The Role of Government in U.S. Capital Markets

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The overall role of government in U.S. capital markets is not prominent in policy discussions, nor is it well understood by the general public. There are a number of important dimensions to this role and significant changes over time. My purpose today is to outline these dimensions to provide a better understanding of the role of government.

The capital markets are the means by which the economy’s saving flows to those who use the saving. Business firms need access to some of this saving to finance productive investment in physical capital and to cover losses during the start-up phase of new enterprises. Governments use some of this saving to finance outlays in excess of current revenues. Households tap some of this saving to finance consumption outlays and, especially, housing investments. In the first part of my lecture, I’ll outline some of the basic facts as to how nonfinancial sectors use funds raised in the capital markets and some of the notable changes over time. I’ll emphasize how the government’s role affects the outcome.

The financial system does not, however, transfer all funds directly from savers to end users of funds. A large fraction of saving flows through financial intermediaries, such as banks and mutual funds. The government’s role in the intermediation process is substantial. That will be the subject of the next section of my lecture.

In the final section of my lecture, I’ll reflect on the Federal Reserve’s role in the financial system. The Fed reflects an important governmental influence, but one more involved in the overall management of the economy than directly in the capital markets. Nevertheless, the Fed’s role is critical to the orderly functioning of the capital markets, which is why this topic fits nicely into the overall topic in the title to my lecture. Indeed, I’ll emphasize just how important the Fed has been in responding to the economic effects of the terrorist attacks on September 11.

I’ve added a postscript that is off the topic, but I know of interest—I’ll reflect a bit on the likely implications of the terrorist attacks on the economy.

Before proceeding, I want to emphasize that the views I express here are mine and do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis for their comments. Robert Rasche, William Emmons, and Joel James were especially helpful. However, I retain full responsibility for errors.

NONFINANCIAL SECTORS USES OF FUNDS

Almost everyone is aware of the fact that in recent years the federal government has changed from a net user to a net supplier of funds—the federal budget has gone from deficit to surplus. Of course, that situation is fluid today because of the changed situation in the wake of the terrorist attacks of September 11. It is too early to make any projections as to just how large the change in the federal budget will be in coming years.

Perhaps the most familiar fact about the federal role in the capital market is that the federal budget went from near balance in 1970 to a deficit of about 5 percent of GDP in the mid-1980s to a
surplus of about 2½ percent last year. Because that fact is so familiar, I’ll not dwell on it.

Less well-known is the use of the credit markets by the state and local governments. These governments have borrowed funds on a smaller and steadier scale than the federal government for many decades. Their net new borrowing each year was equivalent to about 1 percent of GDP through the 1950s, 1960s, and 1970s. State and local government borrowing spiked briefly above 2 percent of GDP in the mid-1980s, before falling back to about zero by the mid-1990s. The most recent evidence suggests state and local borrowing is set to resume its previous pace equivalent to about 1 percent of GDP for the immediate future.

Because of this relatively steady pace of borrowing, the total amount of state and local government debt outstanding has remained between 8 and 18 percent of GDP for the entire post-war period, with no apparent trend in either direction. For example, state and local government debt was equivalent to 14.5 percent of GDP in 1970, 16.1 percent in 1985, and then returned to 13.0 percent by 2000.

State and local governments not only raise funds in the capital markets but also are important lenders. Data on lending by state and local governments to nonfinancial borrowers are fragmentary, and evidence on the amount of such activity is limited to recent years. This activity is best summarized by public debt issued for private purposes, as defined by the Bureau of the Census since fiscal year 1987-88. The data refer to debt issued by state and local governments or their agencies for the purpose of funding private sector activities. Examples of activities supported by such lending activities include industrial and commercial development; pollution control; housing and mortgage loans; private hospital facilities; student loans; and ventures such as sports stadiums, convention centers, and shopping malls. For fiscal year 1987-88, the outstanding amount of such debt was $246.2 billion, or approximately 5 percent of GDP, split equally between state governments and local governments. By fiscal year 1996-97, the latest period for which complete data are available, the outstanding amount had grown to $328.2 billion—a bit less than 4 percent of GDP—of which 60 percent was issued by state government units. In recent years, state and local governments have been a much more important source of direct loans to nonfinancial borrowers than has the federal government.

Governments not only directly absorb or provide saving to the capital market but also influence the use and form of capital raised by the private sector. Of particular note is the growing use of debt over equity by corporate business. For a corporation, debt has the advantage that interest payments are deductible under the corporate income tax law, whereas dividend payments are not. Perhaps as a consequence of this feature of the tax law, or at least in part, the equity portion of capital for nonfarm, nonfinancial businesses has fallen from 64 percent in 1970 to 50 percent today. A possible downside aspect of this trend is that it makes corporations more vulnerable to bankruptcy should economic conditions deteriorate significantly, and that in turn may make the overall economy less stable.

Beyond its direct role in raising capital in the market, the government regulates competitive conditions in the securities markets. Since the enactment of federal securities laws in the 1930s, the emphasis has been to provide investors with information, and not for the government itself to make judgments as to investment merit. This system has worked well, and most investors understand that the government does not substitute its own judgments for those of investors.

**FINANCIAL INTERMEDIATION**

The flow of saving from the original saver, such as a household, to the ultimate user of the saving, such as a corporation, can take the form of household purchases of newly issued common stock or corporate bonds. However, a large fraction of saving flows is intermediated by financial firms. The classic example is the commercial bank, which collects funds from depositors and lends to both businesses and households.
Financial intermediaries serve several important functions. An obvious one is that the intermediary specializes in the analysis of risk and administration of loans. Very few households have the lending expertise that banks do. Moreover, banks can attract funds in small amounts from individuals and make large loans to business firms.

The government role in supervising, regulating, and insuring financial intermediaries is much more extensive than its role in the securities markets in which stocks and bonds are traded. The federal role regarding financial intermediaries ranges from minimal, as with firms such as GE Capital, to extensive, as with regulation of commercial banks and insurance of deposits.

Of all the federal guarantee arrangements, deposit insurance is the most fully developed and best understood. In the United States, deposit insurance arrangements began in the early-19th century. Through a long and painful evolution, including creation of federal deposit insurance in the 1930s and the collapse of the Federal Savings and Loan Insurance Corporation in 1989, the management of the deposit insurance system is now fairly well understood. There are two pillars to the system. One is extensive regulation and supervision of insured depository institutions by federal and state agencies. The second is the requirement that insured institutions maintain substantial capital, which provides a cushion against losses and an incentive for the owners to manage their institutions carefully.

Deposit insurance serves an important function in improving the stability of the financial system. However, it creates the risk that insured depository institutions will engage in unsafe lending practices that may lead to loan defaults and bank failures. An inadequate insurance system sooner or later is likely to lead to excessive taxpayer losses.

Federal insurance programs that cover liabilities of private financial intermediaries date from the creation of the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) in the 1930s. In 1970, credit union shares became insured through the National Credit Union Share Insurance Fund. The FSLIC was abolished in 1989, and responsibility for insuring deposits of banks and thrifts was assigned to the FDIC through two separate funds, the Bank Insurance Fund and the Thrift Insurance Fund. As of the end of 1999, deposits insured by the two FDIC funds exceeded $2.8 trillion, about 71 percent of all deposits at insured banks and 93 percent of all deposits at insured thrifts. In addition, the National Credit Union Administration insured $326 billion dollars in credit union shares.

The statutory responsibility of the FDIC extends only to the first $100,000 of deposits held by a particular individual in all accounts at a depository institution. However, as a consequence of the bailout of Continental-Illinois Bank in 1984, it became clear that in practice the government was following what the market usually calls a “too-big-to-fail” policy, but which is more properly called a “too-big-to-liquidate-quickly” policy. Whatever term is used, the policy means that for large banks all deposits, and not just insured deposits, may be guaranteed; clearly though, shareholders and managements are vulnerable to loss. The extent of this de facto extension of government insurance of depository liabilities beyond the statutory provisions has never been precisely defined. In the event of problems at another large bank, the markets will be uncertain of the extent to which the government will cover losses that large, uninsured depositors might suffer.

Another class of financial intermediaries is government-sponsored enterprises, or GSEs. These are instrumentalities of the federal government and not fully private. They are established and chartered by the federal government to accomplish specific policy goals. However, they may have private shareholders who receive dividends and enjoy most of the rights of fully private firms. The mission of the housing GSEs—including Fannie Mae (originally named the Federal National Mortgage Corporation), and Freddie Mac (originally the Federal Home Loan Mortgage Corporation) and the Federal Home Loan Bank System—is to facilitate the flow of credit to mort-
gage borrowers. In addition to the housing GSEs, other financial GSEs include the Farm Credit System, the Federal Agricultural Mortgage Corporation (Farmer Mac), the Financing Corporation and the Refinancing Corporation (both set up to resolve failed savings and loans in the early 1990s), and the Student Loan Marketing Association (Sallie Mae). There are also non-financial GSEs such as the Post Office and the Tennessee Valley Authority.

All of the financially oriented GSEs together controlled financial assets of $2.125 trillion at the end of the second quarter of 2001, with the lion’s share accounted for by the three housing GSEs. A major activity of the housing GSEs is to purchase mortgage loans from originators like commercial and mortgage banks, and then package them in the form of mortgage-backed securities, which are guaranteed and sold to investors. The pool of outstanding government-related mortgage securities amounted to $2.636 trillion at the end of the second quarter of 2001. This figure includes mortgage-backed securities from Ginnie Mae, the Veterans Administration, and the Federal Housing Authority, which are not GSEs but instead are agencies of the federal government carrying the full faith and credit of the government.

Direct government lending to financial intermediaries, which is quite small today, dates from the creation of the discount facility as part of the Federal Reserve Act, which became law in 1913. In the early years of the Federal Reserve System, such loans were an important source of funds to member banks. In the past decade, except during episodes of financial stress, such as experienced in the days following the September 11 terrorist attacks, the outstanding amount of such loans has been very small. With the exception of the seasonal borrowing facility, the maturities of such loans are very short.

Another significant federal guarantee program arises through government insurance of defined benefit pension plans, through the Pension Benefit Guarantee Corporation. The PBGC was created by the Employee Retirement Income Security Act of 1974. On September 30, 1998, the present value of covered defined benefit pension plans was estimated at $12.3 billion.

In discussing financial intermediaries and federal guarantee programs, I have mentioned dollar amounts in the trillions. The scale of the programs is comparable to the publicly held Treasury debt—often called the “national debt”—which we also measure in the trillions. These programs have significant effects on the capital markets and raise many fascinating and difficult public policy issues.

THE FEDERAL RESERVE’S ROLE

No financial system works well, as experience around the world has demonstrated often and painfully, in the face of monetary instability. In the United States, the Federal Reserve has the essential responsibility of maintaining low inflation and confidence that low inflation will continue into the indefinite future. Without that confidence, the bond market will have a tough time pricing long-term bonds, because the future purchasing power of money will be uncertain. In countries experiencing high inflation, long-term debt instruments literally disappear. Funds can only be borrowed short term, if at all.

The importance of the Federal Reserve’s role in the payments system became fully evident on September 11 and the days immediately following. The Fed provided an enormous amount of extra liquidity to the financial system. The action was not a monetary policy action in the conventional sense, but a response to the physical disruption of the payments system.

To understand what the Fed did, consider your situation if your income stopped, you were unable to borrow funds, and you were unable to sell securities because the markets were closed. Depending on your access to cash, you would be forced, within a few days, to default on bills coming due. Both nonfinancial and financial firms are in a similar situation, except that financial firms especially rely heavily on daily and even hourly receipts to meet obligations to make payments of various sorts.
As a consequence of the terrorist attacks, the securities markets closed, and so funds could not be raised that way. Moreover, the attack caused serious disruption to the operations of several financial firms that play a prominent role in clearing payments. Without certain funds coming in, firms all over the United States, and all over the world for that matter, would have been forced to default on obligations. Let me emphasize that the funds due were indeed owed to the recipient firms; the problem was that the physical destruction and unavoidable delays in bringing backup systems and locations to full operational capacity meant that the funds simply could not be transmitted. In the absence of Fed intervention, we would have seen a cascade of defaults as firms due funds that were not arriving would be unable to meet their obligations. This default cascade would have spread the problem throughout the world economic system.

The Fed provided extra liquidity to the markets in a variety of ways after the terrorist attacks. One method was by making loans through the discount window to depository institutions. Such loans usually run a few hundred million dollars or so. On Wednesday, September 12 the outstanding volume of adjustment credit lent by the Fed to depository institutions rose to $45.5 billion, up from $99 million the Wednesday before. Those loans allowed banks to meet their obligations, even though expected receipts had not arrived, and allowed banks to extend credit to their customers who could then make payments.

A large increase in Federal Reserve float was another mechanism expanding liquidity. The Fed typically clears roughly one-third of the checks generated by the households and businesses that write them. In the normal course of business, a bank receiving a check may take it to the Fed, which then processes the check and sends it on to the bank on which it was written. The dollar amount of the check is added to the clearing account of one bank and deducted from the account of the other bank. These clearing accounts are maintained on the books of the Federal Reserve Banks.

Because many checks are transported by air, the grounding of all aircraft meant that checks deposited with the Fed for clearing could not be delivered to the banks on which they were drawn. Moreover, many banks that do not ordinarily use the Fed’s check-processing services brought their checks to the Fed for a few days after September 11. For both regular customers and these new customers, the Fed gave credit for the balances deposited that vastly exceeded the funds being deducted from the accounts of other banks; the difference is called “Federal Reserve float.” On Wednesday, September 12, float was $22.9 billion, up from $2.1 billion the previous Wednesday.

A third mechanism to inject liquidity into the banking system was Fed purchases of securities in the open market. Fortunately, the market mechanism, though severely impaired, was not completely broken. The Open Market Desk at the New York Fed, itself operating from a contingency site because its office near the World Trade Center was closed, was able to purchase a large volume of securities through a combination of outright purchases and temporary purchases under repurchase agreements. Moreover, the Fed arranged currency swap agreements with several foreign central banks, which enabled them to provide dollars to their financial institutions.

All these mechanisms taken together expanded Federal Reserve credit by $90 billion, or about 15 percent, between Wednesday, September 5 and Wednesday, September 12. As the financial system restored normal payments mechanisms, and securities markets reopened, the extra liquidity flowed back to the Federal Reserve. Loans at the discount window were repaid, float declined as checks cleared, and Open Market Desk purchases of securities under repurchase agreement expired. Today, the system is functioning normally.

One other aspect of Fed operations deserves mention in this context. On the afternoon of September 11, and to a lesser extent during the days that followed, some banks experienced a modest increase in demand for currency. Frightened depositors withdrew cash from teller windows and ATMs. If those sources of cash had
run dry, the word would have spread rapidly that cash was running out, and additional people would have lined up at ATMs to make their withdrawals. The Fed made clear to depository institutions that cash was available and maintained operations to ensure that all demands could be met. A modest amount of extra cash was shipped to banks requesting it. I personally heard of no ATMs running dry, and in a matter of a few days the extra demand for cash disappeared. Here again, the Fed’s role was to maintain normal functioning of the payments system, and by doing so the Fed helped to maintain public confidence in difficult and uncertain circumstances.

Federal Reserve payments system operations are ordinarily considered a rather mundane subject. This experience shows, however, that under conditions of stress the subject is far from mundane. A modern economy depends critically on reliable methods to make and receive payment; when those mechanisms fail, the economy itself cannot function. The crisis of September 11 shows that the Federal Reserve plays an important role in keeping the mechanics of the payments system in good order. Doing so builds confidence across the economy that this essential aspect of life will work in normal fashion.

CONCLUDING COMMENT

The capital markets play a central role in a market economy. In the United States, these markets have a heavy governmental presence, but one that has evolved to differing degrees of government involvement depending on the market being examined. For the most part, government involvement in the primary security markets is relatively limited. The federal and state and local governments do raise significant amounts of funds in these markets, but the regulatory function is concentrated in the area of requiring provision of accurate information.

Financial intermediaries play a significant role. They raise funds from a variety of sources and make loans of many types. The federal involvement with intermediaries ranges from a light touch to extensive regulation and supervision.

POSTSCRIPT

I chose my lecture topic long before September 11 and had in hand a great deal of background work. But I think it would be a mistake for me to stop now without commenting briefly on the likely economic effects of the terrorist attacks.

The long-run prospects for the U.S. economy remain basically unaffected. The dynamic nature of the economy has not been damaged. The prospects for innovation, and the incentives to employ new technologies, have not changed.

The short-run outlook is dominated by uncertainty. Forecasters, required by their profession to put down numbers, show a much wider range of views than usual. I know that every individual forecaster has even less confidence than usual in the numbers written down. The fact is that we have no close parallel in U.S. history to study for guidance as to the likely course of the economy in the months and quarters ahead. Moreover, as the anthrax situation so horribly illustrates, we may have additional unpleasant surprises ahead of us.

Some business analysts seem to use the word “uncertainty” as a euphemism for “weakness,” just as stock market analysts seem to use the word “volatility” as a euphemism for “decline.” What I mean by uncertainty is that likely outcomes for the aggregate economy over the next six to twelve months are spread across a range from modestly poor to modestly good. Without question, the terrorist attacks have hurt the aggregate economy over the near-term. However, I do want to emphasize that we have very considerable strengths in our situation. We should not be pessimistic. I am not saying that I have a personal forecast of a quick rebound, but at the same time neither do I have a sinking feeling. I am genuinely uncertain about the economy’s near-term outlook.

What are the strengths of the economy today? Most important, we have a resilient people who are not going to sit back and watch the situation deteriorate. We are a people who look ahead and do not allow ourselves to wallow in fear. We are already acting to address the problems we face.
Our highly competitive markets are flexible and responsive to changing circumstances. We already see the airlines adjusting rapidly, by cutting routes where necessary and adjusting fares downward to attract passengers. Auto companies have zero-interest rate promotions, and indeed auto sales in early October have been strong. Market after market is responding and adjusting.

The rate of inflation is low and expected to remain low. In many past periods of stress, rising inflation expectations have complicated the situation tremendously. When the Korean War broke out in June 1950, there were immediate fears of a surge of inflation and of goods shortages. Many hoarded goods, and prices spiked up quickly, unsettling the situation.

The U.S. banking system is strong, unlike the situation in August 1990 when the Gulf War broke out. At that time, the economy drifted into recession, and the recovery that began officially in March 1991 was anemic. Part of the problem then was that a banking system with a weak capital position was unable to expand loans even to many credit-worthy borrowers. Today, bank capital is strong and banks are able to lend to good risks.

A substantial amount of monetary and fiscal policy stimulus was already in place before September 11; additional monetary policy stimulus is in place now, and more fiscal stimulus is in the works.

Most analysts believe that lost business on September 11 and the days that followed was sufficient to nudge the economy’s growth rate in the third quarter below zero. If the fourth quarter is also down, then the conventional shorthand definition of a recession—two successive quarters with negative GDP growth—will be met. Some talk as though that outcome is certain. It is not. We should not be surprised if that is the outcome, but neither should we be surprised if the fourth quarter shows positive growth.

The Federal Reserve will be watching the incoming data carefully, as will the market. If necessary, more monetary policy ease will be put in place. As data arrive suggesting revival of growth, we’ll have to watch to be sure that we are not observing a false dawn. We’ll also have to be careful not to overstay policy ease.

You may not find the economist’s “on the one hand, on the other hand” very satisfying, but it sure beats a firm commitment to a policy course oblivious to developing information. That is the situation we face. We in the Fed are paid to exercise our best judgment. That is what we will do.