

Ronald Reagan Presidential Library
Digital Library Collections

This is a PDF of a folder from our textual collections.

Collection: Baker, James A.: Files
Folder Title: [Cabinet Council on Economic
Affairs 01/12/1984]
Box: 12

To see more digitized collections
visit: <https://reaganlibrary.gov/archives/digital-library>

To see all Ronald Reagan Presidential Library inventories visit:
<https://reaganlibrary.gov/document-collection>

Contact a reference archivist at: reagan.library@nara.gov

Citation Guidelines: <https://reaganlibrary.gov/citing>

National Archives Catalogue: <https://catalog.archives.gov/>

THE WHITE HOUSE
WASHINGTON

CABINET AFFAIRS STAFFING MEMORANDUM

Date: 1/11/84 Number: 168882CA Due By:

Subject: Cabinet Council on Economic Affairs with the President

Thursday, January 12, 1984 - 2:00 pm - Cabinet Room

ALL CABINET MEMBERS	Action	FYI		Action	FYI
Vice President	☒	☐	CEA	☒	☐
State	☒	☐	CEQ	☐	☐
Treasury	☒	☐	OSTP	☐	☐
Defense	☒	☐		☐	☐
Attorney General	☐	☒		☐	☐
Interior	☐	☒		☐	☐
Agriculture	☒	☐	Baker	☒	☐
Commerce	☒	☐	Deaver	☐	☐
Labor	☒	☐	Darman (For WH Staffing)	☒	☐
HHS	☐	☒	Jenkins	☐	☒
HUD	☒	☐	McFarlane	☐	☒
Transportation	☒	☐	Svahn	☒	☐
Energy	☐	☒		☐	☐
Education	☐	☒		☐	☐
Counsellor	☒	☐		☐	☐
OMB	☒	☐		☐	☐
CIA	☐	☒		☐	☐
UN	☐	☒		☐	☐
USTR	☒	☐		☐	☐
GSA	☐	☐	CCCT/Gunn	☐	☐
EPA	☐	☐	CCEA/Porter	☒	☐
OPM	☐	☐	CCFA/	☐	☐
VA	☐	☐	CCHR/Simmons	☐	☐
SBA	☐	☐	CCLP/Uhlmann	☐	☐
			CCMA/Bledsoe	☐	☐
			CCNRE/	☐	☐

REMARKS:

The President will chair a meeting of the CCEA on Thursday, January 12, 1984 at 2:00 p.m. in the Cabinet Room.

The agenda and background papers are attached.

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823

☐ Katherine Anderson
☒ Tom Gibson

☐ Don Clarey
☐ Larry Herbolsheimer
Associate Director
Office of Cabinet Affairs

THE WHITE HOUSE

WASHINGTON

January 11, 1983

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER *RBP*

SUBJECT: Agenda and Papers for the January 12 Meeting

The agenda and papers for the January 12 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 2:00 p.m. in the Cabinet Room. Attendance is limited to principals only.

The Council will review two issues:

1. Controlling Federal Credit Activities
2. Monetary Policy and Financial Market Developments

Memorandums on these issues reflecting recent Council discussions are attached.

Attachments

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

January 12, 1984

2:00 p.m.

Cabinet Room

AGENDA

1. Controlling Federal Credit Activities
(CM # 113)
2. Monetary Policy and Financial Market Developments
(CM # 111)

THE WHITE HOUSE

WASHINGTON

January 10, 1984

MEMORANDUM FOR THE PRESIDENT

FROM: THE CABINET COUNCIL ON ECONOMIC AFFAIRS

SUBJECT: Controlling Federal Credit Activities

The Cabinet Council on Economic Affairs has recently undertaken a series of Economic Policy Studies reviewing major areas of economic policy. Economic Policy Study Number 6 focused on federal credit policy. A summary of the study is attached at Tab A with the full report and a set of tables at Tabs B and C, respectively. This memorandum presents the conclusions and recommendations of the Cabinet Council arising from this study.

The Growth and Allocation of Federal Credit

Controlling the size of the Federal Government requires not only restraining the growth of on-budget Federal spending, but also the growth of off-budget Federal outlays (primarily direct Federal loans) and off-budget Federal guaranteed loan activity. From 1976 to 1982, while on-budget Federal spending grew 100 percent, off-budget Federal outlays grew 137 percent and Federal loan guarantee commitments grew even faster.

Direct loans and loan guarantees grew rapidly, in part, because they are not subject to the same Congressional scrutiny as on-budget spending. Loan guarantees, for example, show up in the budget only when there is a default and the government must honor its guarantee. This may occur long after the government offered its guarantee. Neither direct loan obligations nor guaranteed loan commitments are covered by binding budget resolution measures. The Administration includes a budget for direct loan and guaranteed loan commitments in Special Analysis F of the Budget, but that credit budget is not treated the same by Congress as the official budget.

Direct loans at subsidized interest rates and guaranteed loans provide a subsidy similar in its impact to many other Federal subsidies. There is little difference between the economic effects of some forms of grants or price subsidies and subsidized loans. The economy bears a cost from these subsidized loans because they allocate credit to certain sectors of the economy and away from other sectors. Thus, there is a loss of investment that would have occurred in these other sectors.

In general, Federal credit activity has allocated credit away from the business and industrial sectors and toward the agricultural and housing sectors. Almost half of the direct loans made by the Federal Government are in farm programs. These programs support farm purchases and farm operations, as well as crop prices. Some of the farm programs also support home purchases in rural areas. Three-fourths of the guaranteed loan commitments made by the Federal government are for housing.

The subsidies embodied in Federal credit activity are highly variable across lending programs. At least one direct loan program, for example, lends at interest rates as low as 2 percent. This and similar low-interest rate programs were begun in the 1930's when a 2 percent interest rate was slightly above or equal to the prime borrowing rate. Today those loans are still made at 2 percent, though now, obviously, they include an enormous subsidy. Further, guaranteed loan commitments are made to a wide cross section of borrowers who differ markedly in their risk characteristics. A guaranteed loan to a relatively risky borrower provides a large subsidy, while a guaranteed loan to a more credit worthy borrower involves a smaller subsidy.

Proposals

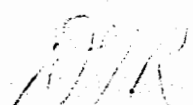
The Cabinet Council on Economic Affairs has four general Federal credit policy recommendations:

1. Support Congressional efforts to move off-budget lending onto the unified budget. This change would require that the direct loan programs of the Rural Electrification Administration and the Farmer's Home Administration, among others, be treated in the same manner for budgetary purposes as other programs. The 1985 budget will not reflect such a change. If, in the future, legislation were enacted to make this change, the published on-budget deficit would appear larger by about \$5 billion to \$10 billion. Such a change, of course, would not affect total Federal borrowing requirements.
2. Include Federal direct loan obligations and guaranteed loan commitments in the Congressional budget resolution process. The Administration already develops a credit budget that is included in the budget submission. Congress, however, does not subject the credit budget to the same scrutiny and binding resolutions it does the Federal budget. While including credit programs in the resolution process will not lead automatically to greater restraint, it is a useful step in the process of evaluating government credit activity.

3. Provide an explicit statement of Administration credit policy. Coherent Federal credit policy requires an up-dated statement. OMB should re-issue its credit policy directive (OMB Circular No. A-70.) The revised circular would:
- (i) Require credit legislative proposals to contain an explicit statement of any subsidies in direct loan or guaranteed loan programs;
 - (ii) Require that interest rates on any direct loans be related to market interest rates so that those interest rates will vary as market interest rates do, rather than staying at fixed levels that may become outmoded when market realities change;
 - (iii) Require those receiving Federal loan guarantees to pay for part or all of the expected Federal default liability on the guaranteed loans;
 - (iv) Encourage risk sharing with the private sector by offering less than 100 percent Federal guarantees rather than the full guarantee frequently used now; and
 - (v) Oppose providing Federal guarantees for Federally tax-exempt obligations.
4. Provide government-wide management guidelines for credit programs. These guidelines would include criteria for forecasting credit write offs, criteria for designating loans as being in default, and procedures for dealing with defaulted loans.

Recommendation: The Cabinet Council on Economic Affairs recommends that you approve the four Federal credit policy proposals outlined above.

Approve _____ Disapprove _____


Donald T. Regan
Chairman Pro Tempore

219:102,84
November 16, 1983

CABINET COUNCIL ON ECONOMIC AFFAIRS
ECONOMIC POLICY STUDY NO. 6
FEDERAL CREDIT POLICY

Growth of Federal Credit

- o The role of Federal credit activity in the U.S. economy has been growing both absolutely and relatively, with limited Presidential or Congressional oversight and control. In the past decade, Federal credit activity has rapidly expanded through on- and off-budget direct loans, guaranteed loans, and Government-sponsored enterprise loans. Since 1970, annual Federal and federally assisted net lending (disbursements less repayments) has increased four-fold to approximately \$88 billion. The participation ratio of Federal and federally assisted lending relative to all funds advanced by non-financial sectors has increased by about half -- from 14% to 22%.
- o Federally subsidized lending is directed much more to some sectors of the economy, such as housing or agriculture, than to other sectors, such as general business. Since it is subsidized, it alters resource allocation relative to the free market and therefore results in loss of economic efficiency. To the extent feasible, the costs of subsidized credit and the resulting loss of efficiency in the private sector must be weighed against any public benefits of subsidized credit.
- o The other side of the ledger from Federal and federally assisted lending is Federal and federally assisted borrowing. Federal borrowing is to finance the budget deficit, including on- and off-budget direct loans. Federally assisted borrowing is used for uncontrolled guaranteed lending, and Government-sponsored lending. Borrowing to finance these credit activities increases Federal and federally assisted demands for borrowing, which causes other borrowers to be crowded out of the nation's financial markets.
- o In 1982, Federal and federally assisted borrowing totalled \$200 billion, up from an average of \$32 billion a year during the first half of the 1970's. The ratio of Federal and federally assisted borrowing to all funds raised by nonfinancial sectors in U.S. credit markets was 49% in 1982. This is the highest participation ratio since World War II and is a large increase since the early 1970's, when the ratio was 21%.

Problems in Controlling Federal Credit Activity.--The problems of controlling Federal credit activity are enormous and systemic for several reasons.

o Budgetary control is inadequate over both the volume and subsidies of Federal credit activity.

- With respect to volume, in 1982 only \$9.1 billion of net outlays from loan programs were reflected in the unified budget. An additional \$14.3 billion in net loan outlays of off-budget entities were not reflected in the unified budget. Moreover, the unified budget does not reflect loan guarantee transactions at all, except in the case of defaults. The development of the Federal credit budget, which is the aggregate of new direct loan obligations and guaranteed loan commitments, is not adequate. Its aggregates are not binding on the Congress and thus do not force trade-offs in the allocation of credit among credit programs.
- There is no practicable and accurate measure of the subsidy from Federal credit programs because of the great difficulty in weighing all aspects by which the Government improves the credit terms for the borrower being favored. This allows interest groups, program managers, and Congress to argue that some forms of credit are "free goods," virtually costless to the Government and the economy. This argument is particularly pernicious when used by the supporters of lending programs that, by virtue of hidden subsidies, routinely make nominal profits. The existence of such nominal profits is used as evidence that these programs should not have their lending volume constrained.

Certain limited measures of subsidies for direct loans are presented in Special Analysis F of the U.S. budget. Subsidies for direct loans and guaranteed loans, however, are not measured formally in the budget. There are, therefore, no estimates in the budget data base to force trade-offs between various credit programs and normal budget expenditures. Such trade-offs as exist between lending programs and other spending programs are limited to a few on-budget direct lending programs and focus more on outlay constraints.

o There is no current statement of Federal credit policy that would provide guidance to credit program managers in administering their programs. The last formal statement of policy (OMB Circular No. A-70, Federal Credit Policy) was issued in 1965. Programs have been warped to fit the desires of special interest groups, and there is no counterweight in the budgetary process to limit the subsidies provided. The lack of a clear statement of Federal credit policy has also encouraged legislation that is poorly conceived, inconsistent, or contrary to the Administration's credit policy goals.

Reform Measures

The best overall means to control Federal credit activity is through a two-pronged approach:

1. a strengthened budgetary process that makes the credit budget totals more binding; and
 2. improved credit program administration through a clear statement of Federal credit policy.
- o A strengthened budgetary process: The unified budget, with its strict cash basis, is an inadequate tool for controlling Federal credit activity. Financial commitments, either direct loan obligations or guaranteed loan commitments, cannot be effectively managed by a fiscal tool that places its sole emphasis on the cash drawer. Nonetheless, the unified budget can and should be made more reflective of Federal credit activity by including the off-budget outlays of the lending programs financed through the Federal Financing Bank (FFB). The Administration is on record in support of the basic intent of legislation (S. 1679) that would accomplish this goal.
 - o To some extent, any budget reflects the agency-by-agency, function-by-function decisions of Congress and the Executive Branch. However, in the past three years, considerable progress has been made in controlling the unified budget totals through aggregate ceilings on broad, across-the-board categories. This has led to better restraint in the totals.
 - o There has been less success with the credit budget, even though it is the best extant tool for potential control of overall Federal credit activity.
 - A major improvement in the credit budget would be for the Congress to establish more binding aggregate limits on new direct loan obligations and guaranteed loan commitments and require an allocation of credit totals by committee. Congressional action on credit should be subject to the same scorekeeping procedures and controls as outlays. This would go beyond the process of limitations on direct loan obligations and guaranteed loan commitments now set in some appropriation bills.
 - A second improvement would be to establish formal measurements of the subsidies in Federal and federally assisted lending. This would be one way to compare credit programs to one another and to other expenditures.

These reform measures would be the best across-the-board mechanisms for limiting the growth of Federal credit activity.

- o Improved credit program administration: The best way to improve the effectiveness of Federal credit activity is to provide Government-wide guidance on administering individual credit programs. This requires a clear statement of Federal credit policy. OMB Circular No. A-70, Federal Credit Policy, is the vehicle of choice for such a statement. Many of the Reform 88 initiatives on credit management

could be used to buttress the policies enunciated in Circular No. A-70. However, improved credit program administration will also require sustained attention to the legislative foundations of various Federal credit programs. Unless these legislative aspects are dealt with in a consistent manner, the jungle of conflicting credit program mandates will continue to grow.

Recommendations on Short Term Credit Issues

The following proposals for improving control over Federal credit are recommended for CCEA consideration and approval:

1. The reissuance of OMB Circular No. A-70, Federal Credit Policy. Circular A-70 was issued in 1965, and is outdated because of changes in credit programs and financial markets. The reissued A-70 should provide policy guidance on the administration of credit programs. It should also set the policy for shaping legislation for new credit programs and amending defective legislation in existing programs. The draft A-70 would be reviewed by the CCEA in February 1984, when it and a background report are completed.

(a) Interest rates on new direct loan obligations. There is no updated policy on the minimum interest rates that should be charged for direct loans. Interest rates range from 2% in a few cases to rates marginally above the yield to maturity on Treasury instruments. Lending at low fixed interest rates may reflect the intended goal of the program, which is to subsidize borrowers. In a significant number of programs, however, where the interest rate does not vary with financial market rates, the subsidies are greater than intended when the legislation was enacted. The following recommendation would determine the basis for a minimum interest rate on direct loans.

Recommended Principle: Direct loans should be offered at interest rates comparable to those charged a particular borrower by private financial intermediaries. This rate would be considered a benchmark interest rate. It would vary from agency to agency, and loan category to loan category. It would raise the average interest rate charged by Federal credit agencies. The yield to maturity on Treasury instruments of a maturity comparable to the direct loan would not be considered a comparable market interest rate (i.e., a benchmark rate) because it is a risk-free rate. Direct loan obligations should therefore normally bear an interest rate above the yields on Treasury instruments.

In cases where the Administration wished to offer an interest rate subsidy, the subsidy would be defined as a discount below the benchmark rate. This would mean greater control over the level of subsidies offered new borrowers, as the subsidy discount would stay the same, even with movements in financial market rates.

(b) Guarantee Fees. There is no current policy on the level of fees to be charged for guarantees. In some cases, these fees are set in law and bear no relationship to either the administrative and servicing costs to

the agency or the expected Government liability in the event of a default. This means the Government bears costs that result in additional subsidies. Loan guarantee program administrators would need to estimate the expected Government liability of their guaranteed loan portfolios.

Recommended Principle: Guarantee fees should cover the servicing and administrative costs and the full expected Government liability in the event of default for a guaranteed loan portfolio.

In cases where the Administration wished to provide subsidies, guarantee fees would not cover the full expected liability of the Government in the case of default. The intended subsidy would be defined through reference to the expected liability of the Government. The guarantee fee would be expected to cover a portion (e.g. 80%) of the Government's liability in the event of default in a loan guarantee portfolio. The guarantee fee would still cover the full administrative and servicing costs.

(c) Interest rates on guaranteed loans. There is no current policy on the interest rate that should be charged by private lenders for guaranteed loans. In some cases, legislation requires that borrowers be protected against "excessive costs."

Recommended Principle: The recommended principle in A-70 would state that the Government should offer guarantees for loans by private lenders in a manner that enhances competition among lenders with respect to the effective interest rate and other terms charged the borrower. For example, potential lenders could be required to bid for the guaranteed transaction in order to assure the borrower of the lowest possible costs.

(d) Co-Insurance. Agencies frequently offer guarantees to private lenders for 100% of the principal and interest for loans. With respect to credit risk, the guaranteed loan is virtually the equivalent of a Treasury security. This may encourage private lenders to be less diligent in offering and servicing loans protected by the guarantee. (We are not here considering guaranteed loans of a type normally financed in the investment securities market.)

Recommended Principle: The recommended A-70 principle would state that (i) private sector lenders should bear a "significant" portion of the risk of default when they benefit from Government guarantees and (ii) in the event of default, the Government's claim on assets should not be subordinated to that of private lenders. The definition of "significant" portion could be defined as 20% of the risk of default. Thus, loan guarantee coverage would be limited to 80% of outstanding principal and interest.

(e) Guarantees of tax exempt securities. Federal direct or indirect guarantees of tax exempt securities offer investors in those guaranteed securities double benefits: they pay no Federal tax and bear no risk. This type of security is therefore a more attractive investment than U.S. Treasury instruments. The

Administration has consistently opposed the direct or indirect guarantee of tax exempt securities.

Recommended Principle: A-70 would confirm the principle that Federal agencies should not offer direct or indirect guarantees for securities that benefit from tax exempt status, except when required to do so by law.

2. Active support for legislation that would set resolution targets on new direct loan obligations and guaranteed loan commitments. Bills in both the House (H.R. 2076, the "Federal Lending Oversight and Control Act") and the Senate (S.1582, the "Federal Credit Control Act of 1983") embody basic provisions that would contribute to improved control over credit. The bills would require that the first concurrent resolution on the budget include appropriate levels of authority for new direct loans and guaranteed loans and would require an allocation of credit totals by committee. Congressional action on credit would be subject to the same scorekeeping procedures and controls as outlays.

Recommendation: The Administration should support the basic intent of both bills, which is to improve Congressional focus on credit aggregates. The Administration would define its position on individual provisions of the bills at a later point, in testimony before Congress.

Recommendations on Longer Term Credit Issues

In addition to the above recommendations, a variety of other credit issues need to be resolved. These include (a) expanded efforts to place the privately-owned, Government-sponsored enterprises on a more equal footing with their commercial counterparts, as well as monitoring their activity more carefully; and (b) getting agencies to follow past CCEA recommendations on Federal credit activity;

- a. Government-sponsored enterprises. Efforts to place privately-owned, Government-sponsored enterprises -- particularly the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) -- on a more equal footing with their commercial counterparts have had only limited success. Although the Administration has generally been able to restrain the Congress from adding new authorities or expanding existing authorities to GSEs and has been able to provide some limited support through administrative and regulatory changes to assist their commercial competitors, the GSEs continue to use their ties to the Federal Government to assist them in obtaining credit. The difficulties encountered in beginning the process of privatizing FNMA and FHLMC argue for the establishment of more binding limits for the funds raised by GSEs as well as on the new direct loan obligations and guaranteed loan commitments of the Federal Government.
- b. Implementation of the 1981 CCEA recommendations. In 1981, the CCEA made a variety of programmatic recommendations on Federal credit to businesses, individuals, housing, and agriculture. The CCEA studies noted several instances in which Federal credit activity could be reduced while sustaining the

objectives of the programs. Unfortunately, many of the recommendations of the major CCEA effort were never fully implemented, even when there was general agreement on the principles that determined the recommendation. The Working Group on Federal Credit Policy should continue to develop policies to implement in 1984 the principles of past CCEA recommendations with respect to credit for housing, business, agriculture, and individuals. These policies and recommendations would be presented to the CCEA on a case-by-case basis.

Agenda

The recommended agenda for implementing these recommendations is:

- To draft OMB Circular No. A-70 by February 1984. The guidelines approved by the CCEA on administration of credit programs should be strongly and clearly included in the FY 1985 budget.
- To support hearings in 1984 on both S. 1582 and H.R. 2076, urging enactment of their major provisions. Establishment of more binding credit limitations should be a major goal for proposed FY 1985 credit activity.
- To continue to develop policies that implement in 1984 the principles that underlay previous programmatic CCEA recommendations with respect to credit for housing, business, agriculture, and individuals.

November 17, 1983

I. Volume and Allocation of Federal Credit ActivityA. Flow-of-Funds Accounting

One useful context in which to analyze aggregate Federal credit activity is the flow-of-funds accounts produced by the Federal Reserve Board (FRB). The flow-of-funds accounts measure total borrowing by non-financial sectors in U.S. credit markets. Total lending, of course, is identical to total borrowing. (Financial sectors are excluded to avoid double-counting of transactions.) It is against this denominator of total borrowing that we can measure Federal and federally assisted borrowing in the case of total funds raised and Federal and federally assisted lending in the case of total funds advanced.

Direct Federal borrowing to finance the deficit, federally guaranteed and direct borrowing for loan programs, and federally assisted borrowing by Government-sponsored enterprises from the U.S. capital market clearly redirect financial resources from all sectors of the economy to favored sectors. The ratios of direct Federal borrowing plus federally assisted borrowing to total funds raised in U.S. credit markets have recently grown to much higher levels than in the past, as shown in Table 1:

Table 1.--RATIO OF FEDERAL AND FEDERALLY ASSISTED
BORROWING TO TOTAL FUNDS RAISED
(in percent)

	<u>1966-69</u>	<u>1970-74</u>	<u>1975-79</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>
Federal borrowing attributable to non-credit activity.....	2%	7%	16%	13%	12%	27%
Federal and federally assisted borrowing attributable to credit activity.....	<u>13%</u>	<u>14%</u>	<u>14%</u>	<u>21%</u>	<u>21%</u>	<u>22%</u>
Total.....	15%	21%	30%	34%	33%	49%

The above table separates Federal and federally assisted borrowing into two parts. The first part is Federal borrowing necessary to finance the non-credit activity of the Government. This is the Federal on- and off-budget deficit, less the amount of on- and off-budget net loan outlays. The second part is that amount for which the Government acted as a financial intermediary. It consists of Federal borrowing to finance direct loans (on- and off-budget), guaranteed borrowing (which is identical to guaranteed lending), and

Government-sponsored borrowing. This amount increased from 14% of total funds raised in the 1975-79 period to 22% in 1982.

B. Volume of Credit Activity

The point of potential control in Federal credit activity is when the Government becomes obligated to extend a direct loan or a loan guarantee. It is for this reason that the Federal credit budget shows the gross aggregate of direct loan obligations and guaranteed loan commitments. Direct loan obligations grew at an annually compounded rate of 17% between 1970 and 1981; guaranteed loan commitments grew at a rate of 10% over the same period. Table 2 presents the volume of new direct loan obligations and guaranteed loan commitments:

Table 2.--NEW DIRECT LOAN OBLIGATIONS
AND GUARANTEED LOAN COMMITMENTS
(in billions of dollars)

	Average					Estimates	
	<u>1970-74</u>	<u>1975-79</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Direct loan obligations.....	13.0	38.4	51.0	57.2	47.6	49.2	40.3
Guaranteed loan commitments.....	<u>31.5</u>	<u>49.9</u>	<u>81.4</u>	<u>76.5</u>	<u>53.7</u>	<u>107.0</u>	<u>90.4</u>
Total.....	44.5	88.3	132.4	133.7	101.3	156.2	130.7

The growth rates in new direct loan obligations and guaranteed loan commitments have been highly volatile over the last several years as shown in Table 3. This is largely due to cyclical movements in the demand for housing guarantees and insurance. Demand was low in 1982, due to the recession and high interest rates, while a large increase in demand is estimated in 1983. Most of the growth in the credit budget aggregates in 1983 is estimated to result from the growth in guaranteed loan commitments, mainly for the housing sector.

Table 3.--ANNUAL CHANGE RATES
(in percent)

	Averages					Estimates	
	<u>1970-74</u>	<u>1975-79</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Direct loan obligations.....	17%	8%	26%	12%	-17%	3%	-18%
Guaranteed loan commitments.....	<u>2%</u>	<u>30%</u>	<u>-5%</u>	<u>-6%</u>	<u>-30%</u>	<u>99%</u>	<u>-16%</u>
Total.....	6%	20%	5%	1%	-24%	54%	-16%

The major direct loan programs responsible for the growth since 1970 are shown in the following table:

Table 4.--GROWTH RATES FOR LARGEST DIRECT LOAN PROGRAMS -- 1970-1982
(dollars in millions)

	<u>1970</u>	<u>1982</u>	<u>Average Compounded Annual Growth Rate</u>
CCC price supports...	3,093	11,500	11.3%
Farmers Home Admini- stration.....	451	8,221 <u>1/</u>	26.7
Export-Import Bank...	2,209	3,516	3.9
Rural Electrification Administration.....	470	4,752 <u>1/</u>	20.8

1/ Includes direct loans made by the agency and sold with an agency guarantee to the FFB.

Despite the sharp growth in some large direct loan programs, new direct loan obligations are estimated to decline 18% from 1983 to 1984. This is due mainly to:

- less lending by the Commodity Credit Corporation because of the new payment-in-kind (PIK) program, in which farmers are offered surplus commodities in return for reducing their production of crops; and
- less lending by the Rural Electrification Administration (REA) because of anticipated decreases in the growth of electric power demand in areas served by rural electric systems.

As noted above, estimated increases in guaranteed loan commitments are responsible for most of the recent growth in the credit budget aggregates. The major factor in the changes in guaranteed loan commitments is the mortgage insurance and guarantee programs in the housing sector. Table 5 shows both the absolute levels of the largest loan guarantee programs, and their average compounded annual growth rates since 1970:

Table 5.--GROWTH RATES FOR LARGEST LOAN GUARANTEE PROGRAMS -- 1970-1982
(dollars in millions)

	New Guaranteed Loan Commitments		Average Compounded Annual Growth Rate
	1970	1982	
Low-rent public housing....	1,517	13,284	19.4%
Federal Housing Administra- tion.....	16,324	18,576	1.1
VA housing.....	3,720	5,983	4.0
Rural Electrification Administration.....	---	5,112	---
Education.....	959	6,895	17.5
Government National Mortgage Association Mortgage-Backed Securities.....	3,710 ^{2/}	36,382	22.5

^{2/} Data are for 1971

C. Sector Allocations of Credit

Federal and federally assisted lending reallocates capital to favored sectors of the economy. One means of gauging the reallocation is to define the sectors approximately along the lines of the sectors in the Federal Reserve Board's flow of funds accounts. In 1982, three major sectors of the economy -- households, agriculture, and business -- accounted for 98% of direct loan obligations and 99% of guaranteed loan commitments. Appendix Tables 4 and 5 present the conceptual division of loan and loan guarantee programs by sector.

1. Households.--The household sector of the economy, which includes for example, VA housing guarantees, guaranteed student loans, and health programs, benefitted from the greatest volume of Federal credit activity. Approximately \$5.3 billion (11%) of the FY 1982 direct loan obligations and \$45.0 billion (79%) of the guaranteed loan commitments were extended to this sector.

2. Agriculture.--The agriculture sector of the economy also benefitted from massive amounts of Federal credit. Credit programs include the Commodity Credit Corporation, and the Farmers Home Administration. In 1982, approximately \$20.5 billion (43%) of the direct loan obligations and \$1.8 billion (3%) of the guaranteed loan commitments were extended to this sector.

3. Business.--The business sector of the economy benefitted from the largest number of Federal credit programs. Credit programs include the Small Business Administration, the Export-Import Bank, the Maritime Administration and several others. In 1982, approximately \$20.8 billion (44%) of the direct loan obligations and \$9.9 billion (17%) of the guaranteed loan commitments were made to this sector.

Table 6 presents Federal and federally assisted net lending (including Government-sponsored enterprises) for each of these sectors as a percent of funds advanced to that sector. The participation ratios are only approximate, however, as it is difficult to classify Federal credit activity in accordance with the FRB's sector definitions. In this analysis, credit activity that benefits a given sector is attributed to that sector. In some cases, the FRB does not attribute the loan to the same sector. For example, Eximbank loans benefit the U.S. capital goods industry, a part of the business sector. However, Eximbank loans are made to foreign borrowers, not to the domestic business sector, and so would be counted as a flow of funds to a foreign borrower by the FRB. In these cases, the FRB flows have been adjusted to reflect these changes.

Participation ratios by themselves do not reveal the full effect of Federal credit activity on the economy. They do not reveal the subsidy effects, for example. Nonetheless, the table shows, in circumstantial fashion, the extremely high degree of participation by Federal and federally assisted entities in lending to certain sectors. The relatively high participation ratios of the household and farm sector reflect the way in which Federal and federally assisted loans redirected capital from the business sector to both the household and farm sectors.

It should furthermore be noted that the fluctuations in the participation rates of given sectors are affected by normal economic cycles, as well as changes in Federal credit programs.

Table 6.--NET FEDERAL AND FEDERALLY ASSISTED LOANS BY SECTOR
AS PERCENT OF TOTAL FUNDS ADVANCED TO THAT SECTOR

	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>
Households.....	16	15	26	26	42	44	80
Business.....	14	7	8	8	15	12	8
Farm.....	66	70	84	70	67	64	97

The household sector's participation ratio has grown monotonically since 1979 to a high of 80% in 1982. This high participation ratio reflects a sharp decline in net funds advanced to the household sector from all other sources and a slight increase in Federal and federally assisted lending. Approximately half of the total Federal and federally assisted lending can be attributed to Government-sponsored enterprises, except in 1982, when this proportion rose to over 60 percent.

The farm sector shows relatively stable participation ratios; the funds advanced to the farm sector have moved in the same direction as net Federal and federally assisted lending to that sector over this period. There was a sharp

drop in funds advanced to the farm business sector in 1982, which resulted in a relative increase in the calculated participation ratio to 97 percent.

The business sector participation ratios fluctuate between 7% and 15% because the net funds advanced to the business sector over several of the years moved in a different direction than Federal and federally assisted lending to the sector.

Appendix Tables 4-7 present both Federal and federally assisted lending and the FRB's flow of funds by sector in more detail.

II. Economic Costs and Subsidies

The measures of the volume of Federal credit activity given above do not present a complete picture of the effects of Federal credit activity on capital allocation throughout the economy. Federal credit activity has a greater effect on capital allocation the greater is the subsidy implicit in the activity. That is, Federal loans to a sector that are made at interest rates near the rate at which that sector could borrow in the private market have much less effect on allocating capital to that sector than highly subsidized loans would have. The figures given above do not capture the depths of the subsidy in the different programs and sectors.

A. Direct Loan Subsidies

The subsidy to borrowers of direct loans depends on the difference between the rate of return they pay lenders with Government assistance and the alternative rate of return they would have had to pay to borrow the same amount of money without Government assistance. However, in a practical setting it is frequently not possible to know and to measure what this alternative interest rate to the lender would have been. Borrowers, and the transactions being financed, differ a great deal. Some borrowers are such poor credit risks that they could not find a lender even at interest rates above 100%. Some transactions would not be viable unless financed at a subsidized rate, and so would not take place in a free market. Therefore, most subsidy calculations use as an estimate of the alternative rate market rates for specified classes of loans that may not be entirely comparable.

In addition to providing interest rates that are lower than private lending interest rates, Government direct loan programs frequently carry other conditions that enhance the partially measured subsidies. For instance, direct loans sometime carry longer maturities than comparable private sector loans. When combined with below-market interest rates, these subsidies persist for protracted periods. Or, the original loan amount may be higher in relation to the value of the underlying enterprise than would be offered by a private lender.

Even if the ostensible direct loan value and maturity are not generous, repayment subsidies may exist. Deferral of interest, grace periods, and low fees increase the value of the loan to the borrower, and cost the Government money. Default clauses may offer the borrower greater protection from foreclosure actions by the Government than clauses typically available from private sector lenders.

Finally, direct loan programs may make credit available to borrowers to whom the private sector would not lend -- at virtually any interest rate, under virtually any repayment terms. An example may be loans for the start-up and construction of subsidized public housing.

Two sets of calculations of direct loan subsidies were made in Special Analysis F, "Federal Credit Programs," in the last two years. One, based on private borrowing interest rates, is characterized as the value of the subsidy to the borrower. It is, nevertheless, incomplete, because it compares the Government lending rate with the private interest rate for a high quality loan at standard

terms. It therefore does not include the additional subsidy from an unusually risky borrower, an unusually risky venture, or unusually risky terms.

The second measure of subsidy is still more incomplete or partial. It compares the Government lending rate with the Treasury borrowing rate and therefore does not allow for any risk of default. As such, it does not measure the cost of the subsidy to the economy, but the cost of the subsidy to the Government. For long-term direct loans made at very low nominal interest rates, this subsidy may be quite large. In a few cases, such as a short-term direct loan at Treasury bill rates plus a premium percentage, it may even be negative.

B. Loan Guarantee Subsidies

A Government guarantee of a private sector loan frees the lender of the risk of default. This has two important effects. First, it encourages private sector lenders to provide credit to borrowers who otherwise would be considered too risky. Second, the guarantee eliminates the full risk premium that lenders otherwise would charge.

Both lenders and borrowers share the benefit of the eliminated risk premium. A 100% guarantee of principal and interest, in credit risk terms, is the equivalent of a direct loan from the Government. Private lenders, however, will normally charge a rate for this loan above the Treasury's cost of capital. In part, this will reflect some of the loan characteristics; the loan will also be less liquid than a Treasury instrument, and servicing and administrative costs are incurred. Nonetheless, the interest rate differential -- the difference between the Treasury's cost of capital and the comparable interest rate on a loan from the private sector -- will probably be shared by both borrower and lender, instead of flowing entirely to the borrower as in the case of a direct loan.

The two effects of the guarantee alter the allocation of credit in the market place. Furthermore, the Government's assumption of risk leads to outlays when borrowers default; this represents the program's direct costs to the Government. Just as with direct loans, the distinction between credit market effects and cost to the Government is important. Even when the Government does not bear the cost itself, the credit market effect may impose private costs by channeling credit and real resources from one sector to another.

C. Estimates of Interest Subsidies

The concept behind the calculation of the value of a direct loan subsidy to a borrower is clear; as noted above, the practical measure of that subsidy is not. Nonetheless, the methods used in Special Analysis F do provide estimates of the relative depth of subsidies in individual direct loan programs and the relative distribution of the subsidies among the direct loan programs. At the least, they provide an ordinal ranking of the subsidies. Subsidy estimates are not available for loan guarantee programs in Special Analysis F, however, except to the extent that the Government pays part of the interest in the student loan insurance program.

Since interest subsidies occur throughout the life of a loan, the measurement of the subsidies requires that annual future payments be discounted into a

single present value. By making this calculation, it is possible to estimate what the cost of the subsidy is to the Government and the economy.

The Special Analysis F estimates of the present value of interest subsidies on direct loans based on comparable private market rates, in 1982, are as follows for the three major sectors that receive almost all of the direct and guaranteed loans:

Households.....	\$1.3 billion
Agriculture.....	\$3.9 billion
Business.....	\$2.0 billion

These estimates almost certainly understate the actual subsidies to the sectors for many of the reasons noted above. The subsidy calculations do not consider the lower fees, longer grace periods, or longer loan maturities available from the Government. Nor do they consider the case where the Government would make a loan, but the private sector would not.

III. Major Reasons for Poor Control Over Credit Programs

There are four principal interrelated reasons for the growth in Federal credit program levels since 1970. First, previous Administrations and Congress treated credit as virtually a free good, or at best, an inexpensive substitute for a grant or direct purchase. Second, the budgetary controls over both the amount and subsidy of Federal credit activity were and are inadequate. Third, legislation was frequently designed to provide greater amounts of credit or higher subsidies than necessary to achieve the stated goals. Many of the goals are poorly defined and thus encourage an excessively broad use of Federal credit resources. Fourth, poor program management may mean that program levels are higher than necessary. The full costs of Federal credit activity are not charged borrowers, thus encouraging greater use of Federal credit.

A. Credit as Free Good

The most pervasive myth surrounding Federal credit activity is that it is a free good. The myth arises in several particular sets of circumstances. Perhaps the most important set of circumstances is when the Government provides a loan guarantee. The loan guarantee is a contingent liability of the Government that may or may not become an actual liability. In the case that it does not become an actual liability, which is to say there is no default on the part of the borrower, it may appear that the loan guarantee is a free good in spite of the fact that it reallocates credit and hence real resources from one sector of the economy to another.

Another set of circumstances in which Federal credit activity appears to be a free good is one in which the Government lends money at the Treasury borrowing rate, thus incurring no explicit cost. Another set of circumstances is one in which Federal agencies earn nominal profits. Supporters of the Ex-Im Bank, the Tennessee Valley Authority, and other Federal agencies have routinely made this last claim.

As noted in the section on subsidies above, there is a significant opportunity cost to the private sector in Federal credit activity even if the Government makes loans at the Treasury borrowing rate. When the Government finances a direct loan by taxation, the taxpayer bears a burden and gives up real resources. When a direct loan is financed by borrowing, less credit is available to other private borrowers and, thus, they must forgo real resources, just as in the tax finance case. Therefore, however the loan is financed, someone must be forgoing the real resources that are transferred to the favored borrower. A loan guarantee has this same effect of making less credit and real resources available to other private borrowers, even though the funds do not transfer through the Government at all.

A second fallacy involves those agencies with significant equity held by the Government. One reason that some lending agencies make nominal profits is that they value Government equity at zero opportunity cost. Eximbank, for example, is required to take its average cost of capital into account when setting its lending rate. The billion dollars of U.S. Treasury equity, as well as retained

earnings of \$1.9 billion, are usually valued at zero cost. Thus, although Eximbank's latest marginal borrowing cost is above 10.5%, it lends to some borrowers at 10.0%.^{1/} It can afford this low rate at least in part because the cost of equity is assumed to be zero. The cost to the Government, however, of \$2.9 billion on which it receives no rate of return is roughly \$300 million annually at today's interest rates.

B. Inadequate Budgetary Controls

The treatment of credit as a free good is reflected in the inadequate budgetary controls over both the volume of lending and the subsidy amounts.

1. Problems in the Unified Budget

The unified budget, with its necessarily strict adherence to cash flows, is inadequate as the sole management control tool for credit programs. It does not measure economic subsidies. It cannot provide control over loan guarantee programs as these do not involve outlays except in the case of default. It can, however, be made to reflect Federal direct loans more accurately than it does now. A major improvement in the unified budget would be to put the transactions of the off-budget FFB into the budget and to attribute the outlays to the agencies that use the FFB and are therefore responsible for the FFB's direct loans to the public.

Size and Growth of FFB Spending

The problem of control posed by the present budgetary treatment of programs financed by the FFB applies to a large volume of Federal activity. As shown in the following table, FFB outlays more than doubled from \$6.4 billion in 1975, the first full year of operation, to \$14.1 billion in 1982. By 1983, they decline to \$10.4 billion.

^{1/} The average Eximbank lending rate for the last year is above 10.5%; it lends only to least developed countries at a rate of 10.0%. However, until this Administration, Eximbank's marginal lending rate had been significantly below its marginal borrowing rate.

Table 7.--OFF-BUDGET OUTLAYS
(dollars in billions)

<u>Fiscal Period</u>	<u>FFB</u>	<u>Other</u>	<u>FFB as a Percent of Total</u>
1974.....	\$ 0.1	\$ 1.3	7%
1975.....	6.4	1.7	79
1976.....	5.9	1.4	80
Tn.....	2.6	-0.8	144
1977.....	8.2	0.5	94
1978.....	10.6	-0.3	102
1979.....	13.2	-0.7	106
1980.....	14.5	-0.3	102
1981.....	21.0	—*	100
1982.....	14.1	3.2	82
1983.....	10.4	2.0	84
1984 est.	11.3	2.7	80
1985 est.	10.4	0.8	93
1986 est.	9.0	1.1	89

As Table 7 shows, FFB outlays have comprised at least 80% of the Federal Government's off-budget outlays since 1976. The problem of off-budget outlays is thus primarily a problem of the budgetary treatment of programs financed by the FFB. Under the July 1983 budget estimates, OMB projects FFB outlays to decline from \$11.3 billion in 1984 to about \$9.0 billion in 1986, primarily due to proposed reduced program levels by the Farmers Home Administration. Achieving these reductions in off-budget outlays will be difficult. One major reason is that the off-budget FFB outlays are not subject to the same budgetary review and control they would be if they were counted in the budget totals and charged to the agencies that are responsible for them.

The magnitude of off-budget FFB activity can be seen in terms of its asset holdings as well as its outlays. The assets held by the FFB at the end of June 1983 are summarized below:

Table 8.--FFB ASSET HOLDINGS
(in billions of dollars)

Agency debt	
On-budget agencies.....	\$27.4
Off-budget entities.....	<u>1.3</u>
Subtotal.....	28.7
Loan assets purchased from agencies.	58.6
Loans directly made to the public...	<u>44.7</u>
Subtotal.....	103.3
Total.....	<u>132.0</u>

As of the end of June 1983, the FFB had financed agency operations amounting to a net total of \$132.0 billion. These are the cumulative results, from 1974 to the present, of FFB purchasing agency debt securities, buying agency loan assets, and making agency-guaranteed direct loans to the public. The FFB's purchases of agency debt are properly accounted for now. An agency incurs outlays when it spends the proceeds of its borrowing, not when it borrows. However, the \$103 billion of loan asset purchases and direct loans made to the public constitute Federal outlays that were not recorded in the budget because the FFB is itself off-budget.

This \$103 billion of off-budget outlays had to be financed by Treasury borrowing, just as did the budget deficit. It therefore added \$103 billion to the debt borrowed from the public and to the amount of debt outstanding that is subject to the statutory limit. Since agency debt is generally not subject to the statutory limit, the replacement of agency debt in the market by Treasury debt also added to the total amount of debt subject to limit. Thus, because of the FFB, these agency issues and guarantees are now properly reflected in the total public debt, and the Administration has publicly supported taking the next step and including these activities in the budget as well.

The FFB's financing is largely concentrated in a few agencies. As shown below, in 1982 the Farmers Home Administration and the Rural Electrification Administration accounted for more than two-thirds of FFB outlays, and the foreign military sales credit program accounted for nearly half of the remainder.

Table 9.--MAJOR USERS OF THE FFB
(in billions of dollars)

	<u>1982</u>
Farmers Home Administration.....	\$4.9
Rural Electrification Administration....	4.5
Foreign military sales credit.....	2.3
Student Loan Marketing Association.....	0.7
Low-rent public housing.....	0.7
Other.....	<u>1.0</u>
Total.....	14.1

The use of the FFB is the greatest evasion of the cash flow concept of the unified budget. The key improvement that we could make in our present budget process is, therefore, to attribute the cash outlays of the FFB to the appropriate agencies and programs in the unified budget. The overall budget totals would then measure more accurately the true size of Government outlays and the Government deficit. Attribution of the FFB's outlays to each responsible agency would improve control over the allocation of credit resources among different uses, agency-by-agency and function-by-function. Alternative programs cannot be compared with each other unless their activities are consistently and fully measured. Failure to correct the current treatment of FFB activity will continue the distortions, abuses, and lack of control over Federal lending that have plagued proponents of sound budget management for years.

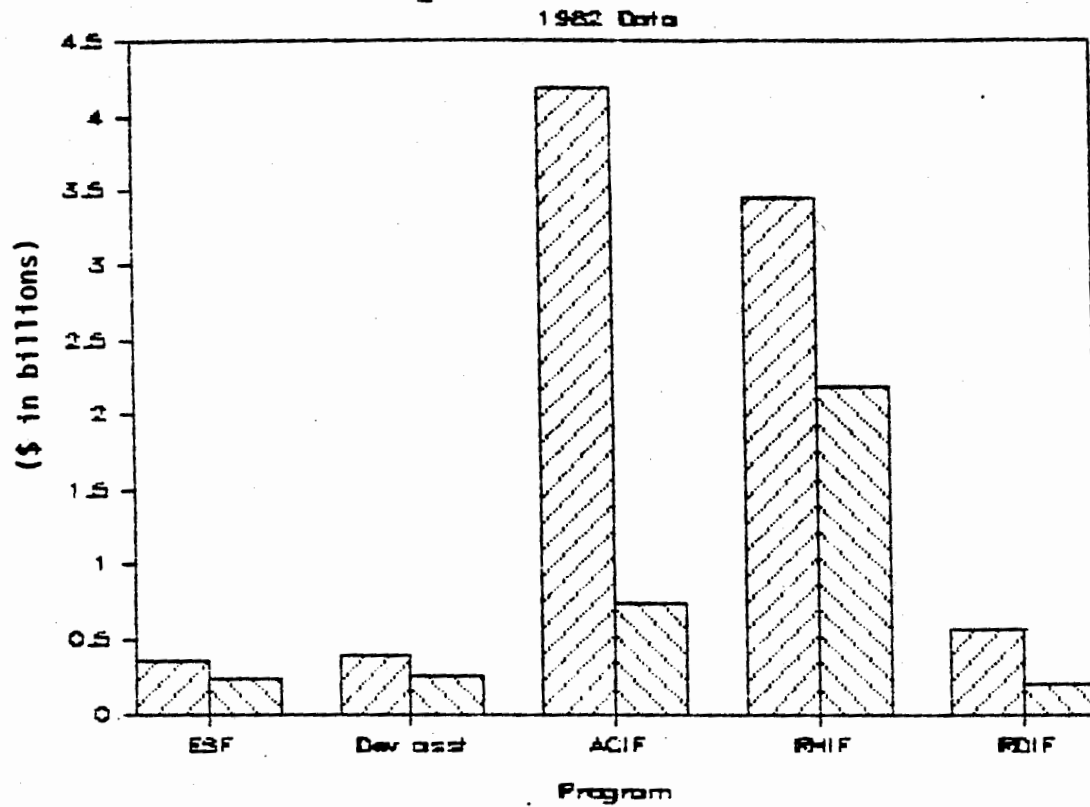
For all of the above reasons, the Administration supports the basic intent of S. 1679, "The Honest Budgeting Act of 1983." Despite its importance, this bill would not by itself provide an adequate mechanism for controlling the credit of the agencies that use the FFB. Such a mechanism requires subsidy estimates and credit budget control, as discussed below.

2. Problems with the Federal Credit Budget

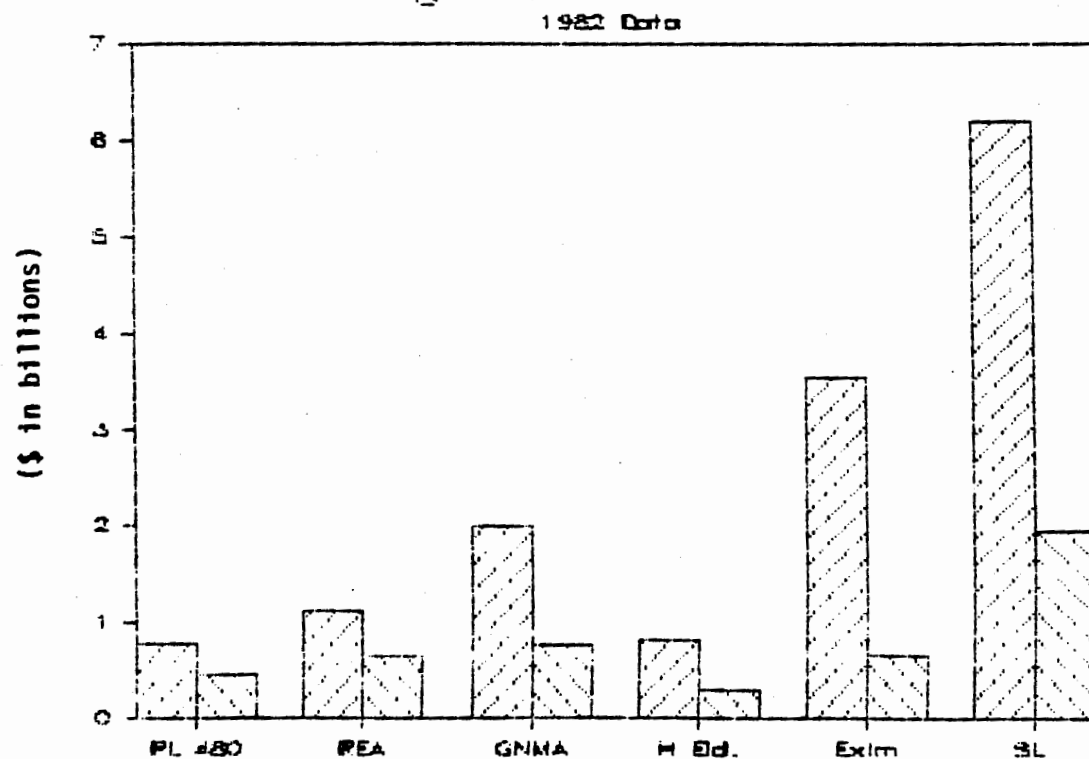
Control over Federal credit activity is most effective at the point when the Government is obligated to provide a direct loan or a guarantee. This fundamental concept is the underpinning of the credit budget and has been the focus of Administration planning. The Administration has consistently proposed gross limitations in its internal planning ceilings on the volume of new direct loan obligations and guaranteed loan commitments.

Controlling the volume of new credit activity, however, is only a half step in controlling its effects on the economy. The other half is controlling the amount of subsidy provided by the credit. The bar graphs in Chart 1 provide comparisons for some key direct loan programs between the level of new direct loan obligations and the estimated present value subsidies of those direct loan obligations. As the graphs illustrate, a low level of direct loan obligations does not necessarily mean a relatively low level of subsidy, although subsidies and obligations tend to move together.

Credit Program Levels & Subsidies



Credit Program Levels & Subsidies



An improved credit budget, therefore, should have two points of control. First, the aggregate ceilings for new direct loan obligations and guaranteed loan commitments should be binding. Ceilings that bind are, at a minimum, necessary to curb the growth of Federal credit activity by forcing some degree of trade-off between the various types of Federal credit activity.

Second, a common metric of subsidy is necessary. Without this measure, proponents of guarantee programs, for example, will argue that they should be subject to higher limits than direct loan programs. Direct loan programs that charge higher interest rates than other direct loan programs will argue that they in turn should be subject to higher loan limitations than these other programs. Both the lack of a binding ceiling and the absence of a formal measure of subsidy contribute to the poor control over Federal credit activity.

C. Defective legislation

A third reason for inadequate control over Federal credit activity is programmatic. Authorizing legislation for credit programs is frequently inadequate or defective relative to Administration policy. Among the frequent major flaws are:

- Program beneficiaries that are ill-defined. This allows loan program administrators a moveable feast. For example, the Rural Development Loan Fund of the Department of Health and Human Services, authorized under the Economic Opportunity Act, was initially developed to increase income and employment opportunities for low income rural residents. In fact, many of the actual recipients of the program live in urban areas.
- Interest rates and fees that are set in legislation and bear no relationship to market forces. The Rural Electrification Administration Act, for example, had its interest rate set at 2% at the time of its enactment in the 1930's, which was above the then prevailing prime rate. It hardly reflects recent prime rates, however. MarAd's ship construction guarantee fee, as another example, is set by law between 1/2% and 1% per annum.

The last example also indicates the need for a measure of the subsidies in direct loans and loan guarantees as a point of control. By specifying the interest rate rather than the degree of subsidy, Congress has no idea what the subsidy will be in the future. As interest rates rise, so do subsidies, without any Congressional review or decision.

D. Poor management

The final overlapping reason for the poor control over Federal credit programs is poor administration. Rudimentary risk analysis, faulty credit standards, and defective credit approval processes result in higher defaults and unnecessary program costs. Although it is not possible to place a dollar value on the amounts of delinquent or defaulted loans due to poor management practices, it is no doubt significant. In September 1983, the principal on delinquent loans owed the U.S. Government was over \$11 billion.

IV. The Administration's Objectives and Policy Issues

In March 1981, the Administration laid out an ambitious program to redress some of the flaws in Federal credit programs. The Administration's broad objectives were:

- to reduce the impact of Federal credit activity on the nation's financial markets;
- to improve control over the allocation of credit and reduce its costs to the Government; and
- to improve program management.

In the aggregate, the Administration has had only limited success in reducing the impact of Federal lending activity in the nation's financial markets. The participation ratio of net Federal and federally assisted lending (disbursements less receipts) to total funds advanced by nonfinancial sectors has increased from 20.2% in 1981 to an estimated 25.0% in 1983.

The major credit policy issues given these objectives are:

- how to improve budgetary controls over Federal credit activity; and
- how to improve credit program administration.

A. Improved Budget Legislation

Controlling credit activity will continue to be a sizeable problem for the Administration unless credit is formally integrated into the congressional budget process. Attributing the outlays of agencies that use the off-budget FFB back to those agencies through legislation such as is required in S. 1679, is an important step. But, as long as lending aggregates are not binding, there is a strong incentive to continue the practice of replacing on-budget outlays with off-budget lending programs.

Recently, legislation was proposed in the Senate to amend the Congressional Budget Act of 1974 in order to provide a statutory basis for including Federal credit totals in the budget resolution. S. 1582 "The Federal Credit Control Act" would "establish procedures for setting targets and ceilings in the congressional budget process for direct loan authority and loan guarantee authority" This Act would incorporate credit activity into the Congressional budget process by establishing guidelines for credit budget aggregates and functional totals similar to those for budget authority, outlays and receipts.

Major provisions of the bill would:

- require that the first concurrent resolution on the budget include appropriate levels of new direct and guaranteed loan authority and attribute the authority level for each function;
- require that the conference report on the budget resolution include an allocation of new direct and guaranteed loan authority by Senate and House Committee;

- require that any legislation specifying new levels of direct and loan guarantee authority shall not be considered until the first budget resolution is passed;
- provide for a point-of-order against bills that exceed the totals in the second budget resolution;
- extend rescission and deferral procedures to direct and loan guarantee authority; and
- specify that the President's budget proposal include new direct and guaranteed loan authority and that the Administration submit current services estimates for credit.

Legislation has also been proposed in the House (H.R. 2076, "The Federal Lending Oversight and Control Act") that would include binding credit aggregates in the credit process. There are four major differences between the Senate and House version.

- The Senate introduces new credit concepts -- direct loan authority and loan guarantee authority. This change recognizes that authority to make and guarantee loans must be provided before obligations and commitments can be made. Authority, therefore, should be the point of congressional control. Direct loan authority and loan guarantee authority are made analogous to budget authority and are necessary to extend the procedures of the Impoundment Control Act to credit activities.
- The Senate version of the bill would extend the procedures of the Impoundment Control Act to both direct and loan guarantee authority whereas the House version would provide impoundment control only for loan guarantee authority.
- S. 1582 specifies that limitations must be included in appropriations bills or else be subject to a point of order. This provision enables Congress to review direct loan programs and establish appropriate activity levels each year similar to the process for discretionary spending programs.
- The Senate bill requires that the President's budget include estimates of the outlays that will result from defaults in loan guarantee programs. In addition, it specifically defines direct loan authority in such a way that it excludes the authority to purchase guaranteed loans that are in default by the Federal Government.

In addition, the House Rules Committee Task Force on revising the Congressional Budget Process is also considering proposals to integrate credit into the Congressional Budget Process and to put the FFB on budget.

In principle, the Administration should support the general provisions of both bills to amend the Congressional Budget Act, although the Administration would want to propose technical amendments to both bills. Integrating credit in the congressional budget process is an important step toward controlling Federal

credit activity. A key stumbling block has been the fear of opening up the Congressional Budget Act to changes because of other controversial issues that would arise. These issues include general enforcement procedures and the roles of the budget committees, as well as proposals for a two year budget cycle and a capital budget.

Enactment of the basic provisions of S.1582 and H.R.2076 would not be a credit panacea, however. In fact, non-binding credit totals by function have been included in the budget resolution for several years--albeit at relatively high levels. In addition, the FY 1983 budget resolution contained some of the other credit enforcement mechanisms that would be required under the proposed reforms of the Budget Act. Credit programs were allocated by committee and subject to the same point of order provision as outlays. With some exceptions, the resolution also called for points of order against legislation that provided lending authority not subject to appropriations. Despite the point of order provision, the Congress breached the supposedly binding credit total--just as it breached the "binding" outlay and budget authority totals for 1983.

B. Administration Initiatives

One of the major gaps in controlling Federal credit activity is a clear and agreed-upon set of guidelines for practical use in management and legislation. The only existing statement is OMB Circular No. A-70, which was issued in 1965, although a revised draft of A-70 was prepared in 1974, but never issued. The present Circular provides out-of-date guidance on the administration of credit programs and the Executive branch's policy on legislation. It is in need of revision due to the changes in financial markets and credit programs since 1965.

A revised Circular should be designed as a clear, agreed upon set of Government-wide guidelines on the administration of credit programs. This guidance would also shape the Executive branch's reaction to both proposed legislation authorizing new credit programs and amendatory legislation for existing credit programs. Furthermore, it would provide the basis for Executive branch initiatives regarding new programs and amendments to existing programs.

Reissuing OMB Circular No. A-70 is a major policy initiative. In order to make the Circular more effective, it should be endorsed by the CCEA. A full draft of Circular A-70 is now under preparation by OMB staff with an expected completion date of February 1984. When the draft A-70 is completed, it will be reviewed by the CCEA.

In the interim, the following principles, which have been proposed for inclusion in A-70, are recommended for CCEA consideration and approval.

1. Interest Rates on New Direct Loan Obligations. There is no updated policy on the interest rates that should be charged for direct loan obligations. Interest rates range from 2% in a few cases to rates marginally above the yield to maturity on Treasury instruments. Low interest rates may frequently reflect the intended program goal of providing interest rate subsidies. In many cases, however, where the interest rate is specified, the subsidies are greater than

intended when the legislation was enacted. By specifying the interest rate rather than the subsidy, the subsidy is allowed to fluctuate with movements in market interest rates, without control or oversight.

One means of regaining control over interest rate subsidies is to create benchmark interest rates that could be used by lending agencies. In line with the above discussion on subsidies, the appropriate benchmark rate will depend on the interest rate charged a particular borrower for a given transaction by private financial intermediaries.

The recommended A-70 principle, therefore, is that lending agencies should calculate these benchmark rates, loan category by loan category, through comparison with the interest rate the private market would charge. As an example, the Rural Electrification Administration could use the yields to maturity on various categories of public utility bonds as one series of benchmark rates. The yield to maturity on Treasury instruments would not be an appropriate benchmark rate, as it is a risk-free rate.

Subsidies could be provided borrowers through lending at a specified discount below the market benchmark rate. In our above example, if the appropriate benchmark rate was the yield on Baa public utility bonds, and that yield was 14%, then an appropriate subsidy might be provided by lending at 90% of the benchmark rate. This would allow significantly greater control over interest rate subsidies than the previous practice of specifying a lending rate that does not move with market rates.

2. Guarantee Fees. There is no updated policy on the level of fees charged for guarantees. In some cases, these fees are set in law and bear no relationship to either the administrative and servicing costs to the agency or the expected liability in the event of default. This means the Government bears costs that frequently lead to unintended subsidies.

The recommended A-70 principle is that guarantee fees should cover the expected Government liability in the event of default as well as administrative and servicing costs. This will require loan guarantee program administrators to estimate the expected Government liability of their loan guarantee portfolios. The Government would still be providing one form of subsidy in that it would be bearing risks that the private sector was unwilling or unable to bear.

In cases where it was deemed appropriate to provide further subsidies, the subsidy could be defined through reference to the expected liability of the Government. The guarantee fee would be expected to cover a portion (e.g., 80%) of the Government's liability in the event of default in a loan guarantee portfolio. The guarantee fee would still cover the full administrative and servicing costs.

Agencies would also have to charge fees in a manner that would allow the adjustment of the fees in light of conditions that increased the risk of default. As an example, fees could be charged on an annual basis over the life of the guarantee rather than collected "up-front" when the guaranteed loan commitment is made.

3. Interest Rates on Guaranteed Loans. There is no updated policy on the interest rate that should be charged by private lenders for guaranteed loans.

In some cases, legislation or agency policy requires that borrowers be protected against "excessive costs." As an example, there is a ceiling on the interest rates that commercial banks who use an SBA guarantee may charge borrowers. The concern is that lenders covered by the guarantee may possibly benefit from monopolistic lending situations.

The recommended A-70 principle is that the Government should offer guarantees for loans by private lenders in a manner that enhances competition among lenders with respect to the effective interest rate charged the borrower. For example, potential lenders could be required to bid for the guaranteed loan transaction in order to assure the borrower of the lowest possible cost.

4. Co-Insurance. Agencies frequently offer guarantees to private lenders of 100% of the principal and interest. With respect to credit risk, the guaranteed loan is virtually the equivalent of a Treasury security. This may encourage private lenders to be less diligent in offering and servicing loans protected by the guarantee. (We are not here considering guaranteed obligations of a type normally financed in the investment securities market.)

In order to encourage greater private sector participation in guaranteed transactions, Federal guarantee coverage should be limited, to significantly less than 100%. Moreover, the guarantee should be structured in such a way as to preclude the Government from bearing more risk than the nominal guarantee cover would suggest. One example of greater real guarantee cover occurs when the Government's security in the event of default is subordinated to that of the private lender. Another example is when the unguaranteed portion of the loan is repaid ahead of the guaranteed portion. Thus, in the later years of the loan, the Government bears 100% of the risk that outstanding principal and interest will not be paid.

The A-70 principle would state that (i) private sector lenders should bear a "significant" portion of the risk of default, and (ii) in the event of default, the Government's claim or assets should not be subordinated to that of private lending. A "significant" portion could be defined as at least 20% of the risk of default.

5. Guarantees of tax exempt securities. Federal direct or indirect guarantees of tax exempt securities offer investors in those guarantees double benefits: they pay no Federal tax and they bear no risk. This type of security is therefore a more attractive investment than U.S. Treasury instruments.

A-70 would confirm the principle that Federal agencies should not offer direct or indirect guarantees for securities that benefit from tax exempt status, except when required to do so by law.

Credit Management Initiatives

The general principles in A-70 should be buttressed by the credit management initiatives of Reform 88. These initiatives, which are under the policy direction of OMB, include:

- A Federal debt write-off policy and procedures project, directed by the Treasury Department, which is to develop uniform standards for assessing the status of delinquent loans. The deadline for this report is March 30, 1984.

- A credit standards project, directed by the Treasury Department, the task of which is to develop a series of uniform standards for extending credit. The deadline for the report on this project is December 1983.
- A risk analysis project, directed by the Treasury Department, which is to develop a model to evaluate the risks associated with lending programs. The deadline for a report on this project is December 31, 1983.

Other projects include credit approval projects led by the Veterans Administration (loans to individuals) and the Commerce Department (loans to businesses).

One example of how the principles of A-70 and the credit management initiative complement one another is the connection between the A-70 principle on the level of guarantee fees and the credit management projects on risk analysis and debt write-off policies and procedures.

The A-70 principle with respect to guarantee fees is that these fees should cover the risks that contingent liabilities may become actual liabilities. In order to implement this principle, a consistent and uniform method of risk evaluation is needed. The objective of the risk analysis task force is to develop such a model. Equally necessary is a method for assessing the quality of the loan assets acquired through defaulted guaranteed loans. The objective of the debt write-off project is to develop a Federal policy for writing-off debt owed the Federal Government and to establish uniform write-off criteria and procedures for Government-wide application.

In addition to the above recommended improvements to Federal credit policy, several other control mechanisms need to be examined.

C. Other Initiatives

1. Expand privatization efforts. The Administration has initiated efforts to privatize several Government-sponsored enterprises (GSE's), most notably FNMA, FHLMC, and SLMA. Although these efforts have had only limited success to date, they need to be continued. The most significant privatization problem encountered so far has been the difficulty in severing Government ties to a GSE with negative net worth (FNMA). GSEs have a natural reluctance to sever their ties, but this tendency is particularly strong when severance of ties would result in bankruptcy. Although FNMA may be a special case, a principle that needs to be followed in all cases is to share the costs of privatization between the private stockholders and the taxpayers. Until strategies that will fairly split these costs between shareholders and taxpayers can be developed, the limits on the authorized activities of GSEs should be contracted where possible.

2. A Unified Perspective on Banking-Type Activities. One major difficulty with credit control is that there is no explicit trade-off between the unified budget and the credit budget. The United States Government engages in a wide range of borrowing and lending operations akin to banking services. When the joint efforts of the Treasury, the FFB, and the on- and off-budget lending

agencies are taken as a whole, a picture emerges of the Federal Government as a net borrower from or lender to the public in any given year.

This perspective might be useful in fashioning credit control policies in a number of ways. One version is recommended in the Committee for Economic Development report, Strengthening the Federal Budget Process. The report notes that the real point of comparison between normal expenditures and lending programs is not the dollar outlay but the subsidy component in the lending program. The report recommends that the Administration place greater emphasis on measuring the interest subsidy elements in Federal loans and loan guarantees. The report also recommends "careful further exploration of the proposal to put all Federal credit and guarantee activities in a national lending fund that would not be allowed to subsidize transactions or take risks on its own account but would receive reimbursements from Government agencies equivalent to the cost of providing subsidized loans or guarantees on behalf of these agencies."

This approach, of course, presents conceptual and methodological problems. The difficulty of measuring subsidies is apparent. Nonetheless, the CED proposal merits examination as a long run alternative to the requirement of having separately a unified budget dependent on cash flow measurements and a credit budget dependent on the gross level of direct loan obligations and guaranteed loan commitments.

3. Implement 1981 CCEA Recommendations. In addition to the systemic improvements recommended in part IV of this report, a reform initiative to evaluate lending programs on a sector by sector basis is necessary. During the fall of 1981, OMB staff prepared five briefings on Federal credit for the CCEA Working Group on Federal Credit Policy. The briefings made specific recommendations for major credit programs in four sectors: agriculture, business, housing, and individuals. Many of the recommendations, however, have not been carried out. The CCEA should consider the best means of implementing these recommendations, the principles of several of which are summarized below:

Credit Assistance to Business

Principle. The private market is the best means of allocating credit to businesses.

Credit Assistance to Agriculture

Principle. The agricultural sector will be served best by a sustained effort to develop independent, unsubsidized sources of funds. The long-term dependence of the agricultural sector on Federal credit assistance has removed a large proportion of the industry from the discipline of the marketplace. This has contributed to a range of problems, including (1) maintenance of inefficient farms that rely on Federal subsidies; (2) little growth in private, non-subsidized sources of funds for agricultural uses; (3) over-investment in capital assets; and (4) rapid increases in land prices, which increase start-up costs for new farmers.

Credit Assistance to Housing

Principle. The Federal housing objectives of the 1930's and 1940's may not be relevant for present and projected housing credit market conditions. One objective should be to strengthen the ability of the private sector to provide adequate credit for homeownership. Deregulation of thrift institutions and the development of innovative mortgage financing vehicles have assisted that process. Changes in Federal involvement in the mortgage markets to revise artificially restrained or augmented housing capital supply are needed.

Credit Assistance to Individuals

Principle. Existing credit assistance to individuals should be revised and guided by several assumptions. First, given that several programs that assist individuals operate like entitlements, credit may not be the most efficient mechanism for providing subsidies. Second, eligibility criteria are not specific enough to exclude recipients who have borrowing options other than the Government. Third, the private sector could provide some functions as well or better than the Government.

V. Summary

The CCEA is asked to endorse a two-pronged approach to controlling Federal credit activity. The first approach is to support, in an active manner, both Senate and House legislation that will subject Federal credit activity to the rigors of the budget process by setting binding limits on new direct loan obligations and guaranteed loan commitments.

The second approach is to improve credit program management. OMB Circular No. A-70, Federal Credit Policy, would be drafted by February 1984, consistent with the general principles noted in this paper and subject to further review by the CCEA. The credit management initiatives of Reform 88 are expected to buttress the policies outlined in A-70.

LIST OF TABLES

	<u>Page</u>
Appendix Table 1. Net Federal Credit Activity and Total Funds Advanced and Raised.....	1
Appendix Table 2. Net Federal Credit Activity and Total Funds Raised	2
Appendix Table 3. Direct Loan Obligations and Guaranteed Loan Commitments -- 1970-1982.....	3
Appendix Table 4. Net Direct Loan Activity by Sector 1975-1982.....	5
Appendix Table 5. Net Guaranteed Loan Activity by Sector 1975-1982..	6
Appendix Table 6. Net Government-Sponsored Enterprise Activity by Sector -- 1975-1982.....	7
Appendix Table 7. Net Federal Credit Activity by Sector -- 1975-1982	8
Appendix Table 8. Credit Program Subsidies.....	9

Appendix Table 1.--NET FEDERAL CREDIT ACTIVITY AND TOTAL FUNDS ADVANCED AND RAISED
(dollars in billions)

	1970	1971	1972	1973	1974	1975	1976 ^{1/}	1977	1978	1979	1980	1981	1982	Estimates	
														1983	1984
Direct loans: 2/															
On-budget.....	3.0	2.0	3.0	0.9	3.3	5.8	5.3	2.6	8.6	6.0	9.5	5.2	9.1	5.2	(0.3)
Off-budget.....	---	---	---	0.1	0.8	7.0	9.3	9.0	11.2	13.6	14.7	20.9	14.3	14.4	10.4
Total direct loans.	3.0	2.0	3.0	1.0	4.1	12.8	14.6	11.6	19.8	19.6	24.2	26.1	23.4	19.6	10.1
Guaranteed loans.....	8.0	16.1	18.9	16.6	10.3	8.6	11.0	13.5	13.4	25.2	31.6	28.0	20.9	55.8	48.9
Government-sponsored enterprise loans (GSEs)	5.2	-1.7	0.1	8.5	11.2	5.6	3.0	11.7	25.2	28.1	24.1	32.4	43.4	55.5	56.2
Advanced under Federal auspices.....	17.2	16.5	22.0	26.1	25.5	27.0	28.6	36.8	58.4	72.9	79.9	86.5	87.7	130.9	115.2
Total funds advanced in U.S. credit markets 3/.	93.6	125.7	151.9	198.2	187.5	177.9	307.9	308.3	383.4	426.4	366.4	427.2	408.7	N/A	N/A
Participation ratio (%).....	16.1	13.1	14.5	13.2	13.6	15.2	9.3	11.9	15.2	17.1	21.8	20.2	21.5	N/A	N/A
Federal borrowing from the public.....	5.4	19.4	19.4	19.3	3.0	50.9	100.9	53.5	59.1	33.6	70.5	79.3	135.0	216.0	194.0
Guaranteed borrowing....	8.0	16.1	18.9	16.6	10.3	8.6	11.0	13.5	13.4	25.2	31.6	28.0	20.9	55.8	48.9
Government-sponsored enterprise borrowing...	4.5	-2.1	0.7	10.6	10.9	5.3	5.5	12.0	21.4	21.9	21.4	34.8	43.8	53.5	55.0
Federal and federally assisted borrowing.....	17.9	33.5	39.1	46.5	24.2	64.8	117.4	79.0	93.9	80.7	123.5	142.1	199.7	325.3	297.9
Total funds raised in U.S. credit markets 2/.	93.6	125.7	151.9	198.2	187.5	177.9	307.9	308.3	383.4	426.4	366.4	427.2	408.7	N/A	N/A
Participation ratio (%).....	19.1	26.6	25.7	23.5	12.9	36.4	38.1	25.6	24.5	18.9	33.7	33.3	48.9	N/A	N/A

1/ Includes Transition Quarter

2/ Data are from the FY 1984 Budget, released in January 1983. Loans are measured on a net basis (disbursements less repayments).

3/ Actuals from Federal Reserve Board Flow of Funds Accounts. Nonfinancial sectors, excluding equities.

**Appendix Table 2.--NET FEDERAL CREDIT ACTIVITY AND
TOTAL FUNDS RAISED UNDER FEDERAL AUSPICES
(dollars in billions)**

	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u> ^{1/}	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>Estimates</u>	
														<u>1983</u>	<u>1984</u>
Federal borrowing for direct loans:															
On-budget.....	3.0	2.0	3.0	0.9	3.3	5.8	5.3	2.6	8.6	6.0	9.5	5.2	9.1	5.2	(0.3)
Off-budget.....	---	---	---	0.1	0.8	7.0	9.3	9.0	11.2	13.6	14.7	20.9	14.3	14.4	10.4
Total direct loans.....	3.0	2.0	3.0	1.0	4.1	12.8	14.6	11.6	19.8	19.6	24.2	26.1	23.4	19.6	10.1
Guaranteed borrowing.	8.0	16.1	18.9	16.6	10.3	8.6	11.0	13.5	13.4	25.2	31.6	28.0	20.9	55.8	48.9
Government-sponsored enterprise borrowing	4.5	-2.1	0.7	10.6	10.9	5.3	5.5	12.0	21.4	21.9	21.4	34.8	43.8	53.5	55.0
Total, Federal and federally assisted borrowing attributable to credit activity ^{3/}	15.5	16.0	22.6	28.2	25.3	26.7	31.1	37.1	54.6	66.7	77.2	88.9	88.1	128.9	114.0
Total Federal and federally assisted borrowing ^{2/}	17.9	33.5	39.1	46.5	24.2	64.8	117.4	79.0	93.9	80.7	123.5	142.1	199.7	325.3	297.9
Participation ratio (%) ^{3/}	86.6	47.8	57.8	60.6	104.5	41.2	26.5	47.0	58.1	82.7	62.5	62.6	44.1	39.6	38.3

^{1/} Includes Transition Quarter.

^{2/} Federal and federally assisted borrowing (Federal borrowing from the public, borrowing for guaranteed loans, and Government-sponsored enterprise borrowing).

^{3/} Net direct loan outlays are treated as if they were financed by direct Federal borrowing from the public.

Appendix Table 3.--DIRECT LOAN OBLIGATIONS AND GUARANTEED LOAN COMMITMENTS 1970-1982
(in millions of dollars)

	1970	1971	1972	1973	1974
Direct Loan Obligations:					
On-budget.....	10,444	10,451	8,498	8,749	13,351
Off-budget:					
FFB.....	---	---	---	---	128
Other.....	---	---	2,967	4,546	5,826
Total gross direct loan obligations.....	10,444	10,451	11,465	13,295	19,305
Less loan assets held by the FFB.....	---	---	---	---	2
Less repurchases of loan assets from the FFB.....	N/A	N/A	N/A	N/A	N/A
Total net direct loan obligations.....	10,444	10,451	11,465	13,295	19,303
Guaranteed Loan Commitments					
Gross guaranteed loan commitments.....	27,920	N/A	44,808	36,411	35,276
Less secondary guaranteed loans.....	438	N/A	3,518	3,607	4,375
Less guaranteed loans held as direct loans by:					
FFB.....	---	---	---	---	128 1/
GNMA.....	---	N/A	7,144	4,778	1,528
Total primary guaranteed loans.....	27,482	38,547	34,146	28,026	29,245
emo: Callable capital.....	N/A	N/A	N/A	N/A	N/A

Appendix Table 3.--DIRECT LOAN OBLIGATIONS AND GUARANTEED LOAN COMMITMENTS 1970-1982 (continued)
(in millions of dollars)

	1975	1976	1977	1978	1979	1980	1981	1982
Direct Loan Obligations:								
On-budget.....	23,044	20,654	25,312	35,233	33,924	39,608	40,857	40,057
Off-budget:								
FFB.....	6,958	13,130	19,042	21,716	16,045	22,188	30,269	26,232
Other.....	4,907	1,555	1,467	1,382	1,434	1,395	1,276	1,284
Total gross..	34,909	35,339	45,821	58,331	51,403	63,191	72,402	67,573
Less loan assets.....	5,055 ^{2/}	2,036 ^{3/}	7,116 ^{3/}	8,716 ^{3/}	10,911 ^{3/}	12,110	15,208	12,630
Less repurchases.....	N/A	N/A	N/A	N/A	N/A	N/A	N/A	7,387 ^{4/}
Total net....	29,854	33,303	38,705	49,615	40,492	51,081	57,194	47,556
Guaranteed Loan Commitments								
Gross Guarantees.....	50,172	51,578	90,172	96,536	146,453 ^{5/}	170,164 ^{5/}	152,729	118,325
Less secondaries.....	5,905	9,188	17,255	17,636	42,360	64,393	44,113	36,382
Less GL held as DL:								
FFB.....	6,958	13,130	19,042	21,716	16,045	22,188	30,269	26,232
GNMA.....	6,842	3,113	2,092	2,197	2,053	2,195	1,832	1,985
Total primary...	30,467 ^{6/}	26,147 ^{6/}	51,783 ^{6/}	54,987	85,995 ^{5/}	81,388 ^{5/}	76,515	53,726
emo: Callable capital..	N/A	N/A	737	882	883 ^{5/}	830 ^{5/}	1,133	2,340

Source: Special Analysis on Federal Credit Programs, 1970-1983.

/ This number reflects the commitments for FFB to disburse loans, consistent with current accounting practices. It is not FFB disbursements, which were \$102 million.

/ Estimated from Table E-5, FY 1977.

/ Loan assets were published in FFB table but not deducted from direct loans prior to 1980.

/ Repurchases deducted only since 1982.

/ Published total adjusted for callable capital, which in other years is shown as a memorandum entry.

/ Published totals for primary guaranteed loans included FFB guaranteed loans held as direct loans in 1977 and GNMA indemn and FFB in 1976 and prior years. These data are adjusted for those deductions.

Note: This table does not adjust for programs (Ex-Im Bank, Housing for Elderly or Handicapped, etc.) whose on- or off-budget status changed over the period. If used to present detailed levels of on- and off-budget activity, rather than the totals, those adjustments must be made to the table.

Appendix Table 4. Net Outlays for On & Off-Budget Direct Loans by Sector 1975-1982 ^{1/}
(in millions of dollars)

									est.	
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
Households, Personal Trusts and Nonprofits										
Low-rent public housing.....	(41)	28	(26)	---	---	---	90	(21)	---	---
GNMA Tandes.....	2,327	(260)	(1,258)	(28)	(170)	1,021	4	(239)	(640)	(68)
VA housing.....	17	(158)	(183)	26	253	(5)	124	251	(390)	239
Other housing programs.....	273	648	(191)	270	395	949	2,006	631	(107)	(582)
Subtotal, Housing.....	2,576	258	(1,658)	268	478	1,965	2,224	602	(1,137)	(391)
Education.....	439	525	314	506	530	465	406	641	470	294
Health.....	55	87	49	40	49	18	38	(9)	23	2
Total households.....	3,070	870	(1,295)	814	1,077	2,448	2,668	1,234	(644)	(95)
Business:										
International:										
International assistance.....	401	1,229	1,660	2,379	2,196	2,618	2,327	2,765	3,299	4,697
International development assistance....	407	413	128	10	63	112	166	100	66	64
Export Import Bank.....	1,504	1,207	446	12	309	1,906	2,037	763	915	1,216
Subtotal, Int'l Bus.....	2,312	2,849	2,234	2,421	2,568	4,636	4,530	3,828	4,280	5,977
General:										
Economic development administration.....	4	3	51	204	58	87	72	(104)	(40)	(203)
Interior.....	17	25	35	42	28	17	22	1	---	---
Railroad programs.....	39	159	122	67	86	170	143	55	56	38
Other transportation.....	1	1	1	(73)	(101)	29	35	31	25	36
VA insurance.....	41	20	9	46	48	119	92	(23)	(14)	(14)
Federal Dep. Insur. Corp.....	100	---	---	---	---	306	(45)	274	(51)	(31)
Federal Home Loan Bank Board.....	1,266	203	(1,529)	---	15	582	187	(86)	(48)	(173)
SBA/Bus. loan insur. fund.....	187	1	113	209	210	354	349	393	152	(251)
SBA/disaster loans.....	18	37	34	2,030	862	773	1,100	(371)	(332)	(274)
US Railway Assoc.....	34	372	943	804	738	638	(220)	(42)	(64)	(21)
Nat. Ocean. & Atmos. Admin.....	---	---	---	(1)	8	24	38	---	---	---
Nat. Con. Credit Bank.....	---	---	---	---	---	5	32	---	---	---
Nat. Credit Union Admin.....	---	---	---	6	11	94	1	34	42	34
Treasury.....	(109)	(167)	(30)	(116)	(116)	---	---	---	151	(251)
MarAd.....	---	---	20	---	72	---	---	---	---	---
Subtotal, Gen. Bus.....	1,538	654	(231)	2,218	1,917	3,198	1,306	162	(123)	(1,110)
Utilities:										
Energy.....	---	---	---	---	---	---	---	4	39	38
TVA.....	---	---	---	---	21	68	99	69	57	55
Rural Elec. & Tel. Revolv. Fund.....	651	724	1,821	2,387	2,527	3,356	4,647	4,597	5,998	5,115
Rural Tel. Bank.....	129	126	77	138	125	191	149	102	173	171
Subtotal, Utilities.....	780	850	1,898	2,525	2,673	3,615	4,895	4,772	6,267	5,379
Total Business.....	4,630	4,353	3,901	6,164	7,160	11,549	11,231	8,762	10,424	10,246

Farm Business:

Farmers Home Administration.....	(1,395)	5,078	5,081	7,969	9,280	6,976	8,912	4,164	3,595	646
CCC.....	(446)	625	2,626	2,729	594	(758)	(920)	6,325	4,382	(2,025)
P.L. 480.....	515	793	587	540	610	651	544	590	531	548
Total Farm Business.....	(1,326)	6,496	8,294	11,238	10,484	6,869	8,536	11,079	8,508	(831)

Total Net Sector Direct Loans.....	6,374	11,719	10,900	20,216	18,721	20,966	22,433	21,073	18,238	9,320
Other Direct Loans.. <u>2/</u>	6,426	2,885	633	(420)	894	3,237	3,638	2,377	1,309	751
TOTAL DIRECT LOANS.....	12,800	14,604	11,533	19,796	19,615	24,203	26,073	23,452	19,597	10,071

1/ Source: Special Analysis F, 1976-1983.

2/ Other refers to both other sectors and unattributed FFB activity. Figures for 1976-1984 attribute both loan asset sales and loan guarantee originations back to the responsible agency for the Foreign Military Sales credit program, REA and FmHA. Data could not be disaggregated for 1975. Data for guaranteed loans, presented in Appendix Table 5, has been adjusted accordingly.

Appendix Table 5. Net Loans Guaranteed Loans by Sector 1975-1982 ^{1/}
(in millions of dollars)

	est.									
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
Households, Pers. Trusts, and Nonprofits										
Low-rent public housing.....	712	574	477	365	483	1,440	1,032	3,247	2,219	1,878
FHA.....	111	2,240	4,864	4,377	11,922	14,401	10,994	6,807	29,169	26,325
VA housing.....	5,088	6,779	7,161	9,871	9,364	10,271	6,434	5,171	17,075	18,314
Other housing.....	56	(1,266)	(1,035)	(515)	(315)	(169)	28	—	—	—
Subtotal, housing.....	5,967	8,327	11,467	13,098	20,454	25,943	18,488	15,225	48,463	46,517
Education.....	608	118	639	613	1,986	4,395	8,021	5,685	2,900	2,300
Health.....	335	244	246	22	6	(166)	43	178	134	126
Total Households.....	6,930	8,689	12,352	13,733	22,446	30,172	26,552	21,088	51,497	48,943
Business:										
International:										
International security assistance.....	755	745	(134)	(103)	(86)	(52)	93	(20)	(20)	(20)
International development assistance....	66	(46)	105	62	49	42	71	163	252	293
Export Import Bank.....	1,021	935	397	(334)	1,179	1,556	766	(914)	490	510
Subtotal, Int'l Bus.....	1,842	1,634	368	(375)	1,142	1,546	930	(771)	722	783
General:										
Economic development administration.....	—	—	(23)	74	636	(86)	113	(70)	(82)	(80)
Nat. Ocean. & Atmos. Admin.....	—	—	13	21	58	65	21	(18)	15	(11)
Defense.....	(3)	—	—	—	—	—	—	—	2	4
Interior.....	—	34	92	4	(3)	14	(2)	24	2	13
Federal ship financing.....	700	1,225	1,123	451	21	494	635	609	125	125
Transportation.....	335	321	63	82	266	516	1,006	169	(81)	(94)
NASA.....	—	—	57	180	186	107	111	120	175	(140)
Nat. Credit Union Admin.....	—	—	—	—	4	47	58	(12)	(5)	(3)
SBA Bus. loan & invest. fund.....	93	301	684	1,216	786	996	1,269	(30)	(249)	(390)
SBA/disaster.....	—	—	—	(1)	(2)	(1)	—	3	(3)	(3)
SBA/pollution.....	—	—	—	16	40	99	100	50	150	150
Fed. Savings & Loan Ins. Corp.....	1,464	—	—	—	—	—	—	—	—	—
Subtotal, general bus.....	2,589	2,381	2,009	2,043	1,992	2,251	3,511	845	49	(429)
Utilities:										
REA.....	255	906	—	—	329	118	103	114	99	564
Energy.....	—	—	2	2	1	35	1,278	782	740	272
TVA.....	—	—	—	—	384	—	237	336	193	181
Subtotal, utilities.....	255	906	2	2	1,014	501	1,518	1,232	1,032	1,017
Special:										
Chrysler.....	—	—	—	—	—	600	400	—	—	—
Total Business.....	4,686	4,921	2,379	1,870	4,148	4,798	5,259	1,306	1,803	1,371
Farm Business:										
Farmers Home Administration.....	5,108	(1,104)	(1,437)	(1,492)	52	366	(305)	(479)	(163)	(223)

CCC.....	---	---	---	---	136	652	1,298	645	3,389	(412)
Total Farm Business.....	5,108	(1,104)	(1,459)	(1,492)	188	1,018	993	175	3,226	(635)

Total Net Sector Guaranteed Loans.....	16,724	12,506	13,292	13,911	26,782	35,988	35,804	22,569	56,526	49,679
Other Guaranteed Loans. <u>2/</u>	(8,124)	(1,506)	160	(531)	(1,550)	(4,388)	(5,332)	(1,713)	(747)	(879)
TOTAL GUARANTEED LOANS.....	8,600	11,000	13,452	13,380	25,232	31,600	27,972	20,856	55,779	48,800

1/ Source: Special Analysis F, 1976-1983

2/ Guaranteed loans that have not been attributed to above sectors and unattributed FFB activity. See footnote #2 in Appendix Table 4.

Appendix Table 5. Net Government-Sponsored Enterprise Activity by Sector 1975-1982 ^{1/}
(in millions of dollars)

	1975	1976	1977	1978	1979	1980	1981	1982	est.	
Households, Pers. Trusts, and Nonprofits										
FNMA.....	3,264	2,825	1,001	6,974	7,983	6,458	4,050	17,259	28,591	24,979
FHLMC.....	2,156	653	2,070	4,412	5,036	3,127	339	16,983	18,840	18,856
FHLBB.....	1,157	(398)	(541)	12,057	9,853	6,454	20,516	2,411	(2,943)	(402)
SLMA.....	91	176	117	192	529	1,039	2,052	1,689	1,928	1,078
Federal land banks.....	3,037	3,171	2,941	3,047	5,057	8,338	7,230	6,053	6,043	6,778
Adjustment to households.. ^{2/}	(3,368)	(751)	2,903	(171)	(4,387)	(5,464)	(4,497)	(548)	(650)	987
Total households.....	6,327	5,676	8,491	26,511	24,071	19,972	29,690	43,847	51,809	52,276
Farm Business:										
Farm Credit Administration:										
Banks for Cooperatives.....	658	1,095	768	882	1,101	828	777	(337)	1,394	1,192
Federal intermediate credit banks....	1,540	1,561	1,703	511	2,370	3,337	1,977	(114)	2,505	2,772
Adjustment to farm business.. ^{2/}	---	---	---	---	---	---	(4)	(46)	---	---
Total Farm Business.....	2,178	2,656	2,471	1,393	3,471	4,165	2,750	(497)	3,699	3,964
Total Net GSE Loans.....	8,505	8,332	10,962	27,904	27,542	24,137	32,440	43,350	55,508	56,240
TOTAL GOVERNMENT-SPONSORED ENTERPRISES..	8,505	8,334	11,333	27,904	27,542	24,137	32,440	43,350	55,508	56,240

1/ Source: Special Analysis F, 1976-1983

2/ Adjustments are primarily deductions for activity by GSE's that are also attributable to guaranteed loan programs. A small proportion of the adjustment is also intra-GSE financing.

Appendix Table 7. Net Federal Credit Activity by Sector 1975-1982
(in millions of dollars)

	1975	1976	1977	1978	1979	1980	1981	1982	est. 1983	1984
Net Direct and Guaranteed Loans										
Households, Trusts and Nonprofits.....	10,000	9,559	11,057	14,547	23,523	32,620	29,220	22,322	50,853	48,848
Business.....	9,316	9,274	6,280	9,834	11,308	16,447	17,490	10,068	12,227	11,617
Farm Business.....	3,782	5,392	6,835	9,746	10,672	7,687	9,529	11,234	11,734	(1,466)
Other.....	(1,698)	1,379	793	(951)	(656)	(1,151)	(2,194)	664	562	(128)
Total Federal Credit Activity by Sector										
Households, Trusts and Nonprofits.....	16,327	15,235	19,548	41,058	47,594	52,592	58,910	66,169	102,662	101,124
Business.....	9,316	9,274	6,280	9,834	11,308	16,447	17,490	10,068	12,227	11,617
Farm Business.....	5,960	8,048	9,326	11,139	14,143	12,052	12,279	10,757	15,433	2,498
Flow of Funds by Sector 1/										
Households, Trusts and Nonprofits.....	43,658	96,428	126,443	159,989	181,895	125,400	133,360	82,587	NA	NA
Business...2/.....	58,401	66,112	87,380	117,764	134,806	108,595	149,152	129,868	NA	NA
Farm Business...3/.....	9,653	12,258	13,376	13,255	20,279	18,053	19,333	11,126	NA	NA
Other.....	71,217	144,216	88,365	47,843	88,881	114,326	116,211	177,612	NA	NA
TOTAL.....	181,929	319,014	315,564	338,851	425,861	366,374	418,056	401,193	NA	NA

Participation Ratios by Sector (in percent)

	1975	1976	1977	1978	1979	1980	1981	1982
Net Direct and Guaranteed Loans								
Households, Trusts and Nonprofits.....	23	10	9	9	13	26	22	27
Business.....	16	14	7	8	8	15	12	8
Farm Business.....	44	44	51	74	53	44	49	101
Total Federal Credit Activity								
Households, Trusts and Nonprofits.....	37	16	15	26	26	42	44	30
Business.....	16	14	7	8	8	15	12	8
Farm Business.....	69	66	70	84	70	67	64	97

1/ Source: Federal Reserve Flow of Funds Accounts.

2/ Adjusted to include Export-Import Bank and foreign military sales credit.

3/ Adjusted to include P.L. 480 and CCC.

Appendix Table 8.--CREDIT PROGRAM SUBSIDIES
(in millions of dollars)

	1982	
Program	Present Value of	
Level	Subsidy	
Economic support fund.....	366	241
Functional development assistance.....	398	252
CCC price supports.....	11,500	292
Agriculture credit insurance fund.....	4,199	744
Rural housing insurance fund.....	3,454	2,203
Rural development insurance fund.....	568	208
PL 480.....	777	453
Rural electric and telephone revolving fund....	1,099 ^{1/}	649
GNMA tandem plan.....	1,985	739
Housing for elderly or handicapped.....	819	285
Export-Import Bank.....	3,516	641
Student loan insurance.....	6,195	1,932

Source: Table F-14a of Special Analysis F, January 1983.

^{1/} Excludes sales of loan assets by REA to the FFB.

THE WHITE HOUSE

WASHINGTON

INFORMATION

January 10, 1984

MEMORANDUM FOR THE PRESIDENT

FROM: THE CABINET COUNCIL ON ECONOMIC AFFAIRS

SUBJECT: Monetary Policy

Since mid-summer the rate of growth in the money supply, as measured by M1, has slowed dramatically; from July through December, M1 grew at an annual compound rate of less than 3 percent. Because the rate of money growth is closely related to economic growth in the short-term, continuing the low rate of money growth of the past five months would raise the threat of a recession sometime in 1984.

The Cabinet Council on Economic Affairs has closely monitored and reviewed the recent developments in monetary policy. This memorandum summarizes our discussions.

The Rate of Money Supply Growth

All members of the Cabinet Council agree that a sustained period of near zero growth in the money supply poses the strong threat of a recession sometime in 1984 and is clearly undesirable. However, the ambiguity of Federal Reserve policy intentions and the accuracy of the policy indicators create some uncertainty regarding the actual course of monetary policy.

There are two basic interpretations of the slow rate of money supply growth over the past five months:

- o The monthly money supply growth rates may be understated because of faulty seasonal adjustment factors and therefore should be treated with some degree of caution. Relying on alternative measures of money growth such as the monetary base suggests that the Federal Reserve's policy is not as restrictive as the money supply figures indicate; and
- o The extraordinary decline in the rate of growth in the money supply is not a statistical aberration but a result of the Federal Reserve's attempt to use monetary policy to maintain the current level of interest rates. The highly volatile rate of money supply growth over the past three years, resulting from the Federal Reserve's targeting interest rates and economic activity, itself contributes to volatile economic growth.

A. Seasonal Adjustment Factors and the Monetary Base

The following table offers a comparison of the 1983 money supply growth rates as measured by (i) the official seasonal adjustment factors for 1983, (ii) the official seasonal adjustment factors for 1982, and (iii) an alternative set of 1983 seasonal adjustment factors that the Fed is experimenting with. It is impossible to say which factors are more correct. What they illustrate is the significance of seasonal adjustment factors. Using either the 1982 factors or the experimental factors suggests that the money supply slowdown is not as dramatic as the 1983 factors suggest.

Annualized Month-to-Month Percent Changes

	<u>Current Seasonals</u>	<u>M1 With 1982 Seasonals</u>	<u>M1 With Experimental Seasonals</u>
Jan.	10.2	14.6	6.3
Feb.	24.9	19.7	24.2
Mar.	17.1	17.5	19.6
Apr.	-2.6	6.1	0.0
May	29.8	15.8	21.4
June	10.7	5.6	7.6
July	9.3	5.7	3.3
Aug.	2.9	3.0	7.0
Sept.	0.9	2.2	-0.5
Oct.	1.9	8.1	4.7
Nov.	0.5	5.6	6.5

Apparently, the official seasonal adjustment factors do not adjust only for variations that occur each year, such as the increased demand for currency at Christmas.* Because of the statistical methods employed, the factors are also affected by financial deregulation and other nonseasonal events. For example, the factors may be affected by financial market changes, such as the introduction of Super NOW accounts, which some believe caused a special one-time increase in the growth of M1 by increasing checking deposits.

Because of the uncertainty created by the seasonal adjustment problems, alternative measures of monetary growth are occasionally considered. The monetary base, an alternative monetary indicator consisting of currency in circulation and bank reserves, has grown at a 7% rate over the same July to

December period when money growth has been slow. The divergence of growth rates of M1 and the monetary base has occurred because nearly all of the growth in the base has been in currency, rather than bank reserves; each dollar of bank reserves supports many dollars of the money supply, so currency growth is a much less "potent" form of monetary expansion.

All members of the Council reject relying on M2 as an alternative indicator of money supply growth. There was no important deceleration of M2 preceding the 1981-82 recession. In addition, M2 was not a reliable predictor of either the acceleration of inflation in 1978-1981 or its deceleration thereafter.

B. Potential Threat to the Expansion

The second interpretation of the low rate of growth in M1 over August-December 1983 is more pessimistic. Although seasonal adjustments and other factors create uncertainty in the money supply estimates, there is sufficient historical evidence that the previous official estimates of M1 correspond closely with economic activity. For example, over the period of August 1982 to July 1983, M1 grew at a 14 percent rate. Some economists discounted the estimates of M1 for this period because of the introductions of Super NOW accounts and MMDA's. Yet economic forecasts that relied on the money supply estimates are now proving to be the most accurate.

As chart 1 indicates changes in the money supply growth rate correspond closely with changes in industrial production. Likewise, as chart 2 indicates, sharp contractions in the money supply growth rate such as the drop from 14 percent growth rate of August 1982 - July 1983 to the 3 percent rate of August 1983 through December 1983 typically result in economic contractions.

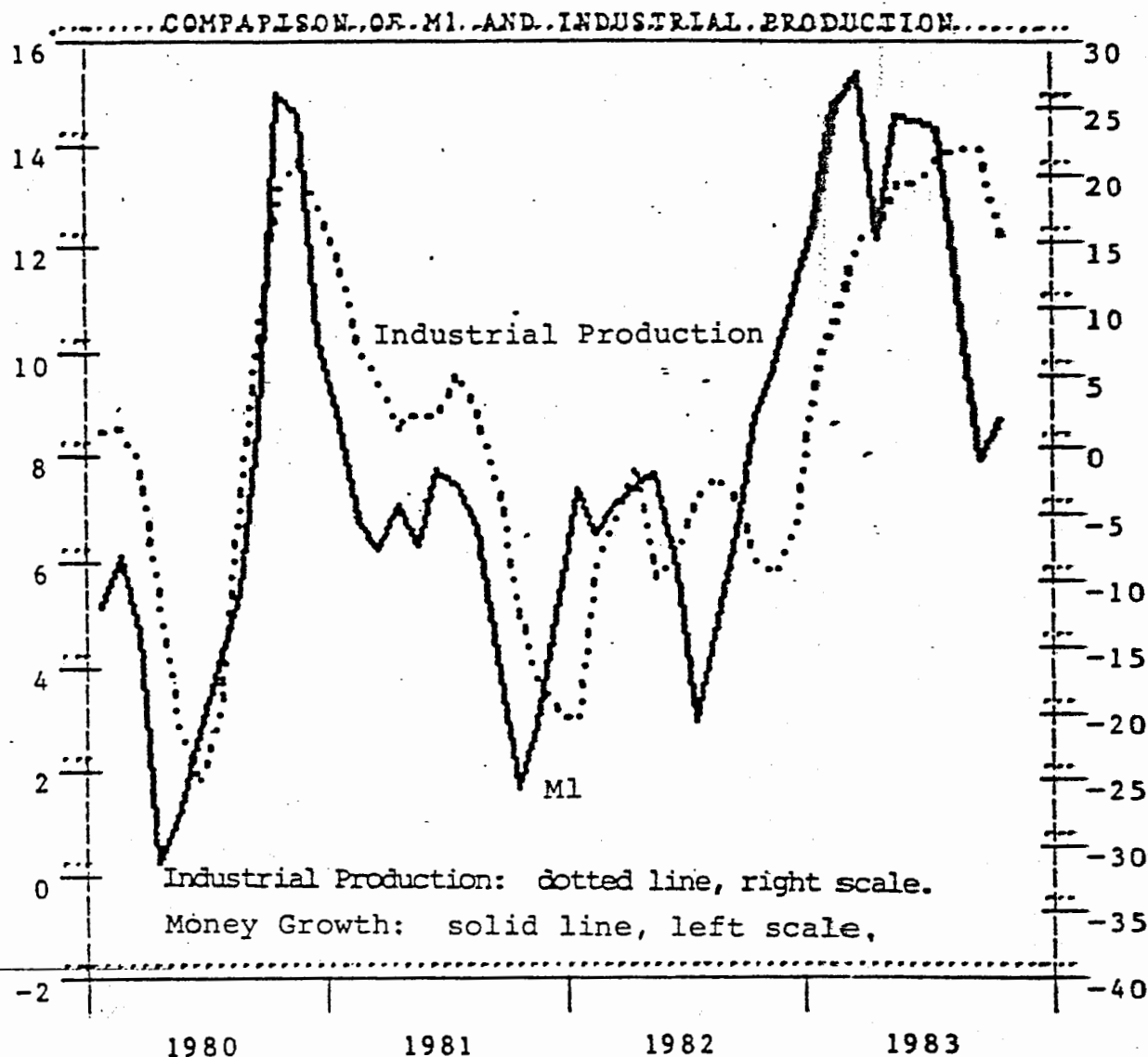
In the last three weeks M1 has shown more significant positive growth, an encouraging sign that the period of flat money growth may be ending. But weekly data on the money supply are notoriously erratic, so inferences cannot be confidently drawn from a few weeks of statistics.

Conclusion

The purpose of this memorandum is to alert you to recent trends in monetary policy. The Cabinet Council will continue to monitor financial market developments and monetary policy and provide you with additional information and options as appropriate.



Donald T. Regan
Chairman Pro Tempore



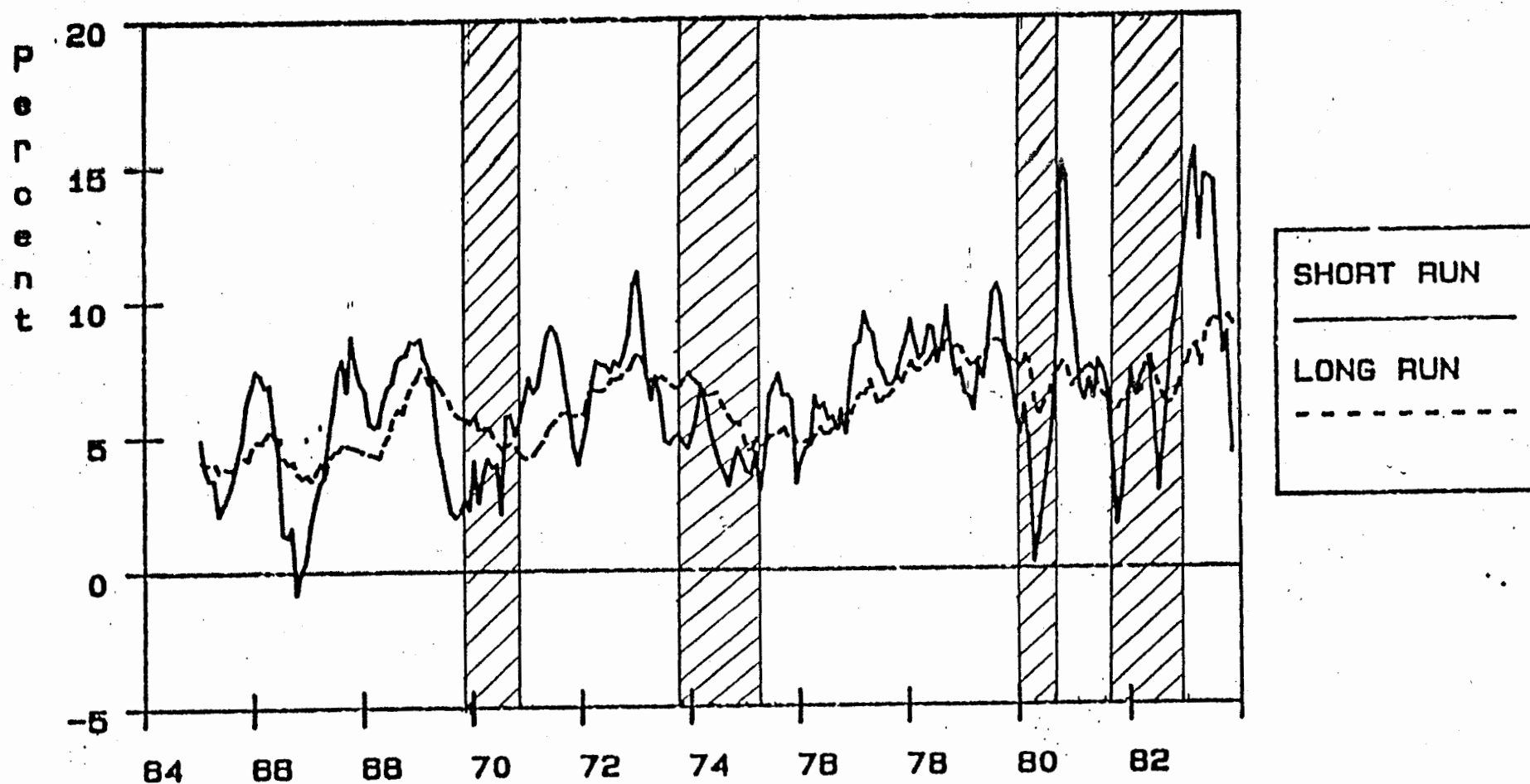
Latest date plotted: November 1983.

Money is a six month rate of change.

Industrial Production is a three month rate of change.

Prepared by the Office of Monetary Policy Analysis. Telephone 566-6261.

LONG RUN AND SHORT RUN MONEY (M1) GROWTH



Short-run is 8-mth rate of change in M1.

Long-run is 2-yr rate of change in M1.

SHADED AREAS REPRESENT RECESSIONS