Government-Sponsored Credit Agencies

The rapid growth in recent years of the Federal Government's role in shaping the flow and distribution of credit through the private domestic financial markets is an aspect of national economic policy that has only recently begun to capture the attention it deserves. In the budget year that will end next June 30, official estimates place the total net increase of all Federal and Federally assisted credit at $19 billion, or approximately a fifth of the probable expansion of total credit for the fiscal year. The Federal Government's private credit activities take three forms: (1) direct lending by agencies that are part of the Governmental structure, (2) direct lending by agencies that are legally privately owned but which are Federally sponsored and operate to serve a public interest, and (3) the insuring or guaranteeing by the Federal Government of loans made by private lenders directly to private borrowers. The latter do not ordinarily involve use of Government or agency funds, except in the case of borrower default, but the risk protection afforded lenders is designed to encourage a greater flow of funds into this type of lending than would otherwise occur.

The Federally sponsored agencies, which are the subject of this article, are of particular interest since they operate with substantial independence and have potentially important implications for the behavior of the economy and the financial markets. Indeed, taken together the sponsored agencies have become major financial intermediaries in recent years, as their role in providing selective credit assistance has expanded in an environment of high interest rates and generally restricted total credit availability. The immediate function of these agencies is to provide credit assistance to borrowers whose position in the financial markets is marginal or is subject to wide swings for cyclical or other reasons. More basically, however, their purpose is to redistribute real resources within the economy and/or to promote a greater degree of stability for some sectors than would otherwise be the case. The activities of the major sponsored agencies are now focused on the housing and agricultural sectors of the economy, but their scope has been broadening and the use of this technique for Federally assisting other sectors of the economy is increasingly being proposed.

THE MAJOR GOVERNMENT-SPONSORED AGENCIES AND THEIR CREDIT MARKET ACTIVITIES

Of the five major sponsored credit agencies, three serve the agricultural sector of the economy and two provide financial support for the housing sector. The agricultural agencies—all of which are under the general supervision of the Farm Credit Administration—are the Federal Land Banks, the Federal Intermediate Credit Banks, and the Banks for Cooperatives. The housing-related agencies are the Federal Home Loan Bank System (FHLB) and the Federal National Mortgage Association (FNMA). The Land Banks and the FHLB became fully privately owned institutions a few years after the end of World War II, while the remaining three credit agencies continued under mixed Federal and private ownership until late 1968. In October of that year, the important open market function of the FNMA was shifted to full private ownership, and the remaining functions of the original organization were transferred to a new Federally owned agency—the Government National Mortgage Association. Both the Federal Intermediate Credit Banks and the Banks for Cooperatives were converted to private ownership at the end of 1968, when all remaining Federal investment in these agencies was retired.

The change to private status has, of course, had a substantial impact on the operations of the credit agencies. In particular, it has freed them from the constraints of the Federal budget, enabling them to expand their scale of operations more rapidly than would otherwise probably have been the case and also to respond more flexibly to short-run developments in their borrowing and lending markets. In Federal budget accounting, the net lending of agencies that are owned in part or in full by the Federal Government is considered to be a budget outlay which contributes to a reduced overall surplus or a larger deficit. This, of course, tends to place limits on the activities of Government-owned agencies, especially at times when the overall aim of fiscal policy is to achieve a particular budget outcome within fairly narrow limits. By the same token, the conversion of agencies to private status also benefits the appearance of the Federal budget. Thus, when the FNMA and the two agricultural agencies were dropped from the Federal budget in 1968, the effect was to produce a considerable betterment of the relationship between total reported budget outlays and budget receipts. Indeed, were these three agencies still included in the budget, their projected net lendng for fiscal 1970 would add more than $6 billion to total budget outlays, resulting in a sizable overall Federal deficit rather than the modest surplus officially forecast earlier this year.

All the five major sponsored agencies are highly specialized lenders. This is particularly true of the three that serve the agriculture sector, as their titles suggest. The Land Banks supply long-term real estate loans to farmers and ranchers through 643 local Land Bank Associations. The Intermediate Credit Banks, of which there are twelve, supply working capital by acting as banks of discount for agriculture. They discount agriculture and livestock paper and make loans to local financing institutions, such as production credit associations, agricultural credit corporations, livestock loan companies, and commercial banks. The Banks for Cooperatives, which number thirteen, specialize entirely in financing through short-term loans the operations of farmers' cooperatives.

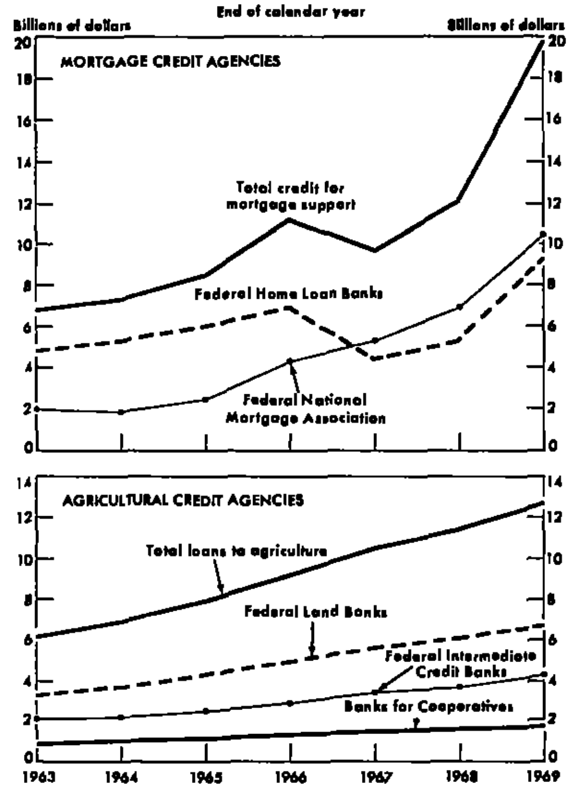
The housing-support agencies also have closely defined lending authority, though their policies and procedures have been subject to considerable change over recent years as they have probed for new and better ways to serve the tight residential mortgage market. The FNMA, since becoming privately owned, operates almost entirely in the secondary market for home mortgages insured by the Federal Housing Administration or guaranteed by the Veterans Administration and for certain loans insured by the Farmers Home Administration. The corporation, as an active buyer and seller of these mortgages, provides a substantial degree of liquidity to this sector of the mortgage market. More importantly, through heavy net purchases of such mortgages, the FNMA increasingly in recent years has acted as a major supplier of net new money to the Government-underwritten area of the mortgage markets, and thereby has tended to have an impact on credit availability throughout the residential mortgage markets.

The Federal Home Loan Banks assist the mortgage markets in a less direct fashion than does the FNMA. While not dealing in mortgages directly, the district Home Loan Banks—which number twelve—supply credit assistance to their member savings and loan associations and mutual savings banks, thus smoothing the operations of these mortgage-specialized institutions and helping to finance larger portfolios of mortgages at these private institutions than would otherwise be the case. The role of the Home Loan Banks as a net supplier of loanable mortgage funds to its members has taken on increasing importance in recent years as these depositary institutions have enconntered difficulty in attracting deposit funds from individuals and others. Indeed, the provision of expansion loans to its members has become a major policy goal of the Home Loan Bank Board.

Taken together, the five sponsored credit agencies in recent years have been one of the most rapidly growing classes of financial intermediaries (see chart). In late 1964, before the current inflationary period began, the

CREDIT OUTSTANDING AT SPONSORED CREDIT AGENCIES

End of calendar year



Note: FNMA data, prior to its becoming a private agency in October 1968, include secondary market operations only, for comparability.

Source: Board of Governors of the Federal Reserve System.

total credit outstanding at the five sponsored agencies was only $14.2 billion, but by the end of 1969 the total had more than doubled to $32.6 billion, an annual rate of growth of more than 20 percent. The two housing-support agencies accounted for the predominant share of this expansion; their loan portfolios nearly tripled in the five-year span from the end of 1964 through 1969, rising from just over $7 billion to nearly $20 billion. However, the agricultural credit agencies also enlarged their loan portfolios very sharply—at an average rate of about 13 percent per year.

The importance of these agencies in supplying funds for agriculture and housing has fluctuated widely from year to year, responding to changes in the availability of private credit to those sectors of the economy. For instance, in 1964, when overall credit conditions were relatively easy, the FNMA's secondary market operations were about balanced between purchases and sales, and the FHLB extended a modest $½ billion in additional advances to their member associations. However, the activities of both these agencies stepped up rather sharply in 1965, as mortgage market conditions began to tighten appreciably. Then, in 1966, when thrift institutions experienced massive losses of deposits and mortgage credit availability was curtailed sharply, net secondary market purchases by the FNMA soared to nearly $2 billion and outstanding FHLB advances rose almost $1 billion. The next year mortgage credit conditions eased greatly, and as a result net FNMA purchases of mortgages dropped back to about $1 billion while FHLB advances outstanding to members were actually reduced by more than $2½ billion. In 1968, both agencies were again heavy net suppliers of funds to the mortgage markets, and in 1969, when the supply of private mortgage funds was under renewed severe pressure, FHLB advances rose an unprecedented $4 billion and net FNMA mortgage purchases reached $3.7 billion. The three agricultural agencies, taken together, almost doubled their net lending from 1964 to 1966, advancing about $1.3 billion to borrowers in the latter year, and since then have closely maintained the high 1966 lending pace. Lending in 1969 was almost exactly equal to the 1966 total, as a sizable increase at the Intermediate Credit Banks was offset by reduced net credit extension at both the Banks for Cooperatives and the Federal Land Banks.

The rapid expansion of the Federally sponsored credit agencies has made them the most important single source of funds for both agriculture and housing. Since 1966, the three agricultural lending agencies have supplied more than half of the net increase in farm debt, exceeding the next largest source of farm credit—commercial banks. The share of total residential mortgage credit supplied directly and indirectly by the FNMA and the FHLB has been subject to rather wide fluctuations, but the trend clearly has been upward. In 1969, these two agencies supplied a total of $7.7 billion of funds to the mortgage markets, or more than a third of all credit made available for housing. This was a considerably larger share than the 20 percent supplied in 1966, when mortgage credit availability was also greatly restricted. The dollar volume of mortgage credit made available by the FNMA and the FHLB in 1969 actually exceeded that supplied by savings and loan associations and mutual savings banks out of funds obtained from sources other than FHLB advances.

All five agencies raise the bulk of their funds in the private credit markets through the sale of their own debt obligations. Except for certain participation certificates, these securities are not guaranteed by the Federal Government as to principal or interest. However, because the agencies are operated under Government auspices and have had a record of sound financial management, their obligations have typically sold at market yields lower than those on private securities of comparable characteristics—though higher than the rates on issues backed by the full faith and credit of the Federal Government.

The securities offered by the sponsored agencies span a wide maturity range, but for the most part fall within the short- and intermediate-maturity bracket. The Federal Land Banks formerly financed much of their farm real estate lending through longer term issues, but recently have confined their borrowing largely to maturities of five years or less. On the other hand, the other two agricultural agencies—the Intermediate Credit Banks and the Banks for Cooperatives—have historically financed through issues of no longer than one-year maturity. The latter issues—debentures which are the consolidated obligations of all the regional banks in each system—are liquid, readily marketable instruments that have become viable alternatives to other short-term investments for a fairly broad range of investors. The two mortgage-support agencies also tend to finance in the shorter term end of the market, though there has been some tendency toward a lengthening of their new issue maturities as the nature of their lending operations have changed to place greater emphasis on supplying funds on a relatively permanent basis. In 1969, the FHLB's new issues averaged 1.14 years to maturity date, while the FNMA's new borrowing averaged a significantly longer 2.16 years to maturity date.

Because of the relatively short maturities of their outstanding obligations and their massive demands for new funds to finance expansion, the Federally sponsored agencies are very active in the financial markets, entering them with increasing frequency for increasingly large amounts of funds. In 1969 alone, the five major sponsored agencies entered the markets on sixty-five separate occasions to borrow a gross total of \$23.5 billion. The FHLB was the most active, conducting twenty-one separate financings that ranged in individual size from \$200 million to \$650 million and totaled more than \$8 billion. The FNMA was somewhat less active, borrowing a little over \$4 billion in fourteen separate financings. The Banks for Cooperatives and the Intermediate Credit Banks together raised more than \$9 billion in twenty-three separate borrowings, the bulk of which was needed to refinance their maturing short-term obligations. Finally, the Land Banks in 1969 sold almost \$2 billion of securities through seven separate flotations, and concentrated those issues in the six-month to three-year maturity category.

All issues by the Federally sponsored agencies are by custom or law subject to review by the United States Treasury. This procedure allows for Treasury and agency borrowing to be coordinated in order to minimize disruptions in the financial markets that might arise as a result of the bunching of large Treasury and agency issues. Such coordination is likely to become increasingly necessary, in view of the growing size and frequency of agency issues and their concentration in the same maturity bracket as that of much new Treasury borrowing.

THE ECONOMIC SIGNIFICANCE OF THE FEDERAL AGENCIES

The rapid growth of the Federally sponsored credit agencies in recent years has greatly expanded their potential for influencing the structure and overall performance of the economy. However, largely because of their exclusion from the Federal budget, the activities of these agencies do not receive as wide attention as other Federal programs, including those lending activities which still remain within the coverage of the Federal budget. This situation is all the more unfortunate since the credit programs that have been placed outside the budget are large and growing rapidly, while those that have been left under full Federal ownership are, in the aggregate, expanding little.

To be sure, most fiscal analysts have long argued that Federal credit programs have a considerably weaker impact on the overall economy than do Federal spending programs directly affecting income and expenditure flows —that is, Federal spending on goods and services or transfer payments. It was partly for this reason that the President's Commission on Budget Concepts in 1967 recommended the procedure, currently in use, of drawing together all direct Federal loan programs into a budget account separate from that covering expenditures for goods, services, and transfer payments. Federal loans are similar to other Federal outlays in that they provide the private sector with spendable cash. However, unlike funds received through Government spending on goods, services, and transfer payments, the recipient of a Federal or agency loan incurs an obligation to repay the proceeds, with interest. Moreover, in the case of the sponsored credit agencies—all of which obtain their loan funds from the private financial markets rather than from general Federal revenues—the effect on the private sector's assets and liabilities is offsetting, since the agencies absorb funds (sell financial claims against themselves) equal to the amount lent.

This, however, does not mean that the sponsored agencies have no significance for the overall economy and the behavior of the financial markets. These agencies are intended to strengthen the position of borrowers whose position in the financial markets is most tenuous. To the extent they achieve this end, the credit agencies encourage larger spending in their area of lending than would otherwise be the case. The question is whether their borrowing in the private capital markets results in smaller credit formation elsewhere, and a resulting spending offset. If there is no full offset, the activities of the agencies would tend to enhance the flow of total credit in the economy and to spending on goods and services as well. And, inasmuch as agency borrowing competes in the securities markets against some of the most strongly positioned borrowers in the economy, such as the Treasury and large corporations, it can be argued that the offset is incomplete. If such is the case, the agencies do tend to add to the flow of total credit in the economy, and thus to exert an important stimulative impact on overall economic activity. Unfortunately, the state of knowledge in this area is not adequate to permit confident judgments about the magnitude of any such overall credit effect. However, it might be noted that, if Federal credit activities do tend to be financially stimulative, then the achievement of any particular economic stabilization objective through overall credit restraint would involve a greater degree of general credit stringency, and a higher level of interest rates, than would be necessary in the absence of agency borrowing and lending.

Another closely related area of uncertainty is the extent to which Federal agency borrowing bids funds away from the credit markets in which they lend. To be fully effective in shifting resources to a particular sector of the economy, the funds an agency raises in the credit markets must not come from the pool of private funds that would otherwise be placed directly in the agency's lending area. For example, borrowing by the Home Loan Banks must not divert depo[illegible] funds from the thrift institutions if FHLB advances to me[illegible] ber institutions are to be fully effective in augmenting the total supply of mortgage funds available from its members. If, however, a significant proportion of actual or potential depositors at thrift institutions are highly sensitive to interest rates available elsewhere in the securities markets, FHLB borrowing in the securities markets may, by tending to bid up rates in those markets, cause a large shift of deposits away from thrift institutions, resulting in a substantially offsetting reduction in their mortgage market lending. A similar offset might occur if, in the process of borrowing in the securities markets and lending in the mortgage markets, the FNMA gave rise to an initial change in relative yields on these two classes of instruments that encouraged a substantial shift by other private lenders out of mortgages and into securities. Indeed, the effectiveness of the Federally sponsored credit agencies rests largely on the condition that financial markets are imperfect in the sense that lenders and borrowers do not—for reasons of custom, regulation, inertia, or other barriers—move freely among financial alternatives in response to differential interest rate movements, or that interest rates are sticky and do not fully respond to the demand and supply effects that agencies exert on individual markets. Again, too little is known about these particular characteristics of the financial markets, but it is probable that offsetting actions by private investors and lenders are important, and that the net impact of an agency's activity on total credit availability to a particular class of borrowers is significantly less than that indicated by the magnitude of the agency's own lending to those borrowers.

The uncertainties about the structural and aggregative economic effects of the sponsored agencies apply as well to other areas of Federal credit involvement, including the provision of Federal loan guarantees, insurance, and interest rate subsidies. In view of the increasing application of Federal credit programs to achieve national policy goals, the effects of these programs on overall economic performance and on the efficacy of monetary and conventional budget policy deserve considerably greater attention than has so far been the case.