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# Economic Freedom: Waxing or Waning?

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The real strength of the U.S. economy is its reliance on private markets. Because government intrusion into economic matters is limited, individual initiative can and does flourish. Nowhere is this more apparent than in our financial sector, which is among the most innovative in the world. The revolutionary changes in financial markets over the last decade have been possible because individuals and businesses have seized the initiative to pursue new approaches to meeting the needs of a dynamic economy in a period of rapid technological improvements.

Some government regulation of financial markets is inevitable, however, because of the importance of a smoothly functioning financial system for the overall economy and the special characteristics of financial markets -- what economists call externalities. The real question is: how much and what kind of government involvement is necessary? In my view, government involvement, although well intentioned, has often been ill-conceived, unnecessary, or too prolonged.

Today, however, there is a growing political trend to reduce government's role in the U.S. financial system. This trend reflects a more general change in the climate of opinion both in this country and elsewhere toward more reliance on free markets to solve economic problems. There are also, of course, cross currents of reregulation. On balance, developments point toward an overall increase in economic freedom both here and abroad.

Government involvement in the economy increased dramatically in the 1930s, in response to economic and financial calamities, the bank failures and the bread lines of the Great Depression. Many intellectuals and political leaders were convinced that the federal government needed to manage and regulate economic markets, and New Deal legislation authorized a wide variety of new regulations. Financial markets were singled out for especially comprehensive regulation in part because of the perceived role of the stock market crash and successive waves of bank failures in worsening the economic turmoil. Deposit ceiling rates, margin requirements, separation of commercial and investment banking, government support of mortgage markets through creation of the Federal National Mortgage Association (FNMA), and numerous other forms of government involvement in financial markets can be traced to the legislation passed in reaction to virtual financial panic from 1929 to 1933.

Another wave of financial regulation came in 1965 to 1975. Some of the new regulations were intended to protect consumers -- against racial and sexual discrimination in borrowing, against misleading advertising of lending terms, and against a myriad of other real or imagined abuses. Other regulations, such as deposit ceiling rates, were extended in scope. The government's involvement in mortgage finance was also expanded substantially with the creation of the Government National Mortgage Association (GNMA) and Federal Home Loan Mortgage Corporation (FHLMC). Paradoxically, the growing number of mortgage finance agencies resulted in part from deposit ceiling rates, which led to episodes of disintermediation that disrupted the flow of mortgage credit.

Even as government regulation was being expanded, the means for circumventing many of the regulations were being developed. The computer revolution progressively lowered the transaction cost of shifting funds among assets. Local markets were increasingly integrated into a national market. Federal funds, repurchase agreements, and money market mutual funds evolved as alternatives to traditional deposits, which became increasingly unattractive as deposit ceiling rates collided with the secular rise in inflation and market interest rates. Ultimately, U.S. financial markets were integrated into a world financial system. Capital markets in New York, London, and Tokyo are now linked through sophisticated swaps, futures, and forwards. The funds to finance homebuilding and capital investment may come from savers in Japan or Saudi Arabia as well as from Americans. In such a globally integrated and technologically advanced financial system, financial regulations have become increasingly complex -- and in some cases inequitable.

By the late 1970s, the need to reevaluate financial regulations had become apparent. The most obvious target: deposit ceiling rates, the wisdom of which the Federal Reserve had long questioned. Spurred by loss of funds by banks and thrifts to such largely unregulated institutions as money market mutual funds, Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980. The phaseout of deposit ceiling rates mandated by that act will be completed later this month, after which banks and thrifts will be able to pay a competitive rate on all deposits other than demand deposits.

Removing deposit ceiling rates is part of a broader movement toward less government involvement in financial markets and in the economy at large. The Reagan Administration's orientation toward less government involvement is well known, but many of the initiatives for deregulation were begun even before President Reagan's election. Airline and truck deregulation -- in addition to the financial deregulation of the Monetary Control Act -- was already under way. Moreover, the recognition that government involvement in economic affairs often reduces efficiency and limits freedom is not just a U.S. phenomenon. Many other countries have reversed the trend toward increased government regulation and government ownership of business enterprises. The British government has sold much of its former holdings of public housing units and state-owned enterprises, including companies in the important aerospace and automobile industries. Even China has reduced government control over agriculture, leading to a surge in Chinese farm output. And lessened government interference is an important element of the IMF's conditionality provisions for evaluating economic policy in developing countries. As one who believes in the efficiency of the market system, I welcome these and other developments that limit government interference in the economy and thereby enhance the scope for private initiative.

Many of the Federal Reserve's recent actions have been in this same spirit. The Board has searched its statutory authority for ways to respond positively to applications for the exercise of broader powers for commercial banks in such areas as commercial paper issuance and investment banking powers in overseas affiliates. However, there are more externalities in the financial sector than in most other sectors of the economy. Decisions made by management of one financial institution can have repercussions on other financial institutions and their customers, as has been brought home recently by the thrift crises in Ohio and Maryland. The Federal Reserve and other agencies are charged with maintaining the safety and soundness of financial institutions and of the financial system as a whole, thereby allowing the market system to function more efficiently. The question then becomes how best to achieve this goal without imposing undue constraints on private decision making.

One way of accomplishing this is to avoid inflexible regulations that apply uniformly to all institutions regardless of differing circumstances. The Federal Reserve Board has taken such considerations into account recently in determining how to address new problems. Disinflation and other factors have caused severe financial strains among lenders to agriculture, energy, developing countries, and other borrowers. To ensure an adequate cushion to absorb further shocks, such as the recent oil price decline, the Board has established minimum capital standards for banks, which were expressed relative to total assets. Of course, some money center banks extend credit indirectly through various off-balance sheet mechanisms, increasing their risk exposure in developing new sources of fee income in increasingly competitive world markets. To keep up with the changing nature of these markets and of the associated risks, the Board responded by issuing for public comment a proposal for supplemental capital guidelines that take account of off-balance sheet risk exposure. Neither the minimum capital standard nor the supplemental guideline is intended to replace on-site examination that allow flexibility in evaluating the unique circumstances of individual institutions. Our intention is to prevent strains from impairing the safety of the financial system, while at the same time maintaining ample freedom for managers and directors to pursue policies in the best interest of their shareholders and customers.

Moreover, the Board has applied a self-regulatory principle in controlling daylight overdrafts to the reserve accounts of financial institutions. With the speed that funds travel around the world, it is not surprising that banks have found it more difficult to synchronize receipts and disbursements, even within a day. Such asynchronization can nonetheless result in massive, unintended credit extensions that increase risk in the payments system. To control such risk, the Board worked with the banking industry to set up a voluntary program for limiting the size of daylight overdrafts. The responsibility for monitoring overdrafts is left primarily to officers and directors of individual institutions. This program, too, follows the principle of maintaining financial stability while retaining scope for initiative.

Congress has been less willing to permit market forces to shape the financial system, especially with regard to terms on which financial services are offered to consumers. For example, legislation is currently being considered to restrict the interest rate on credit card loans. Such a restriction would not only distort the allocation of credit but might also be inequitable in the sense of reducing the availability of credit to low income households.

Have we so soon forgotten the experience with usury laws and the credit control program in 1980? That experience shows among other things that lenders respond to ceiling rates on loans by using nonprice terms to ration credit. Stricter qualifying standards for loans tend to fall disproportionately on lower income and minority households -- that is, the groups the ceiling is meant to protect. As in so many other areas of government intervention in the economy, the result of regulating interest rates is the opposite of what was intended. For this and other reasons, the Board has repeatedly argued before Congress that credit is most fairly and efficiently allocated when there are no legal or regulatory constraints on interest rates.

National and state legislatures have also taken a recent interest in setting down rules for the check clearing process. Banks and other financial institutions typically delay for several days access to funds deposited by check. This delay stems from credit risk concerns arising from the return of checks due to insufficient funds, improper endorsement, or other reasons. Here in California, the legislature has already passed a law restricting the ability of state-chartered institutions to delay availability to their depositors. The Congress is now considering similar laws to require that availability of funds be granted in three days or less. The Federal Reserve has urged that the delayed availability problem be resolved instead through the voluntary efforts of depository institutions, or at most statutory provisions on disclosure and on expediting the check clearing process.

What are we to make of recent Congressional initiatives toward greater regulation of financial markets? I claim that these and similar actions are merely aberrations from the general trend toward less government involvement in the economy. The tide of intellectual and political opinion is moving in the other direction and will ultimately swamp efforts to increase government intrusion into the detailed working of individual markets. But even if I'm right, that doesn't mean that those who favor freer markets can be complacent. There are abuses in the financial system. The question is how to limit the adverse effects of such abuses without resorting to inflexible -- and frequently irrational -- government mandates.

One promising way of doing so is through self-regulation. Although it may seem an oxymoron, self-regulation has a venerable tradition in free market economies. Self-regulation simply means effective management acting responsibly; it does not mean price or rate fixing. Business leaders, acting for the common welfare, can share information, procedures, and analytical tools to help propagate good management practices. Examples of what I advocate can be found in the New York Stock Exchange, NASD, municipal bond markets, and the accounting profession. The accounting profession has a peer review process for establishing professional standards of quality and for monitoring compliance with those standards. In this way, the industry has been fairly successful in policing itself. Through a similar process of self-regulation, financial firms could improve their own industry from within and thereby reduce the perceived need for government regulation, which is inevitably less flexible and less attuned to preferences in individual markets.

Another way to accelerate the trend toward less government involvement in the economy is to adopt the presumption that such involvement should be temporary. Although we need not build a formal "sunset" provision into each law or regulation, we can nonetheless reevaluate the need for existing government programs from time to time to determine if they are still warranted. Such reevaluation would limit the prospect that a governmental program that once was judged useful leads to continued involvement long after the initial purpose has been fulfilled. One area ripe for such a reevaluation is housing finance, a sector of the economy in which the federal government's participation is particularly strong.

Much of the government's involvement in housing finance is in such indirect forms as credit guarantees by government agencies or borrowings by federally sponsored, but off-budget, institutions. Of the total amount of residential mortgage credit outstanding, fully 40 percent is either guaranteed or held by federally related institutions.

Housing analysts distinguish between the primary mortgage market -- where mortgage loans are actually made to home owners -- and the secondary market -- where previously originated mortgages are sold, swapped, pooled, and repackaged. The federal government's involvement is substantial in both markets. In the primary market, home loans guaranteed by either the Federal Housing Administration (FHA) or the Veterans Administration (VA) have accounted for 15 to 20 percent of the total dollar volume of home loans originated in the past two years. In the secondary market, mortgages held by or pooled and securitized by federally related institutions last year accounted for half of the total growth in residential mortgage credit.

This federal involvement in the secondary mortgage market comes primarily through the auspices of the three cousins -- Ginnie Mae (Government

National Mortgage Association), Fannie Mae (Federal National Mortgage Association), and Freddie Mac (Federal Home Loan Mortgage Corporation). These three institutions differ in purpose, but the motivation for each is to integrate the mortgage market with capital markets. This integration has helped moderate the boom and bust cycles in mortgage credit.

An additional objective of the government-sponsored housing finance agencies has been to demonstrate the feasibility of new methods and instruments for supplying housing credit. A totally private company would have been reluctant to provide all of the new products and services introduced by the federally sponsored housing finance institutions -- the required scale of operations and financial risk are simply too great. Examples of such new products abound. Freddie Mac introduced a collateralized mortgage obligation (CMO), which has attracted money from pension funds to the mortgage market. Fannie Mae promoted FHA programs and the VA loan program by presenting those mortgages in volumes. And the FHA pioneered a home mortgage insurance program that has been emulated by private mortgage insurance companies.

Whatever the initial justification for the federal involvement in housing finance, I believe that the time will soon come for reducing the scope of government's role in the mortgage markets. Now is not the moment because thrift institutions are going through a terrible transition, encumbered by low rate mortgages that various government agencies encouraged them to make in years past. However, many objectives of federal involvement have by now largely been met for mortgage borrowers, and in my view the costs to society of continuing such widescale involvement exceed the benefits. Here I am not talking about low-income housing assistance, but rather about broad, sector-wide policies that benefit housing at the expense of other potential uses of the nation's productive resources. When the thrift industry has made its adjustments, say in 1990 or 1991, we should "take the housing agencies private."

I must confess that I am not a disinterested observer of this scene, having served as Chairman of the Federal Home Loan Bank Board during the founding of its subsidiary, Freddie Mac, in 1970. FHLMC has, in my view, been an outstanding success in achieving its objectives. Nonetheless, there will come a time for a change in Freddie's operations.

By way of background, Freddie Mac's mandate was to provide an outlet for thrift institutions wishing to sell their mortgages -- especially "conventional" mortgages, those not underwritten by FHA or VA. Freddie Mac provides this service primarily by buying mortgages, pooling them, and then issuing a variety of securities representing ownership shares in those "pools" of mortgages. Such securitizing of mortgage credit brings into the mortgage market new investors that are themselves unwilling to originate or service mortgages -- pension funds, for example -- by separating these functions from mortgage funding and by substituting Freddie's superior credit rating for those of individual mortgage borrowers. FHLMC has brought this country a wave of housing finance innovations and in doing so has promoted the integration of mortgage finance with the capital market at large.

Freddie Mac's financial performance has been equally impressive. It is a high volume operation that may issue as much as $50 to $60 billion in mortgage-backed securities in 1986! The corporation has been profitable in each of the past 15 years, and its profits have skyrocketed in recent years. Freddie Mac was tax exempt until last year. But even after taxes, Freddie had a net income of more than $200 million in 1985. Because Freddie has held relatively few loans in its portfolio, concentrating instead on mortgage-backed securities programs, it has been spared the brunt of the troubles that high and volatile interest rates have caused other housing finance institutions in recent years.

If Freddie Mac has been so successful, why consider rocking the boat? The answer is that market conditions are different from those existing when FHLMC was founded. The innovations of FHLMC and FNMA have helped establish the financial viability of secondary market operations. Moreover, the private mortgage insurance industry can now provide large amounts of both loan insurance and pool insurance, especially since insurers have adjusted their underwriting standards to the lower inflation of the 1980's. Most importantly, the ceilings on deposit rates and mortgage lending rates that contributed to the boom-bust cycle in housing have largely been eliminated. In my view, emerging market conditions present fertile ground for increased private sector involvement.

Moreover, society bears a large, although subtle, cost from the operation of FHLMC and the other federally sponsored housing finance institutions. That cost takes two forms. First, the federal connection provides subsidized mortgage credit, steering some capital to housing that would otherwise be allocated by market forces to other sectors of the economy.

The government intervention essentially overrides the market's determination of the most valuable use of that capital. The second, even less tangible, cost to society is the contingent liability of the government to bail out these institutions if they fail. The government's explicit commitment differs for GNMA, FNMA, and FHLMC. But in each case, the federal origins, indirect ties, and dominance in the markets have resulted in a market consensus that Washington would not allow these institutions to go under. Thus, the taxpayers are ultimately deemed to be the insurers.

How do you go about "privatizing" an institution like the Federal Home Loan Mortgage Corporation? Selling it wouldn't work. For one thing, it's not clear what would be sold. Simply changing ownership from the Federal Home Loan Bank System to other holders would do nothing to change the competitive market advantages that Freddie currently enjoys. There would have to be other changes in Freddie's operations at the same time, and market uncertainty about the value of the new Freddie might preclude reasonable bidding.

A second option for privatization holds more promise. This strategy would be to gradually wean Freddie and his cousins from their federal connections, while at the same time removing unnecessary barriers to the emergence of private sector competitors. This strategy is in fact now being pursued. Private issuers of mortgage-backed securities have benefitted from legislation passed in 1984 that lowered some of the regulatory roadblocks to development of these investment vehicles. The Reagan Administration's budget proposal for the next fiscal year calls for a gradual phasing in of "user fees" assessed on the dollar volume of securities issued by Freddie Mac and comparable charges for the other federally related housing finance institutions. The rationale is that the user fees will compensate to some extent for the competitive advantages enjoyed by these institutions and will result in both a more market-determined allocation of capital across sectors of the economy and the emergence of viable private competitors. A major issue is whether the fees are implemented gradually enough. The thrift industry needs time to adjust, and Americans need housing financed to meet their needs during this adjustment period. That is why I suggest 1990 or so as a time for a new review of United States housing policy in all its guises.

Reducing the federal presence in the housing finance industry is something that should be undertaken in a few years. However, the reduction should be phased in cautiously and gradually to avoid market disruptions. One reason is that actions affecting Freddie Mac indirectly affect the Federal Home Loan Bank System and its deposit insurance subsidiary, the Federal Savings and Loan Insurance Corporation. Freddie Mac, through dividends paid on its common stock held by the Federal Home Loan Banks and the recently issued preferred stock held by member thrifts, has been a source of revenue to an industry much in need of income.

Moreover, any actions to reduce the government connection of Freddie Mac would have to be coordinated with actions affecting the other housing finance agencies, in particular Fannie Mae, which more and more is a direct competitor of Freddie. We don't want to replace the current duopoly with a monopoly.

Another reason for a gradual transition is to allow for an orderly, smooth development of new and growing private firms. There have been several recent instances of difficulties in the private mortgage insurance and private mortgage-backed securities industries. These industries are still on their learning curves, and it would be a mistake to make a precipitous switch.

I urge a complete reassessment of housing policies of all types for a future Congressional agenda. We as a nation should acknowledge gratefully that our people have been well served by government's initiatives in housing. But after the thrift industry emerges from its terrible transition, I would hope that the Congressional review would produce the policy of government taking a back seat in housing finance, leaving more of the driving to the private sector.

What I advocate for mortgage markets in consistent with greater reliance on private markets. The pendulum is swinging in that direction already. The U.S. economy can and should serve as a model for the other western industrial countries and for developing countries throughout the world, demonstrating that private initiative is the key to sustained economic growth. By so doing, we can ensure that economic freedom -- and the accompanying political freedom -- will flourish and grow as we enter the 21st century.