perform this function in the insured sector of the market. As recently as the Emergency Home Financing Act of 1970, Congress expanded its power to perform this function into the uninsured sector of the market. In addition Congress allowed the creation of the FHLMC to do much of the same thing. The Hunt Commission proposed the expansion of these programs as important improvements in the functioning of the mortgage market.

Thus, these activities seem hardly an uncontrolled, devious, back-down financing device. The secondary mortgage market is an idea long proposed by economists as a sensible if not critical element in a program to improve the functioning of the mortgage markets and the viability of S&Ls. It is hardly uncontrolled. The FHLBB under

Preston Martin and now Mr. Bomar seems a quite sensitive group politically and the Congress has had many recent direct dealings in this area.

In this area of a second mortgage market, as was true in the area of mortgage insurance, further competition is developing. Private mortgage insurance companies or investment bankers in conjunction with major insurance companies are packaging existing mortgage loans and issuing guaranteed collateral trust notes for sale to private investors. These activities extend further the secondary market in mortgages and could grow quite rapidly.

With respect to the FHLBB and the credit it extends to S&Ls, these activities seem quite consistent with the Congressional objective of 26 million units of housing in periods of credit tightness. It is also subject to some limits and competition. The competition for FHLBB advances can come from at least two sources. First, S&L debentures and longer-dated deposits can provide S&Ls with a more-flexible way of managing liabilities and lessen the need for FHLBB advances. Also, the FHLBB must be careful to keep its advance rates competitive with the other borrowing alternatives open to the S&Ls that borrow, such as commercial banks. In addition, the Hunt Commission proposals for blurring the distinction between commercial banks and thrift institutions, if they ever get out of the Executive Branch, would seem to offer a real threat to the future growth of FHLBB advance activity. Greater liability flexibility and greater asset symmetry with commercial banks and, say a mortgage investment tax credit for lenders, may end the rationale for FHLBB advances.

An Alternative Means of Control

Here again, rather than develop a Federal Financing Bank on top of the bureaucracy we now have, a better approach to "controlling" the credit influenced by the FHLBB may be through a response to the Hunt Commission proposals or to the Congressional committees who will act on its recommendations.

The remaining 40 percent of the credit financed by agencies outside the budget is held by the Farm Credit Banks and the Export-Import Bank. In late March, the House Ways and Means Committee held hearings on a proposal to increase the tax paid by Farm Credit Banks. I remember reading a statement by the Investment Bankers Association documenting the effects of the unfair advantage the FCBs had over truly private lenders. Hereagain, some of us may see these banks as issuing credit in too large amounts, but it is hardly

uncontrolled. Rather than a FFB, it would seem more useful to direct attention to the need for the tax subsidy offered to these banks.

There is one quite legitimate dispute with my use of the word "controlled" with respect to these Federal credit programs. Perhaps each individual program is controlled, but there is not coordinated control over all of them and certainly no integration of the aggregate of their activities with the spending and taxing activities of the Government. Perhaps the FFB would be of help here.

I think one can make a case that it cannot. There are two problems. One is political. It seems somewhat naive to me to expect the diverse set of Congressional committees which control Federal credit programs to subject themselves to a common Federal credit budget constraint when it has been impossible to get the various subcommittees of the one Appropriation Committee to relate to each other, never mind to the Ways and Means Committee. A second problem with the practicality of a FFB to assist in the control of the overall level of Federal credit programs is economic. President MacLaury reports, and the Appendix to his paper states, that we do not know even in a vague way the impact on the aggregate level of economic activity of the Federal credit programs. The Bosworth-Duesenberry model and its successors may give us some guidance on these issues but at the moment we have rather little sure evidence on which to control the programs.

Given this ignorance, how would we propose that a FFB measure the impact of different combinations of Federal and federally assisted credit programs? If in fact, we cannot measure their overall impact with any preciseness, is it not misleading to suggest a FFB can provide economic control over Federal credit activities? With no real economic basis for judging the appropriateness of a given set of Federal credit programs, a FFB might very well become another executive department exercising political judgment in an area formerly controlled by the Congress.

As I hope is becoming clear, the thrust of my argument thus far is that the major volume of federally assisted credit is associated with programs the Congress evaluates carefully and often and takes a form which, while it avoids the budget, also follows the suggestions made by most academics and public commissions. In this context the individual programs appear to be less of a problem than one might conclude from much of what is said about them. Moreover, the effectiveness of a FFB to control the overall level of these programs seems not well thought out and in my view quite questionable. The growth of Federal credit programs may present problems but it is not clear how the FFB will solve them.

Proliferation of Programs

Let me turn for a moment to the issue of the proliferation of the *number* of Federal credit programs. The problems here seem to be three. First, a Federal agency comes to market every three to five days. Second, many of the issues are small and bear high rates of interest due to the lack of public awareness or the lack of a secondary market. Finally, the argument is advanced that once we do this for one activity we get drawn into doing it for another and another and the concern is, "Where will it stop?" A different version of this argument is the one advanced by Henry Kaufman yesterday, that each new credit program advanced to protect one "weak" sector makes the others all the weaker.

I must confess some confusion on the issue of the problem that agency issues pose for the Treasury. Most of yesterday's discussion and most of the empirical evidence seems to show that the volume of Treasury or even Agency issues has little effect on interest rates. Congestion may be an administrative problem but it does not seem to be much of an economic one.

The issue of higher costs for some issues because the issues are not well known also seems less of a problem than it is sometimes made out to be. If I understand it correctly, the burden of the privately held national debt is usually thought of as a distributional one and not as a major social problem. If so, how much should we worry about a procedure that raises some debt costs by perhaps 50 basis points? Does a situation which makes an unimportant problem 10 percent worse really warrant the creation of a new bureaucracy?

On the last issue of who gets rationed out as more and more activities receive Federal credit assistance, I agree that if one of the weak sectors of the economy receives Federal credit assistance the remaining weak sectors get even weaker *and* more of the economy is protected from the quantity rationing effects of monetary policy. However, I do not think it follows that the Federal Government should not try to help weak sectors in their fight against strong. I think the logic is rather that you clearly wish to assist some, and, once assisting some, you must assist all. This means that you reduce, if not eliminate, rationing and make interest rates play a larger role in allocating credit. That this means interest rates may have to fluctuate more does not mean you should avoid these Federal credit assistance activities. Would we really prefer a system with extensive rationing and relatively stable rates to one with little or no rationing and more variable rates?

Despite all these negative comments about the need for a FFB, I guess I agree with the current Treasury position that the FFB should coordinate and pool the issues of the smaller agencies. However, I disagree with the assertion by President MacLaury that such an FFB is a necessary or efficient way of providing control over the whole Federal credit activity.

I think it is possible to make the case that the growth of Federal credit, while posing important problems, is not the dramatic problem it is made out to be — there is more control over the individual agencies than is often suggested. Moreover, an FFB charged with the responsibility to rationalize the total of Federal credit programs would have a very difficult political and economic job. I suspect a more effective approach for the time being is to work individually on each agency's activities and make the *Special Analyses of the Budget of the United States* deal regularly and lucidly with what we are learning about their individual and aggregate effects.