For release on delivery
Expected at 9:30 a.m. E.S.T.
October 29, 1981

Statement by

Nancy H. Teeters

Member, Board of Governors of the Federal Reserve System

before the

Task Force on Enforcement, Credit and Multi-year Budgeting

of the

Committee on the Budget

U.S. House of Representatives

October 29, 1981

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Mr. Chairman, it is a pleasure to be here today to present the Federal Reserve Board's views on the budgeting and control of federally assisted credit. In particular, it is a pleasure to have the opportunity to express our support for H.R. 2372, the bill introduced by Mr. Mineta and Mr. Bethune to establish procedures for budgetary control of federal credit programs. This is a particularly appropriate time to consider such steps. Given the serious inflation problem currently plaguing our nation, it is imperative that growth in money and credit be held to a moderate pace. Within this context, every effort should be made to insure that federal credit activities as well as federal spending are carefully evaluated in order to avoid creating serious distortions in financial markets.

Indeed, it would be most inappropriate for off-budget federal loan programs and loan guarantees to provide a less conspicuous substitute for direct, on-budget federal spending at a time when strenuous efforts are being made to bring the growth of spending under control. Although the economic and credit market consequences of federal loans and loan guarantees are not in all cases the same as those of deficit financed federal spending, there are enough similarities to warrant parallel procedures for budgetary review and control. I shall argue, therefore, that formal procedures for budgetary control of federal credit activities are highly desirable. Furthermore, I shall renew my earlier recommendations for establishment of a new budget commission to analyze the appropriate accounting for federal credit programs, and for continuing analysis and evaluation

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

of the appropriate tools--direct spending, loans, loan guarantees or tax expenditures--for achieving alternative program objectives.

Growth of Federal Credit Programs

As you know, Mr. Chairman, federal credit programs have expanded enormously, both in amount and in scope, in recent years. The total volume of outstanding direct loans and loan guarantees, for example, has been projected to total over $540 billion by the end of the fiscal year which just ended last month. This is nearly triple the $190 billion level reached just 10 years ago. In addition, the volume of loans held by government-sponsored agencies was projected to total about $170 billion at the end of fiscal year 1981, up $20 billion from last year and more than four times the level of 10 years earlier. In fact, their growth has been much larger than anticipated, principally due to increased demands on the Federal Home Loan Banks.

Federal credit activities, moreover, are likely to continue to grow rapidly in the years ahead unless deliberate efforts are made to constrain them. The January budget projected that net credit advanced under federal auspices--direct, guaranteed and sponsored--would total over $100 billion during fiscal year 1982. The Mid-Session Review of the FY1982 budget called for a significant reduction in loan obligations and guarantee commitments and further reductions are soon to be announced. Even so, if total credit flows in the coming years were roughly to match those of the past year, funds raised under federal credit

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

auspices will account for well over one-quarter of the total net funds raised by nonfinancial and financial borrowers in domestic credit markets.

The widening range of economic activities assisted by federal programs is also noteworthy. In the late 1950s, 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, and was expected to have been about 73 percent at the end of the last fiscal year, mainly because of an expansion of loan guarantees into new areas--such as military sales 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 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. Over time, these more liberal terms gained general acceptance among all types of private lenders.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Many other federal credit assistance programs have been introduced over subsequent 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 the fiscal year just ended amounted to almost $27 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, and in some cases unanticipated, default losses in addition to the measured interest rate subsidies to borrowers. In the past few years, the federal government has also guaranteed sizable loans to single borrowers that carry a large potential for default.

Impacts of Federal Credit Programs

Since the general purpose of federal credit programs, obviously, is to enable individual borrowers or groups of borrowers to obtain credit which would otherwise be unavailable to them, or only available at a higher cost, it follows that these programs will generally tend to increase credit use by program beneficiaries. Whether this increase will, in turn, result in greater use of credit in the aggregate, and the desirability of such an increase, depends on the characteristics of the particular programs and on the state of the economy at large.

Let me give some examples to demonstrate the differences in the economic effects of federal credit assistance programs.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

In some cases, programs may serve as close substitutes for deficit-financed, federal spending. Consider, for example, a situation in which the Congress was contemplating expanding the program in which the federal government guarantees debt issued by state and local authorities who then use the proceeds to provide low cost housing to the poor. Many of the end results of such an expansion could be quite similar to those that would be observed if the federal government were, alternatively, to increase its direct spending to undertake the construction of the rental units, and were then to rent space on a subsidized basis. Note that under either approach construction funds would be provided by private investors either through the acquisition of federally guaranteed securities or by acquiring more Treasury securities than otherwise; the same essential type and volume of productive resources would be used to construct the rental units; and low income families would be provided with better housing than they are otherwise able to obtain.

While stressing basic similarities, however, I should also note some important differences. The most important is that loans must be paid back. Thus, if such a program were to grow to a plateau and then remain constant in size, the volume of loan repayments would equal new loans being guaranteed and the net economic effect would be small. Growth in the net volume of guaranteed loans outstanding, however, could have an effect similar to that of deficit spending. In addition, interest paid on the debt instruments issued by states and localities under

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

the program is not subject to federal tax, as it would be on a direct debt issue of the federal government, so net tax revenues would also be reduced by an expansion of the program.

There are, of course, other credit programs which have much less similarity to noncredit federal spending. For example, homebuyers who take out mortgages under federal guarantees could, in most instances, obtain private credit without the guarantee, albeit at a slightly higher rate. Providing roughly equivalent assistance through direct federal spending in this case would require the federal government to give homebuyers only a modest interest subsidy. The small size of this subsidy suggests that net demands on real resources and credit markets are relatively little affected by the guarantee program. Many cases obviously fall somewhere between these two extremes. Compare the effects of direct federal loans and outright grants in-aid. In both cases, beneficiaries gain immediate command over goods and services. The major difference between the two approaches--that in the case of the loan the government obtains a claim on the beneficiary while it does not with the grant--is an important distinction. It is, however, a distinction without substance in those cases where the borrower defaults.

In general, the closeness of the analogy between assistance provided by federal credit programs and deficit-financed direct federal spending appears to depend less on whether the aid in question is provided through direct loans or loan guarantees than on such things as credit worthiness of beneficiaries, the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

size and riskiness of their undertaking and their relative ability to tap private credit sources on their own.

As in the case of deficit-financed federal spending, federal credit activities may reduce the availability of credit to others who are not program beneficiaries. The extent to which such "crowding out" takes place, however, depends importantly on the state of conditions in the economy and financial markets. During recessionary periods when credit supplies are readily available, credit assistance may work mainly to enable borrowers to obtain additional funds which can be used to increase demands for goods or services. Thus, in these periods the net result of such programs may, to a great extent, promote a more intense use of resources and an expansion of economic activity rather than a transfer of credit (and resulting effective demand) from one borrower to another.

In times when there is less slack in resource utilization and credit market conditions are relatively tight, however, there is a much greater tendency for credit extended under federal auspices to channel loanable funds, and hence command over real resources, toward assisted borrowers and away from others. In other words, just as private borrowers can, at times, be crowded out of credit markets when federal outlays are financed through the issuance of Treasury debt, so can some private borrowers face higher credit costs when other selected borrowers obtain loans with the assistance of the federal government. There need be nothing inherently wrong with the resulting allocation of credit if the federal intervention in credit markets reflects a careful assessment of the market imperfections that the government is trying to overcome and a careful weighing of costs and benefits. Continuous

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

scrutiny of priorities under a credit budget process is important, however, if such balancing of costs and benefits is to be achieved. And such scrutiny is essential in current circumstances when the growth of credit is necessarily limited by anti-inflation policies.

Budgetary Control of Federal Credit Activities

As you know, Mr. Chairman, Congressional review and control of federal credit activities have been evolving over time. The utilization of the "unified budget" concept, beginning with the 1969 budget, is one notable watershed. At that time, the government adopted for control purposes a budget framework that was, in most respects, a cash accounting system. In making this choice, it was decided (after considerable debate) to include the net outlays of all direct lending programs on budget. This new approach, however, was uncomfortably silent on how federal loan guarantees were to be treated. In the early 1970's, moreover, there was some backsliding from the comprehensive coverage of the unified budget, as a number of agencies were removed from the budget and newly established agencies were accorded off-budget status.

Furthermore, the advantages for orderly marketing of federal debt gained through creation of the Federal Financing Bank in 1974 had an unfortunate side effect. Since the FFB's activities have been off-budget from the outset, its acquisition of loans is not reflected on the budget. Accordingly, the budgetary scrutiny intended to apply to direct loan programs as a result of the comprehensive coverage of the unified budget tended to be eroded. And, agencies that made direct, on-budget loans to the public were able to sell these loans to the FFB thereby enabling them to extend new loans without constraint.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

In recent years, this erosion process has begun to be turned around. A number of important steps have been taken to make coverage of the unified budget more comprehensive and to improve controls of credit programs. In addition to incremental improvements in budget coverage, major strides have been taken in the development of a separate, credit budget process. In the past two years, totals have been calculated and presented in the budget for gross new direct loan obligations and new loan guarantee commitments. Components of the credit budget total have been shown in respective budget functions and have been subdivided by agency and program in the Special Analysis accompanying the budget and in the budget Appendix. Also, the outlays of the FFB (direct loans and loan-asset purchases) are now attributed to the originating agency, which in my view eliminates the tendency for the operation of the FFB to obscure the nature of credit programs. A final important step taken by Congress last year was to have the budget resolutions include target ceilings for total new loan obligations and total new guarantee commitments and to distribute these totals by budget function.

Both the past and the current administration have also proposed that a substantial proportion of the credit budget totals be made subject to annual appropriations limitations. The January budget proposed that 63.8 percent of the credit budget for FY1982 be so limited. Those programs exempted are limited to: unambiguous entitlements that cannot be effectively limited by appropriations; programs that provide for unforeseeable contingencies, such as deposit insurance; guarantees of certificates of beneficial ownership that are sold by the Farmers Home Administration and Rural Electrification Administration; and a

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

catch-all of programs, such as export promotion loans by Commodity Credit Corporation, that the last administration believed appropriate not to curtail due to economic circumstances. That final area of exemption, in particular, deserves careful evaluation by the Congress.

Broadening the coverage of the unified budget and the formulation of a separate but parallel credit budget sets the stage for a number of further steps in implementing an effective process to bring credit programs under systematic review and control. H.R. 2372 would formalize the credit budget process implemented on an experimental basis last year. This bill would amend the Budget Act to apply to the credit budget the same enforcement procedures and legislative time tables that apply to the rest of the budget. The Federal Reserve Board, in general, enthusiastically endorses the establishment of these formal procedures as, logically, the next step in budgetary control of credit programs.

It is the Board's view, however, that the section of this bill pertaining to appropriations limitations should be modified. Limitations are, of course, central to the budgetary control process proposed by the last administration and endorsed by the present administration. However, exemption of at least some emergency assistance and entitlement programs appears warranted. The Board, therefore, suggests that all such programs continue to be exempted from appropriations limitations at least until more experience is gained with the new budget process and a case-by-case review of these programs can determine the possible difficulties or advantages of applying appropriations limitations to them. The exemption of entitlement and emergency assistance programs from appropriations limitations need not imply

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

changing the current procedures whereby legislation creating or expanding entitlements is referred to the Appropriations Committee for review. The Board's recommendation that entitlements and emergency assistance programs be exempted from binding appropriations ceilings is intended only to promote the effective operations of those programs thought by the Congress to be worthwhile, even in the event of unanticipated demands upon them resulting from natural disasters or unforeseen economic developments.

Although enactment of H.R. 2372 would go far to bring order into the federal credit program scene, there are other steps that I would like to recommend. One is a systematic review of the treatment of federal credit programs in the unified budget. The current haphazard situation, in which some loan programs are included in the unified budget and others are not, should be ended. A careful analysis should be undertaken of the question of whether or not the principal amount (net) of all direct loans should be included in the unified budget and whether, if the principal amount of direct loans is excluded as I am inclined to prefer, the amount of the implicit or explicit interest subsidy should be placed on budget. Similarly, a comprehensive review of guarantee programs would be desirable in order to determine whether the potential subsidy or future outlay for defaults is taken appropriately into account. I have previously called for the establishment of a new budget commission which would be charged with analyzing and resolving these questions. In my view, the passage of time has not reduced the advisability of establishing such a commission.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Finally, I recommend to this Committee a continuing evaluation of the extent to which direct spending, direct loans, loan guarantees or beneficial tax treatment can most effectively be used to achieve particular program objectives and the extent to which, in particular budget functions, there may be duplicative and excessive use of these various approaches. The budget process has come a long way in providing the accounting framework and legislative process needed to address such questions. I look forward to further progress and I believe that enactment of H.R. 2372 would contribute to it.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis