Budget Impact of Financial Rescue

Perspective Preparation: The Summer Baseline Deficit update by the Congressional Budget Office (CBO) this year projected a deficit in 2009 of $438 billion based on laws enacted through August 2008. Many have asked how recent actions by the Federal government to stabilize the United States financial markets will affect the deficit in upcoming years.

Below is a budget perspective that will offer a summary of federal relief proposed for or extended to major financial entities in the U.S., discuss the difference between the actions of the Federal Reserve and the Federal Treasury, as well as how this activity could impact the U.S.

Summary of Federal Action Taken on Major Financial Institutions in 2008:

- **Bear Stearns** *(unilateral intervention by the Federal Reserve)*: The Federal Reserve announced in March a $29 billion line of credit available to JP Morgan (through an LLC called Maiden Lane) to buy Bear Stearns. In return, collateral is pledged against the loan in the event there is a default.

- **Fannie Mae and Freddie Mac** *(Congressional action allowing Treasury intervention)*: Congress enacted legislation in July, and the US Treasury Secretary used that authority in September to announce the Treasury is prepared to provide up to $100 billion in assistance to each of the two Government Sponsored Enterprises (GSEs).

- **AIG** *(unilateral intervention by the Federal Reserve)*: In September, the Fed makes $85 billion line of credit available to AIG. In exchange, AIG will repay the Fed first at an interest rate exceeding 11%, and the Fed will own 79.9 percent of AIG's stock.

- **Market Stabilization (MS) Proposal** *(requires Congressional action and Treasury implementation)*: The proposed legislation would give the Secretary of the Treasury the authority to purchase mortgage-related assets. The measure limits the amount of mortgage-related assets the Treasury may purchase to $700 billion outstanding at any given time. The authority would expire after two years.

The *Deficit* Question of the Day: How will all the interventions involving the Fed and Treasury affect the deficit for 2009 (or beyond)? For example, does the deficit for 2009 go up by, say, $1 trillion ($315 billion + $700 billion) because of action in 2008 related to the GSEs, Bear Stearns, AIG, and the MS proposal?

The *Less-than-a-Trillion Dollar* Answers: The deficit will NOT increase by over $1 trillion in 2009. Instead, the deficit impact in the outyears is expected to be much, much less than the total initial amount of resources that Treasury and the Fed are using (or are asking to use) to address these financial market problems.

The key to thinking about how these four sets (if you take the GSEs as one entity for simplicity of discussion) of loans affect the federal budget deficit is to distinguish between the gross cash flows of this assistance (gross cash out in loans, gross repayments of cash back in later) and the net difference between the cash out and repayments in (aka profit or loss on the loans).

A *profit* on the loans will actually *reduce* future deficits. (The eventual sale of any positive-value stock in these companies that the Treasury or Fed may own would also increase the profit the federal government would see from these arrangements, thereby decreasing the deficit.)

But any *loss* on the loans will *increase* the deficit in the year the loss is recognized by the Treasury or the Fed. Let's take each one in turn to see how it works.

Federal Reserve Action:

Background: The Fed is not even on the books of U.S. budget. Though created by the federal government, the Federal Reserve is an independent entity – it is a bank – that has deposits that earn interest and that makes loans (always collateralized) to borrowers who repay with interest. Total assets of the Fed are approximately $895 billion, but these do not appear in the U.S. budget. Only the profits that the Federal Reserve makes from its transactions are turned over to the Treasury as federal revenues, which in turn are part of the annual deficit calculation. Typically, the Fed turns about $30 billion in profits per year over to Treasury as federal revenues.

Bear Stearns

- The Fed first intervened in March to prevent the market from having to digest a failed Bear Stearns.

- At the end of June, the Fed extended nearly $29 billion in credit to Maiden Lane LLC, which was formed to acquire bad assets of Bear Stearns and manage them to minimize financial market disruption and to maximize the repayment of loans over the 10-year repayment period.

- The first repayment due under the loan terms is June 26, 2010. To the extent the loan is repaid with interest, the Fed will not suffer a loss. If some of the loan is

not repaid, the Fed holds $30 billion in collateral and is in first position to be paid, and so still may not suffer a loss depending on the amount of recovery from the collateral.

- So we won't know for a few years whether the loan is on track to being repaid or whether the Fed will suffer a loss on the loan. If the Fed ultimately does report some of the loan as a loss, that will then affect the Fed's profit for that year. If the Fed's profit decreases because of a loss on a loan, then the federal deficit in a year would increase by only that amount of the loss.

AIG

- Next, take the more recent case of AIG. Most people are saying that the Federal government just spent $85 billion and seem to think the deficit has already gone up by that amount. The truth is that the $85 billion commitment has no direct or immediate impact on the deficit.

- While the Fed agreed to provide up to $85 billion in credit to AIG, thus far this credit line has been tapped for only $28 billion. The Fed has demanded a high interest rate that, combined with the fact that the Fed now owns 80% of the stock of the company and has extra collateral pledged under the loan, is likely to incentivize AIG to repay in full before the two-year term of the repayment period has expired.

- This suggests that it is unlikely the Fed will lose money on this arrangement. If the Fed makes money because of the high interest rate, it will increase its profits above the typical $30 billion per year, and that would reduce the federal deficit.

The Treasury Action

Background: Unlike the Federal Reserve, Treasury actions appear directly on the books of the U.S. budget. The Treasury is responsible for the cash management needs of the U.S. government. If the Treasury needs cash to liquidate federal obligations (i.e., issue checks or make outlays) or to provide working capital for Treasury operations or federal direct loan programs, then Treasury can borrow the cash (up to the limit on the debt) by holding an auction of Treasury securities.

Fannie Mae/Freddie Mac

- The law Congress enacted over the summer gave the Treasury secretary broad authority to provide assistance to the housing GSEs without specifying any numerical constraints on the authority.

- Since then, Paulson has announced that he is initially prepared to provide up to $100 billion in "assistance" to each GSE. Assistance could take the form of providing a loan, buying their stock, or buying their mortgage-backed securities (MBS).

- Thus far, the Secretary has implemented none of these actions, although he has announced Treasury will be buying $5 billion in MBS from the GSEs.

- It is unclear how Treasury will set the price it pays to the GSEs for the MBS (the GSEs will then be able to take the cash Treasury pays and will be able to purchase new MBS for new home loans to be made). If the principal and interest repayments on the MBS perform and return to the Treasury what it paid up-front for the MBS, then the Treasury will have a wash.

- If the Treasury pays too much or the loans in the MBS do not perform then Treasury will suffer a loss and the federal deficit will increase. (If the Treasury pays too little and the loans in the MBS perform far better than expected, the Treasury will make money.) The same concept applies to any loans that Treasury might make to the GSEs directly.

Market Stabilization – Paulson Proposal

- The 3-pages of legislation proposed by the Treasury Secretary would give him broad authority to purchase assets from the market. The proposal appears to have already undergone some change on its way to quick enactment, but some of its key elements follow.

- The legislation would give the Secretary of the Treasury the authority to purchase mortgage-related assets, though his authority to purchase such assets would be limited to $700 billion outstanding at any one time. This authority would expire after two years.

- The debt limit would be increased by $700 billion -- from $10.615 to $11.315 trillion.

- CBO and OMB plan to reflect this authority as a federal credit instrument (the government would be buying loans or securities made up of loans). That means that instead of showing the effects of this authority on a cash basis, which is the norm for most transactions in the federal budget, the budget will reflect these effects on a "credit reform" basis, which is the legal requirement for displaying loan programs.

- That means that, even if the Treasury Secretary goes out and spends the whole $700 billion on mortgage-related assets in 2009, the federal outlays will <u>not</u> go up by $700 billion, and the deficit will <u>not</u> increase by $700 billion.

- Instead, OMB and CBO will estimate the amount that they expect the Treasury will lose (or even gain?) in buying and then selling these assets, and will record that difference as part of the deficit calculation. For example, if the Treasury buys $700 billion in assets in 2009, and CBO and OMB expect Treasury will eventually sell them for $600 billion over, say, the next 10 years, then they will estimate the deficit in 2009 will be $100 billion higher than otherwise.

- If the actual sales of those assets in the future yield more or less than the $600 billion initially estimated, then the deficits measured in future years will go down or up (respectively) as a result of the actual experience in selling the assets (compared to the initial estimate of $100 billion).

- So for example, if we learn 10 years from now that we eventually sold all the assets for $650 billion, then the deficit effect of this bill will be recorded as a deficit increase of $100 billion in 2009 and a deficit decrease of $50 billion in 2019. If instead we learn 10 years from now that we eventually sold all the assets for only $500 billion, then the deficit effect of this bill will be recorded as a deficit increase of $100 billion in 2009 and a deficit increase of another $100 billion in 2019.

Summary to the Trillion Dollar Question:

The 2009 deficit is not going to increase from $438 billion to $1.4 trillion because of these actions taken by and authorities available to the Treasury and the Fed.

For most of the actions, it will be some time – years – before we know whether these entities suffered a loss or came out ahead. Under some of the arrangements (AIG), it is highly likely the federal government will come out ahead. Under some others, there is more of a possibility of a loss, but the loss will be only a percentage of the initial assistance level provided (in the S&L crisis, the federal government through the Resolution Trust Corporation – RTC – recovered nearly 80 cents on each dollar of assistance that it had to lay out initially).

Better estimates of the deficit effect are impossible until more info is available on how Treasury will use its GSE and MS (if enacted) authority and until more time passes to assess the true value of the mortgages that underlie all the assets in question.