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Statement by

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Before the

Senate Budget Committee's

Special Subcommittee on Control of Federal Credit

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Mr. Chairman and members of this Special Subcommittee on Federal Credit, I am pleased to be here today to discuss measures to improve control over federally assisted credit programs.

The need for more adequate budget treatment and control of these activities has long been recognized. Both the 1963 Report of the President's Committee on Federal Credit Programs and the 1967 Report of the President's Commission on Budget Concepts called for reforms in the budgetary treatment of federal credit. Until recently, however, little progress was evident. In particular, the Congressional Budget Act of 1974 specifically exempted loan guarantees from the budget process and did not develop a comprehensive framework for evaluating these activities. It was therefore especially heartening that the administration recommended a new budgetary framework for controlling federal credit programs in its 1981 budget, and that the Congress has incorporated a new federal credit budget into its First Concurrent Resolution.

As you know, federal credit programs have expanded enormously, both in amount and in scope. Direct loans and loan guarantees outstanding, for example, are projected to total over $425 billion in the fiscal year ending September 30. This is nearly triple the $164 billion level reached just 10 years ago. In addition, loans held by government-sponsored agencies now are projected to be $176 billion at the end of

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fiscal year 1980, up $17 billion from the year before and more than four times the level of 10 years earlier. Federal credit activities, moreover, are projected to continue growing rapidly in the years ahead. The Administration forecasts that net credit advanced under federal auspices--direct, guaranteed and sponsored--will increase by more than $70 billion during fiscal year 1981. If total credit flows in the coming year turn out to be roughly the same as in the past year, funds raised under federal credit assistance will account for over one-sixth of the total net funds raised in financial markets.

The widening in the range of economic activities sponsored by guaranteed loans has been particularly notable. In the late 1950's, the home mortgage guarantee programs of the Federal Housing Administration and the Veteran's Administration accounted for 90 percent of the total volume of guaranteed and insured loans outstanding. This proportion has since trended down, reaching 68 percent last year, mainly because of an expansion of loan guarantees into new areas--such as military sales, rural electrification and student loans.

The provision of federal credit assistance through direct loans and loan guarantees to achieve particular social and economic objectives has been widely recognized as a legitimate and valuable activity. Many credit programs originally

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were established to correct imperfections in capital markets that denied credit to some groups or made its cost prohibitive. For example, the FHA-insured loan programs were devised during the Great Depression to reduce the risks perceived by lenders. By pooling risks across a large number of loans issued in a standardized fashion, the government program encouraged private lenders to advance credit at a lower cost to borrowers and on less restrictive terms than would otherwise have been possible. As a result, private individuals were able to finance the purchase of homes on terms involving more reasonable interest charges, more liberal loan-to-value ratios and longer maturities than before. Over time, these more liberal terms gained general acceptance among all types of private lenders.

Many other federal credit assistance programs have been introduced over the years to foster social objectives. Increasingly, these programs have involved substantial interest subsidies. According to OMB estimates, the present value of the interest subsidy on new direct loan obligations and commitments to guarantee loans in fiscal 1981 will amount to almost $30 billion. In contrast to the home mortgage area, moreover, the default rate in some of these programs--such as student loans and assistance for low-income housing--has been comparatively high. Thus, the government has had to absorb sizable default losses in addition to providing a very large interest rate subsidy to borrowers. In the past few years, the federal

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government has also guaranteed sizable loans to single borrowers that carry a large potential for default.

Purposes of Controls over Federal Credit Programs

Improvement in the budgetary treatment of federal credit programs should seek to achieve several interrelated purposes.

First, it should encourage recognition by the Congress and the public that resources used in programs financed by federal credit activities may have been shifted away from more productive uses. In setting annual credit targets, the Congress must not lose sight of the long-run consequences resulting from such a shift in resource use.

Second, it should identify where possible the costs entailed in federal credit activities. These costs include not only the interest subsidides, the administrative expenses, and the default losses but also the loss in public welfare that occurs when federal credit programs are expanded beyond socially desirable and efficient levels.

Third, it should focus attention on the macroeconomic effects of federal credit activities--on employment and output, on prices, and on developments in credit markets. Information that helps to assess these effects is, of course, especially

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important to the Federal Reserve in its formulation of monetary policy.

It has long been recognized that federal borrowing can "crowd-out" private borrowers--and thereby transfer command over resources from the private to the public sector. The degree of such displacement depends on the extent to which the economy's real resources are being utilized and on conditions in credit markets. During recessionary periods, when credit supplies are readily available, credit assistance programs may help promote a more intensive use of resources and an expansion in the level of economic activity. In this instance, the principal effect of the increase in expenditures made possible by the federal credit activity is likely to be an increase in aggregate demand rather than a redistribution of resource use. On the other hand, when little excess capacity exists in the economy and credit supplies are tight, there is a much stronger tendency for credit extended under federal auspices to raise interest rates and to divert loanable funds, and hence real resources, away from private producers. Moreover, when such programs create additional demands on limited resources, they also add to pressures on prices.

It would, however, be potentially misleading in a discussion of the crowding-out problem to focus simply on the cyclical condition of the economy. The long-run potential for

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the diversion of resources from private to public uses stemming from Federal credit programs is a serious problem.

In recent years, the performance of productivity in our economy has been dismal. We do not know all the reasons why, and that will limit our ability to deal effectively with the problem. We do know, however, that a substantial increase in the share of national output will have to be devoted to capital formation if we are to have much hope of increasing the rate of productivity advance. Since the need for additional capital to deal with our nation's energy and environmental problems will also be large, it will be critical to adopt tax and expenditure policies that free up resources--real resources as well as financial resources--to make that possible.

The need for a higher rate of business capital formation is critical to the long-run health of our economy. Holding down the share GNP devoted to federal expenditures will contribute importantly to that effort. So also will the orientation of future tax cuts toward business investment incentives. But these efforts may go for naught if we do not control carefully the share of national resources absorbed by federal credit programs.

One of the problems that has impeded the development of better budgetary treatment of federal credit programs is the lack of a good analytic framework in which to assess the

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economic effects of these programs. Some federal credit programs affect the economy much like direct federal expenditures. Loan guarantees for low-income housing and foreign military assistance are the most obvious examples. Others provide only marginally lower interest rates, or marginally better nonprice credit terms, to borrowers whose credit needs would otherwise probably have been met by the private financial market. These differing effects, moreover, do not bear any necessary relation to whether credit is supplied through direct loans or loan guarantees.

Since research in the area of federal credit programs has barely begun, what appears extremely complex today may appear more simple tomorrow. I suspect, however, that the problems we face in this regard stem from the diverse nature of these credit programs. If so, we will have to be satisfied with statistical measures and budgetary solutions for dealing with federal credit programs that are inherently less than fully satisfactory. For example, the proportion of total borrowing in financial markets that is federally assisted can be used as an indicator of credit resources whose direction is governed by federal lending programs. Similarly, the share of GNP accounted for by the total of federal expenditures plus credit activities is a rough measure of the proportion of real resources whose use is directed by the federal government.

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Summary measures such as these have inherent weaknesses because they add up things that are really very different. But they are better than nothing.

Your committee is rightly concerned about the potential problems that federal credit programs may create for monetary policy. It is sometimes argued that expansion in federal credit programs during periods of monetary restraint might frustrate the achievement of the objectives of monetary policy by insulating some borrower groups from the discipline of the market place. For most federal credit programs, however, interest charges vary with market rates of interest; moreover, increases in the quantity of credit available from federal sources seldom are large enough to offset completely the declines in the quantity available from private sources. It is true, nonetheless, that assuring larger numbers of borrowers ready access to credit requires higher interest rates to achieve a given degree of monetary restraint. This is one more reason for putting limits on how fast federal credit programs can expand.

Suggestions for Improvement in the Budgetary Treatment of Credit Programs

Let me turn now to a few suggestions on ways to sharpen the focus on the effects of federal credit programs.

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First, procedures should be developed that would permit policymakers to determine the tradeoffs between accomplishing social objectives through direct outlays, on the one hand, and through Federal credit programs on the other. Similar criteria need to be developed to provide guidance for choosing between giving credit assistance through direct loans or loan guarantees.

Second, further consideration might be given to ways of controlling net as well as gross lending. The present credit limits apply to gross loans; that is, I believe, the appropriate place to begin. Gross lending and guarantee activities reflect the current scope of various programs, thus indicating the overall support being given to a sector by the federal government. On the other hand, the net change in such programs determines the current impact of federal credit activities on economic and financial market conditions. So perhaps we ought to seek to limit the net, as well as the gross, increase in federal credit extensions.

Third, the budgetary treatment of nonrecourse loans--such as those made by the Commodity Credit Corporation to farmers--should be studied in greater detail. Since nonrecourse loans need not be repaid, it is not clear whether these transactions should be treated as outlays or as loans at the time when the funds are disbursed.

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Fourth, the accounting treatment of loans made through the Federal Financing Bank could be further improved. FFB activities in the past have reduced the accountability of federal credit programs, because lending activities typically have been attributed only to the FFB rather than to the agency originating the transaction. The new budget rectifies a large part of this difficulty by attributing FFB outlays to the originating agencies (within the FFB account), and by establishing limitations on the absolute amount of credit--direct and guaranteed--that can be financed by an agency in a given year. The attribution process, however, is not yet complete because the combined total of outlays and direct and guaranteed loans never appears in a consolidated statement by function and agency. If this final step were taken, the unified budget accounts would provide a more complete picture of the federal government's support for particular programs and activities.

Finally, if the control system established by the Congress is to be successful, it must be accompanied by a detailed scorekeeping system. To satisfy this requirement the Congress should consider establishing a Credit Control Office within the Congressional Budget Office in order to provide the Congress with detailed technical data on the costs and benefits of federal credit programs, and with up-to-date reports on federal credit activities. These reports also would include a credit information system that encompasses total federal lending

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activity by budget function and by economic sector. Ideally, such a system would provide information that highlights the federal government's total involvement in, and assistance to, sectors in the form of direct outlays, direct loans, and loan guarantees.

To sum up, the Board of Governors welcomes the progress that has been made in establishing a credit budget. It will improve our ability to evaluate and control federal credit activities, and enhance the long-run prospects for increased private capital formation. We will be happy to provide you whatever assistance we can in refining further the procedures for dealing with federal credit programs in the budget.

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