an economic review by the Federal Reserve Bank of Chicago

Business Conditions

Our turbulent economy

The new Federal Financing Bank

may 1974

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While this newly-created bank may not be a panacea for federal agency financing problems, an official centralized borrowing mechanism for these agencies is long overdue.

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Our turbulent economy

Remarks of Mr. Robert P. Mayo
President of the Federal Reserve Bank of Chicago
before the Rotary Club of Chicago
May 7, 1974

The current state of the U. S. economy presents a picture of crosscurrents, variety, and indeed, tumult unknown in our recent history. Anyone glancing only at overall gross national product data for the first quarter would have to conclude that the U.S. economy had all the earmarks of a recession period. Indeed, some economists view it just that way. Yet during the same time that total real output dropped at an annual rate of almost 6 percent, more sharply than any time since 1958, many of our major industries were operating at or near capacity. While the overall number of unemployed was rising nearly 10 percent, we had major industries operating below capacity because they could not hire the skilled labor they needed. And despite this overall decline in output, materials and intermediate products of every sort were in short supply, with producers allocating their output to customers.

Not only did the most recent quarterly period show a decline in real output, but the growth during the three previous quarters was significantly below the long-term growth trend. Yet the upward movement of prices—at an annual rate of over 10 percent—was the greatest since 1951. The amount of slowdown which occurred would normally be expected to be accompanied by declining growth in borrowing and lower interest rates. Instead we are seeing new records set in short-term rates and long-term rates pressing against record levels. If this is a recession, it is indeed the strangest one the economy has ever undergone.

Inflation and oil

As early as a year ago, when data relating to the first quarter of 1973 became available, it was clear that the economy could not continue the extremely high rate of growth that was then in progress. A gradual slowing through the balance of 1973 and possibly early 1974 was generally expected, with a return to a so-called "normal" rate of about 4 percent in the latter half of 1974. It was logically expected that a slowing of the inflation rate would accompany this slowdown. Given conditions at the time, all of these were reasonable expectations. And, indeed, second- and third-quarter output did show the expected slowdown. But there was little evidence of any slowing of the inflation rate, primarily because of the intense worldwide demand for food, but also because of high levels of demand for a wide range of other commodities. Then came the October War and the Arab oil embargo that caused sharp petroleum product supply disruptions and rapid increases in prices of petroleum products.

The embargo is now behind us, even though the energy problem is not. And we have to learn to live with the increased price of energy. The new price level for gasoline is not the only consequence. Higher petroleum prices are seeping pervasively through the economy to raise the cost of producing virtually everything we use from toothpicks to computers. In large measure, the increase in energy costs was responsible for the unpredicted accelera-

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tion of the general price level both in late 1973 and in early 1974.

Beyond prices, the oil embargo had a serious impact on industrial output. There were direct production cuts in petroleum products themselves—plus cutbacks in electric power production and natural gas consumption which came from conservation measures. Automobile sales, which had been declining gently from the unprecedented levels of the first quarter of 1973, tumbled drastically, and production was cut severely to prevent enormous inventory gluts. The recreational vehicle industry virtually closed down. Hotels, resorts, and other businesses dependent on the auto vacation traveler felt the pinch. Airlines were forced by fuel shortages and fuel costs to curtail service. In short, a significant portion of the decline in output during the past two quarters can be ascribed to the oil embargo and to the impact of the higher oil prices that still prevail now that the embargo has ended.

At the same time that the embargo was making us all aware that we were rapidly outgrowing our supplies of energy and was causing a slowdown in several industries, it was also acting in an expansionary direction—providing incentives for the coal industry and rail transportation, and accelerating work schedules on nuclear power plants. Today, domestic oil exploration activity is at a level not seen since the early 1950s. Expansion in these areas added strongly to a demand for capital goods that had been underway for several quarters as a result of strong pressures on capacity, the need for modernization, and the requirements to meet environmental and safety regulations. Even the depressed auto industry began making major capital investments to meet what is generally viewed as a permanent shift in consumer demand toward smaller and more efficient cars and to meet the pollution control requirements which become much more stringent with the 1975 model year.

Thus we had a very strange economic environment in the first quarter of 1974. While all recent surveys of consumer attitudes have been very pessimistic in tone, the consumer has been spending his money. Consumer spending grew nearly twice as fast as the growth in disposable income. But the consumer was enjoying it less. While spending was up, the real level of goods and services that this spending purchased was down slightly, and one place the consumer did not spend his money was for new housing. Expenditures on housing were curtailed by high interest rates, reduced personal saving, and uncertainty about the cost and availability of fuel. In addition, the shifting of savings from normal channels into areas yielding markedly higher returns sharply curtailed the availability of mortgages.

If we were in the midst of a typical recession, this decline in real consumer spending would be accompanied by a slowdown in capital spending. But, instead, we are witnessing accelerated capital spending and appropriations combined with fairly rapid returns to more normal conditions in many areas affected by the petroleum embargo, along with a slight decline in the unemployment rate. In addition, we are on the threshold of what promises to be a record year in agricultural output, weather permitting. It seems to me that two things are holding back the resumption of rapid economic growth—inflation and capacity limitations.

The outlook for any significant reduction in the current rapid rate of inflation is dim in the next few months. The full impact of increased energy costs has yet to work its way through the price system to the final sales level. We are just at the beginning of a long period of labor negotiations in which settlements are bound to include "catch-up" provisions that will add further to costs. Despite the promise of a bumper U.S. harvest, world food stocks are low, so that demand will

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put a floor under agricultural prices. At the same time, energy and fertilizer price hikes will increase the costs of producing our food. Under the best of circumstances, it seems likely that several quarters will elapse before the rate of inflation recedes to levels on the high side of what were our goals only two years ago.

Just as it is going to take substantial time to subdue inflation, so an extended period of capital expansion is needed to add production capacity in those industries that are particularly short of capacity. Production of almost every raw material used to feed our industrial machine, from paper to steel, must be expanded if substantial economic growth is to resume. Massive additions have to be made to our coal, petroleum, and electric industries, particularly if the nation decides to move toward energy self-sufficiency. Even in industries where capacity is adequate to permit growth, capital investment is required to meet environmental problems, to comply with the occupational health and safety regulations, and to increase productivity as an antidote to rising costs of energy, materials, and labor.

Slower growth indicated

The outlook, then, for the next few quarters, is likely to be one of slower growth of the economy—slower than the 4 percent or so annual growth we have come to consider normal—with the fixed capital investment sector (except housing) significantly stronger than the consumer area. This sluggishness is likely to be accompanied by levels of unemployment somewhat above those we have customarily set as our national objective in the postwar period, and somewhat higher than we would like to see. The reward for going through this pain will be a slowdown in the general rise in the price level, but it is going to be slow in coming. This means that considerable political pressure is going to build up for stimulative fiscal and monetary policy.

We have already heard several calls from leading political figures for a major tax cut to stimulate consumer spending and employment. Yet it is easy to make the case that virtually all of the first-quarter drop in output and the increase in unemployment resulted from cutbacks in the auto and petroleum-related industries, and residential construction. We will probably not know where the economy is heading over the longer term until second-quarter data are available. Given the special circumstances of the last six months, it seems very unlikely that we are in a recession in any normal sense of that word. Policies appropriate to bringing about rapid recovery in a more typical business slowdown could easily bring on substantially worse inflation than we are now experiencing without significantly increasing real growth. This brings me, then, to the question of appropriate economic policy for the next several months.

Sources of current inflation

The current situation presents a formidable challenge to economic policy. With the decline in real output during the first quarter and the continuation of sharply rising prices there is now more than the usual amount of uncertainty concerning the underlying state of total demand relative to total capacity.

For purposes of framing economic policy, we must start with the critical factors involved in the current situation and the possible remedial steps that might be taken to improve that situation. But it is also important to review how we got to this unenviable position in order to avoid repeating past errors.

Following the economic downturn of 1969-70, monetary policy, in my opinion, was not excessively expansive in 1970 and 1971. But the growth in monetary

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aggregates during 1972 and the first part of 1973 was higher than warranted by subsequent economic developments, and higher than desired by the Federal Reserve. Given the lagged effects of monetary expansion on aggregate economic activity, and the fact that the economy was fast approaching capacity output in the latter part of 1972, this unintentional expansion of the aggregates most likely added to inflationary pressures.

Nevertheless, other factors share even more importantly the responsibility for the current inflation problem. Fiscal policy, in terms of budget deficits, was excessively expansionary in 1971 and 1972. Providing for the financing of the deficits is one reason for the monetary expansion we have witnessed. The successive devaluations of the dollar were also important. Coupled with simultaneous strong economic expansion of industrialized nations abroad, the devaluations led to sharper-than-anticipated export demand for U. S. goods.

In addition, crop failures abroad led to much larger-than-foreseen demands for U.S. agricultural output and this resulted in sharp increases in domestic food costs. Finally, of course, the oil embargo, coming at a time when U.S. import demands for petroleum products were rising sharply, resulted in shortages of petroleum and petroleum-based products and sharp increases in prices for such products in a very short period.

I would also add my personal opinion that the wage-price control program which was just buried was kept alive too long. The controls had the unfortunate damaging effect of masking inflationary pressures. They caused distortions in relative wages, prices, and output, and they made it increasingly difficult to acquire accurate economic intelligence.

Viewing our current situation from a slightly longer-term perspective, the quickening in the pace of inflation following 1967 brought into sharp relief a serious problem associated with the goal of fostering full employment of resources as expressed in the Employment Act of 1946. While public policy attempts to achieve full employment with relatively stable general prices, the latter goal has been subordinate to the employment goal for a number of years.

It appears to me that some labor unions and some businesses increasingly have come to act on the assumption that increased wages and increased costs can be passed through to final product prices almost with impunity. Given the commitment to full employment, unwarranted increases in prices and wages—unwarranted in the sense of maintaining employment levels given demand and productivity conditions—have tended to be underwritten by government policy in order to avoid unemployment. Resulting general price increases renew the cycle. It seems clear that this pointless spiral of wage-cost-price inflation must be brought under control without denying a role for collective bargaining and for market pricing which allows for relative price changes and possible income share changes as economic conditions change through time. Establishing a permanent price-wage review board with principally a public-reporting responsibility, along with some adjustment in the priorities attached to employment and inflation, might be one way of approaching the problem short of direct controls.

However, this problem and the problem of closer and more appropriate coordination of longer-run monetary and fiscal policies are matters that will be grappled with in future periods. The pressing question now is what policy actions should be taken in the current adverse situation. Several factors must be considered here, and they lead me to a conclusion regarding short-term policy that some may view as an unacceptable position.

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Uncertainty and conflicting policy proposals

I believe we must recognize that the current situation differs substantially from anything we have experienced in recent economic history. Supply conditions and international considerations must be taken into account more explicitly than they have been in the past. And we must recognize that rising energy costs represent a loss of real income in favor of other nations. The extent of these real income losses is by no means clear at this juncture, nor is it clear how the oil-producing nations will employ the income transfers they are now receiving. Finally, we have just seen the end of a protracted period of price-wage controls, and the results of removing those controls are not yet certain.

As indicated earlier, first-quarter economic data indicate that the real output decline we suffered so far is concentrated in those few sectors most affected by the energy problems and most sensitive to high interest rates. Unlike other periods of decline in real output, the overall investment picture for the economy appears to exhibit sustained demand strength thus far. Financial market demands remain strong. Real consumer spending, while not buoyant, does not show pronounced weakness; the unemployment rate, after increasing sharply, has been declining marginally in the short run.

In the face of the conflicting signals concerning the present state of the economy, policy proposals and recommendations diverge more sharply than usual. One group advocates sharp restraint in general monetary and fiscal policy to reduce inflationary pressures, with the resulting unemployment and specific industry effects to be dealt with by appropriate special programs. Special programs, I might add, the dimensions and form of which are not at all clear, let alone in place.*

Another group believes the underlying demand situation is weak or borders on weakness. For that reason, expansive or at least accommodative policies are advocated to maintain employment and encourage investment spending. It is argued that most of the very sharp price increases we experienced both last year and this year are attributable to nonrecurring special factors. If this be the case, with inflation expected to subside somewhat later in the year, a sharply restrictive monetary policy would only exacerbate the process of rising unemployment already started. Tax relief is advocated by some to restore a portion of the lost real income in the lower- and middle-income brackets and as an incentive to organized labor not to seek a restoration of real income by means of increased nominal wages.

The need for caution

Given such uncertain circumstances and conflicting proposals, I should like to counsel caution in setting economic policy in the short term. If underlying aggregate demand is strong, an expansive policy would simply worsen the inflationary situation, given supply constraints attributable to energy problems and deficient investment in recent years. If underlying demand is weakening, a sharply restrictive policy would result in an unacceptable unemployment rate that would elevate pressures for a fast reversal of policy—a process we have seen enough of in recent years.

On balance, I conclude that moderate monetary restriction is called for under present circumstances. I take the position that inflation attributable both to special factors and more generalized pressures requires restraint even though that might en-

*Subsequent to the delivery of this speech, three programs to assist the housing industry were established by Presidential directive.

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tail some small increase in the unemployment rate for a year or so at least. But I would be reluctant to see the unemployment rate rise substantially.

Although I am in sympathy with the concerns of those who advocate tax relief for the lower- and middle-income brackets, as yet I see no indication that the tax cut proposal would in fact lead to restraint on the wage side in the aggregate. Without such restraint, an expansive policy would, in my opinion, only foster a more severe inflationary situation. My position is not doctrinaire, however. I am willing to revise my opinion if a viable means of confronting the problem of so-called "stagflation" can be demonstrated, and if it stands a good chance of being carried through in all of its facets.

In the absence of such a demonstration, I believe it important that we recognize that our current inflation problem cannot be resolved quickly at reasonable cost. The problem has built up over a long period. It will take a long period to resolve it. Precipitate attempts to solve the problem would only result in the imposition of social costs that would, in my opinion, be disproportionate to the social benefits received. More than anything, we must now have patience in order to help establish a sound basis for sustained growth at more reasonable rates of price increase in 1975 and the years ahead.

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The new Federal Financing Bank

The Federal Financing Bank, created by an act of Congress in December 1973, is expected to embark on its assigned mission of coordinating and consolidating the borrowing activities of about 20 federal agencies with its first market borrowing sometime in June. Reports suggest that securities totaling around $500 million may be offered with the minimum denomination being $10,000. This initial offering will facilitate the financing of such federal agencies as the Environmental Financing Authority, the Small Business Administration, and the Washington Metropolitan Area Transit Authority.

The creation of the Federal Financing Bank (FFB) culminates many years of Treasury Department efforts to obtain authorizing legislation. In its testimony before Congress, the Treasury argued that such a bank was needed to serve as an intermediary between credit markets and the frequent but uneven borrowing needs of a growing number of individual agencies. The Treasury argued that the expanding number of federal agencies coming directly to the credit markets for their financing needs was a source of confusion to market participants, caused disruptions in the market, and resulted in relatively high interest costs to the borrowing agencies.

As envisioned by the Congress, the FFB will provide agencies that are wholly or partially owned by the U. S. Government with a central source of financing; homogeneous FFB obligations will replace the proliferation of federal agency issues; the number of government-related trips to the market will be substantially reduced; high-quality FFB obligations will warrant lower interest rates, with savings passed on to the borrowing agencies.

"Federal agency" defined

Not all of the agencies that are generically referred to as federal agencies are authorized to use the FFB. For FFB purposes (and as used in this article), a federal agency is "an executive department, an independent Federal establishment, or a corporation or other entity established by the Congress which is owned in whole or in part by the United States."

The large government-sponsored agencies are excluded by this definition because they are privately owned. The government-sponsored agencies which are not eligible to use the FFB include the Federal Home Loan Banks (FHLB), the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association (FNMA), and the three Farm Credit Administration agencies—the Banks for Cooperatives, the Federal Intermediate Credit Banks, and the Federal Land Banks. However, there is an exception to this prohibition. The obligations of a government-sponsored agency can be purchased by the FFB if the obligations are guaranteed by a federal agency that is eligible to use the bank. Thus, obligations of the Student Loan Marketing Association (SLMA—a privately-owned, government-sponsored agency) that are guaranteed by the Department of Health, Education, and Welfare (an executive department defined as a federal agency) can be purchased by the FFB.

The list of federal agencies authorized to use the services of the FFB is quite long. To date, these agencies have financed their activities by issuing their own obligations directly in financial markets or by guaranteeing the obligations of private

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borrowers or state and local governments. Among the better known federal agencies marketing direct obligations are the Export-Import Bank (Eximbank), the Tennessee Valley Authority (TVA), the U. S. Postal Service, and the Small Business Administration (SBA). The Eximbank and SBA also guarantee obligations of private borrowers. Other federal agencies that guarantee obligations include the Maritime Administration, Department of Housing and Urban Development (HUD), Farmers Home Administration (FmHA), General Services Administration (GSA), and Washington Metropolitan Area Transit Authority.

Principal federal agencies or programs eligible to use FFB

Farmers Home Administration
Export-Import Bank
Maritime Administration
Rural Electrification Administration
Department of Housing and Urban Development
- Public housing
- Urban renewal
- New community debentures
- Government National Mortgage Association

U. S. Postal Service
Amtrak
Rural Telephone Bank
Small Business Administration
U. S. Railway Association
Department of Defense military credit sales
General Services Administration
Tennessee Valley Authority
Environmental Financing Authority
Overseas Private Investment Corporation
Department of Health, Education, and Welfare
- Medical facilities
- Student Loan Marketing Association

Washington Metropolitan Area Transit Authority

Government-sponsored agencies not eligible to use FFB

Banks for Cooperatives
Federal Intermediate Credit Banks
Federal Land Banks
Federal Home Loan Banks
Federal Home Loan Mortgage Corporation
Federal National Mortgage Association

The case for the FFB

At the end of fiscal year 1973, outstanding federal and federally-assisted borrowing from the public amounted to $538.6 billion. This represented a net increase of $44 billion in borrowing over the fiscal year. Of this $44 billion, $19 billion was direct Treasury borrowing and $10.7 billion was government-sponsored agency borrowing. The remaining $14.3 billion, $0.3 billion in direct federal agency borrowing and $14 billion in federal agency guaranteed borrowing, is now eligible for channeling through the FFB.

It is estimated that federal agency direct plus guaranteed borrowing for fiscal years 1974 and 1975 will amount to $13.7 billion and $12.8 billion, respectively. Not all of this anticipated borrowing will be accomplished through the credit markets, the primary concern of the FFB. Some of it, such as Federal Housing Administration (FHA) guaranteed mortgages, will be financed by local institutions. The Treasury estimates, however, that in the next year about $10 billion in new cash needs of federal agencies will be financed in the credit markets. Also, another $10 billion will be needed for refinancing of maturing issues.

From January 1 through December 31, 1973, no fewer than 75 separate security offerings were made by federal agencies now authorized to use the FFB. The amount financed through any individual federal agency offering varied greatly, ranging from the over $500 million

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offerings of the FmHA to the less than $20 million offerings of various merchant marine bonds.

Some federal agencies were regular borrowers while others marketed debt only infrequently in 1973. TVA power notes and HUD-guaranteed public housing and urban renewal notes were auctioned each month; GSA participation sales certificates were issued only twice; SBA had but one direct debenture offering and guaranteed two Small Business Investment Companies offerings. Interestingly, several federal agencies which are authorized to borrow from the public, such as the U. S. Postal Service, the Environmental Financing Authority, and the Rural Telephone Bank, did not go into the credit markets even once in 1973.

The varying characteristics of the different federal agency securities have been a source of confusion to market participants for years. For example, TVA power notes and bonds carry no U. S. Government guarantee; FmHA insured notes pay interest annually, in contrast to the general practice of semi-annual payments; HUD-guaranteed urban renewal notes are exempt from federal income taxes, whereas most other agency securities are not.

The disparities inherent in the various federal agency offerings result in the agencies paying higher interest rates than the Treasury does. Furthermore, each federal agency must cope with the problem of timing its market financing with its credit needs under uncertain market conditions. For example, the newly-created SLMA postponed stock offerings twice during 1973 because of unfavorable market conditions. Instead, SLMA raised $200 million by auctioning $100 million of 182-day notes on two dates in October at a cost that was $394,000 more per $200 million than the Treasury paid for six-month bills on the same dates. Similarly, in November, the Eximbank offered $300 million of five-year debentures at a net interest cost to the agency of 7.4 percent. Five-year Treasury notes were yielding 7.07 percent that day, implying an almost $1 million per $300 million lower annual cost to the Treasury than to the Eximbank.

How the FFB works

The FFB operates under the general supervision and direction of the Secretary of the Treasury. The bank's policies are determined by a five-member board of directors, with the Secretary of the Treasury chairing the board, and other members appointed by the President from officers or employees of the FFB or another federal agency.[1]

The FFB can buy obligations that federal agencies until now have issued, sold, or guaranteed in the credit markets. This process transfers the myriad of debt management problems from the agencies to the FFB, which itself has access to Treasury debt management expertise, and consolidates the many agency issues under one roof for distribution to the public.

The FFB finances these purchases by selling its own obligations directly in the credit markets. Initially, outstanding FFB obligations up to $15 billion are authorized. In addition, the Secretary of the Treasury may be required by the FFB to purchase up to $5 billion of FFB obligations and the Secretary has discretionary authority to purchase more.

It is expected that FFB obligations will be offered on a regular schedule to

[1]On May 6, 1974, President Nixon designated that the four board members would be whomever holds the positions of Deputy Treasury Secretary, Undersecretary of the Treasury for Monetary Affairs, the Treasury Department's General Counsel, and its Fiscal Assistant Secretary. On the same day, the President issued an executive order creating the Federal Financing Bank Advisory Council. The members of the Advisory Council include the Secretaries of the Treasury, Agriculture, Commerce, HEW, HUD, Transportation, the President of the Export-Import Bank, and the Postmaster General.

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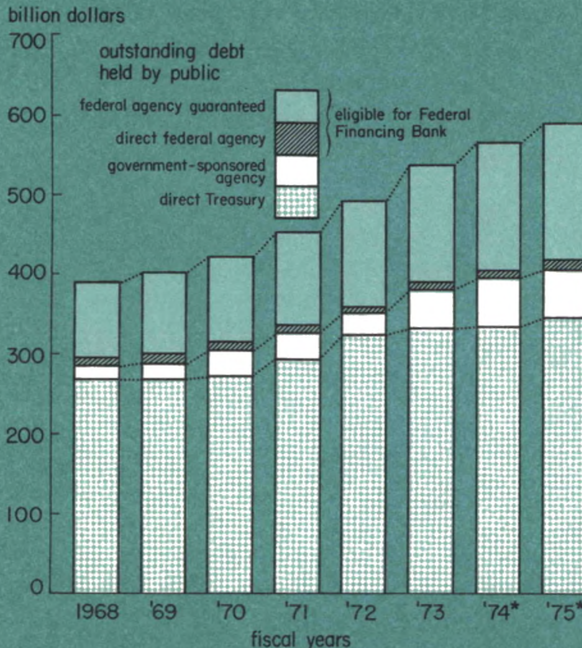

*Estimate.
SOURCE: Special Analyses, Budget of the U. S. Government, fiscal years 1969 to 1975.

facilitate marketing and investment planning. This principle already applies to Treasury obligations, with major refinancing required once in each calendar quarter. Insofar as possible, the authorizing legislation requires maturity structure conformity between FFB debt and assets. Since FFB assets will consist of federal agency obligations with varying maturities, it is expected that, in time, short-, intermediate-, and long-term FFB obligations will be marketed.

The FFB is not expected to handle directly federal agency obligations financed by local financial institutions such as the thousands of individual FHA/VA guaranteed mortgages. However, the FFB could handle these guaranteed mortgages indirectly by purchasing the securities of the Government National Mortgage Association, which are participations in pools of these guaranteed mortgages.

For federal agencies selling their obligations to the FFB, neither their budget status nor their method of budget accounting is affected by the authorizing legislation. The receipts and disbursements of the FFB itself are to be excluded from the U. S. Government budget totals and are exempt from any statutory limitations on expenditures and net lending of the United States.

The funds raised by the FFB do not represent new federal debt, but merely replace funds that federal agencies would have raised themselves. Statutory limits on agency borrowing authority and loan guarantee activity are unaffected by the creation of the FFB. Certain agency obligations are themselves subject to the overall limit on the public debt. To avoid duplication, FFB obligations will be exempt from that limit.

Because income from state and local obligations is exempt from federal taxation, the coupon rate on these obligations is generally less than that on Treasury securities of comparable maturity. When the FFB buys the obligations of a local public body that are guaranteed by a federal agency, the authorizing act contains a special provision to ensure that the borrowing costs to the local public body are not increased. The cost to the local body will be the amount that the head of the guaranteeing federal agency, in consultation with the Secretary of the Treasury, estimates it would be if the bank were not used. The guaranteeing federal agency, in turn, is authorized to make payments to the FFB from its appropriations to cover the differential.

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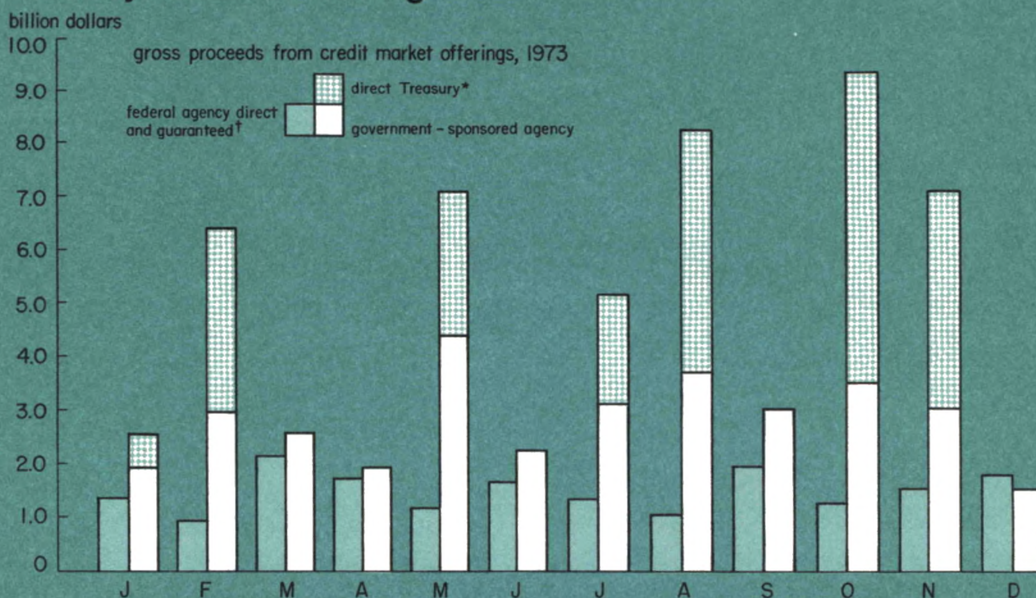
While financing through the FFB is voluntary on the part of authorized federal agencies, the ability to obtain financing when needed, independent of market conditions and at rates comparable to Treasury rates, should lure federal agencies to the FFB. The FFB is expected to begin operations slowly, financing the credit needs of the smaller, less well-known, or newer federal agencies first.

Characteristics of FFB obligations

The language of the authorizing legislation does not state directly that FFB obligations are guaranteed by the United States. Legal precedent exists, however, for FFB obligations to be considered general obligations of the United States. The pertinent language of the legislation says that (1) the FFB may *require* the Secretary of the Treasury to purchase up to $5 billion of its obligations, and (2) the Secretary is authorized to purchase any additional amount with the purchase of such obligations being treated as public debt transactions of the United States under the Second Liberty Bond Act. This language is similar to the Eximbank legislation that says the Secretary of the Treasury is *directed* to purchase the obligations of the Eximbank issued to him by the bank. The opinion of the U. S. Attorney General was that these obligations are general obligations of the United States backed by its full faith and credit, and that legal



*Other than regular weekly and monthly bill offerings and Federal Reserve and government account exchanges.

†Based on 75 major federal agency credit market offerings now eligible for FFB purchase.

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FFB obligations are like Treasury obligations in that they are:

- available in "book entry," registered, and bearer form;
- eligible for Federal Reserve wire transfer at all Federal Reserve banks or branches;
- exempt from state and local taxation to the same extent as Treasury securities;
- lawful investments and acceptable as security for all fiduciary, trust, and public funds (including Treasury Tax and Loan accounts), the investment or deposit of which is under the authority of any officer of the United States;
- eligible as collateral for Federal Reserve bank advances;
- eligible for Federal Reserve open market purchases;
- payable as to principal and coupon interest at Federal Reserve banks or at the Treasury;
- payable by Treasury check for interest on registered securities;
- eligible for denominational exchanges, transfer, and interchanges among bearer, registered, and book entry form at Federal Reserve banks or at the Bureau of Public Debt of the Treasury;
- eligible for relief in the event of loss, theft, or destruction in the same manner as Treasury securities;
- eligible for purchase by national banks without restriction;
- eligible for investment by federal credit unions and small business investment companies;
- countable as liquid assets by members of the Federal Home Loan Bank System.

holders of these obligations "have acquired valid general obligations of the United States, and are therefore in a position to reach beyond Eximbank and its assets to the United States for source of payment, if necessary."

Most of the federal agency obligations which can be sold to the Federal Financing Bank are either fully- or partially-guaranteed by the United States. Notable exceptions are TVA obligations and certain U. S. Postal Service obligations.

Income from FFB obligations is exempt from state and local taxes but subject to federal income taxes. This tax status is the same as that currently accorded income from Treasury securities and some federal agency obligations. Income from some federal agency obligations—such as those of the Eximbank and FmHA—is subject to state and local taxation as well as federal taxation. Income from other federal agency obligations—such as HUD-guaranteed public housing notes and bonds—is subject to state and local taxation but exempt from federal taxation.

Purchases of FFB obligations by national banks are not subject to the 10 percent of capital stock limitation. This treatment is similar to that of Treasury securities and some federal agency obligations. The 10 percent limitation does apply to the obligations of TVA and the U. S. Postal Service.

Federal Reserve member banks may use FFB obligations as collateral for advances from the Federal Reserve System. Treasury securities and most federal agency obligations can also be used as collateral. In addition, obligations of the FFB, Treasury, and most federal agencies are lawful investments and acceptable as security for all fiduciary, trust, and public funds under the authority and control of the United States, including Treasury Tax and Loan accounts. The types of federal agency obligations that are not eligible for these collateral purposes are the individual

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mortgages guaranteed by FHA or VA.

FFB obligations can be purchased by the Federal Reserve in its open market operations. Technically, all direct and fully guaranteed obligations of federal agencies, as well as Treasury obligations, are eligible for open market purchases. Guidelines for open market operations in federal agency securities, however, prohibit purchases of issues smaller than $200 million for over five-year maturities and $300 million for shorter maturities, ruling out many federal agency issues.

FFB securities, like Treasury securities, are available in "book entry," registered, and bearer form, and eligible for Federal Reserve wire transfer. Currently, most government-sponsored but very few federal agency securities are available in "book entry" form and eligible for wire transfer. Only U. S. Postal Service bonds and FmHA certificates of beneficial ownership have these features.

Submission of financing plans

Because the FFB will be directed by the Secretary of the Treasury, FFB financings will be coordinated with direct Treasury debt management operations.

To further coordinate federal borrowing, the legislation creating the FFB requires federal agencies to submit their financing plans to the Secretary of the Treasury for prior approval as to the method, source, timing, and terms and conditions of financing obligations issued or sold in credit markets. Prior approval is not required, however, for the financing plans of obligations guaranteed by federal agencies, obligations of FmHA, nor obligations of TVA. As with use of the FFB, government-sponsored agencies are also excluded from this submission provision. The FHLB and FNMA, however, are already required by law to obtain Treasury approval on certain aspects of their market borrowings. While not required by law, the other privately-owned agencies have, as a matter of practice, consulted with the Treasury on proposed borrowings.

Once the required federal agencies have submitted their financing plans, the Secretary must approve them within 60 days unless market conditions are adverse; in such cases, the Secretary must submit a detailed explanation of these conditions to Congress. In no case, however, can the approval be withheld for more than 120 days.

The outlook for the FFB

Rather than diverting funds away from any existing or yet-to-be-created federal credit program, the Federal Financing Bank provides a convenient and immediately-available source of financing for these programs. Initially, at least, the larger, already market-established federal agencies are likely to be cautious in seeking financing through the new FFB. With characteristics so closely paralleling those of Treasury securities, however, FFB obligations should find wide market acceptance at interest rates comparable to Treasury rates. Given time to demonstrate its debt management capabilities, the FFB should be able to replace the plethora of federal agency obligations now competing with one another in the credit markets with its own high-quality obligations. While the FFB is not a panacea for federal agency financing problems, the benefits to be derived from centralizing federal agency borrowing could prove to be significant.

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