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THE POTENTIAL BUDGET IMPACT OF GOVERNMENT INTERVENTION

THE PROPOSED FINANCIAL SYSTEM RESCUE

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INTRODUCTION

The Bush administration's latest proposal to shore up U.S. financial markets has led to confusion about the exact budget impact of such an action. Some have called it a "$700-billion bailout," because the Treasury has requested authority to purchase up to that amount in mortgage-backed securities, a key component of the market turmoil. Others have suggested the government could *make* money off this authority, because the Treasury subsequently would sell, for a profit, the assets it had purchased.

The most likely outcome is somewhere in between.

The ultimate cost of the administration proposal is unlikely to reach $700 billion; but viewing the potential hazards associated with purchasing these assets, the government runs a risk of recouping significantly less than the price its pays for them. In addition, the government is likely to incur administrative and other costs associated with the program.

This paper briefly describes the administration's proposals, reviews the potential budget implications, and provides some additional background.

FINANCIAL SYSTEM RESCUE

The Treasury Proposal

The administration's proposed rescue package, announced on 19 September 2008, has three budget-related components.

- First, it allows the Treasury to purchase up to $700 billion in mortgage-related assets.
- Second, it increases the debt limit by $700 billion.
- Third, it provides that the purchase of these securities be treated under the Federal Credit Reform Act – an important consideration in budgeting for this action.

The Federal budget is generally considered to be "cash-based": whether it is the purchase of land, transfer payments to beneficiaries, or funding a war, the government records the full amount of the payment as an outlay.

One notable exception involves the credit transactions of the Federal Government. In 1990, Congress changed the budgetary treatment of direct loans and loan guaranties from a cash basis to an accrual basis. Before that, the Federal budget overstated the cost of direct loans – by recording an outlay equal to the initial cash disbursement – and understated the cost of loan guaranties, recording no cost with Federal guaranties of private lending unless and until there was a default. Since 1990, the Federal budget has recorded the net long-term budget impact of both Federal loans and loan guaranties in today's dollars.

Table 1 provides an illustrative example of the different ways of scoring a proposal for the government to buy, hold, and then sell mortgage-backed securities. This is *not* intended to be an analysis of the Treasury plan. Instead, it compares scoring of a hypothetical purchase of $100 worth of securities under a cash- or credit-reform basis.

As the table shows, cash-based scoring overstates the cost of the purchase of these securities because it does not reflect, in the initial outlay, the future income to the government they will produce. Conversely, credit reform scoring takes into account future receipts, but does not account for additional risks associated with the Federal Government investing in securities. The third presentation shows credit reform scoring *with* a risk adjustment (5 percent is an assumption, not an assessment of current risks). This builds in the inherent risk the government assumes in investing in these securities.

Table 1: Illustrative Example of Scoring of $100 Rescue Plan

Assumptions	
Treasury buys securities in fiscal year 2009 for	100
Treasury sells those securities in fiscal year 2010 for	90
Administrative costs total 5 basis points (0.05 percent) over 2 years.	
Treasury cost of borrowing is 3 percent.	
Cost of risk is 5 percent.	

	FY 2009	FY 2010	Total
Cash Basis			
Purchase of Securities	100.00		100.00
Sale of Securities		-90.00	
Administrative Costs	0.03	0.03	0.05
Total Spending (and deficit impact)	**100.03**	**-89.98**	**10.05**
Credit Reform Basis Without Cost of Risk			
Purchase of Securities	100.00		100.00
2010 Sale of Securities Discounted into 2009 Dollars	-87.38		-87.38
Administrative Costs	0.03	0.03	0.05
Total Spending (and deficit impact)	**12.65**	**0.03**	**12.67**
Credit Reform Basis With Cost of Risk			
Purchase of Securities	100.00		100.00
2010 Sale of Securities Discounted into 2009 Dollars	-83.33		-83.33
Administrative Costs	0.03	0.03	0.05
Total Spending (and deficit impact)	**16.69**	**0.03**	**16.72**

Note: Securities do not pay coupon interest.

Regardless of how the budget records this spending, the Federal Government must borrow funds, i.e., increase the debt, to finance Federal spending. In the case of the Treasury's proposal, the government will need to increase borrowing by up to $700 billion to finance the purchase of mortgage securities.

There is great risk concerning the value of any securities the government will purchase, which presents challenges in projecting the budget impact of the Treasury proposal under either a cash-based or a credit-reform approach.

Other Elements of the Administration's Action

Another component of the administration's rescue plan provides government insurance to money market mutual funds. These sorts of funds generally are of high credit quality and invested in cash or cash-equivalent securities; they typically have little risk. Nevertheless, the insurance is intended to help restore confidence in the financial markets. This is a temporary guaranty program for the U.S. money market mutual fund industry. The Treasury will insure the holdings of any publicly offered eligible money market mutual fund, both retail and institutional. Beginning next year, the Treasury will assess a fee for participation in the program.

This action did not require legislation. It was done under existing statutory authority and uses the Exchange Stabilization Fund, which was established by the Gold Reserve Act of 1934. This authorizes the Treasury "to deal in gold, foreign exchange, and other instruments of credit and securities" to promote international financial stability. The Treasury plans to use the assets of the Exchange Stabilization Fund, up to $50 billion, to guarantee the payments of money market mutual funds.

It appears that the Federal Government's extension of insurance to money market mutual funds will operate similarly to the budgetary treatment of bank deposits covered by the Federal Deposit Insurance Corporation. If so, when the Treasury charges a fee for the insurance, those receipts will be recorded. Outlays are recorded when there is a failure, and the Treasury disburses funds to cover those losses.

OTHER GOVERNMENT INTERVENTIONS IN 2008

Bear Stearns Companies Inc.
(16 March 2008)

The Government's Action. Early this year, the major investment bank Bear Stearns Companies Inc. faced a severe shortage of liquidity due to mounting losses on its mortgage-related assets. On 16 March, the Federal Reserve extended a $30-billion line of credit to JP Morgan Chase & Company to help it acquire Bear Stearns. The Fed's actions effectively took $30 billion in distressed, illiquid securities off of Bear Stearns' books, thereby overcoming JP Morgan's initial reluctance to assume the full extent of Bear's portfolio.

Under the terms of the deal, JP Morgan will absorb the first $1 billion of losses on these assets. The remaining $29 billion of losses would be absorbed by the Federal Reserve. The Fed tapped

Blackrock, a money management company that specializes in distressed securities, to manage the $30 billion of hard-to-sell assets ($20 billion of these assets are reportedly mortgage-backed securities). These assets will be liquidated over time. In testimony before Congress, Fed Chairman Ben S. Bernanke has said that he is "reasonably confident" that the Fed will recoup the full $30 billion it posted in this deal.

JP Morgan bought Bear Stearns at a price of about $10 per share (the original offer was $2 per share), effectively wiping out Bear Stearns' shareholders. In 2007, Bear Stearns' shares were trading at more than $100.

Potential Budget Implications. Because this action was taken by the Federal Reserve, an off-budget entity, the additional line of credit is not reflected in the Federal budget. If the Fed sustains losses from this action, the Federal Government would incur those losses.

Fannie Mae and Freddie Mac

(7 September 2008)

The Government's Action. In July this year, Congress granted the Treasury extraordinary authority to provide financial assistance to the Federal National Mortgage Association [Fannie Mae] and the Federal Home Loan Mortgage Corporation [Freddie Mac], the giant private-sector corporations designed by the Federal Government (formally termed Government-Sponsored Enterprises [GSEs]) to promote homeownership by enhancing the supply of residential mortgage funding. The Treasury exercised this authority in September.

Fannie's and Freddie's main book of business is the buying, securitizing, and guaranteeing of payments on qualified mortgages. But the firms also have a second line of business that involves purchasing assets, mainly mortgage-backed securities or whole mortgages, for their own investment portfolios to deliver profits for their private shareholders. These portfolios, which have grown tenfold since 1990, are funded by virtue of the GSEs' preferential borrowing rates (market participants believed all along that the GSEs had the backing of the Federal Government).

Economists and policy analysts have warned for years that these immense investment portfolios posed a so-called systemic risk to the broader financial markets, and urged stronger and more effective regulation of the mortgage giants. But Fannie and Freddie deployed large sums of money to lobby against such efforts. The GSEs consistently argued they were well capitalized, their risk management strategies were more than sufficient, and their accounting methods were transparent. In short, they claimed their business practices posed no risk to the American taxpayer or the overall economy. As is evident from the events of recent months, they were wrong.

Fannie and Freddie faced mounting losses on their considerable stock of mortgage-related assets, and these losses were expected to continue in the future, as foreclosures mounted and the housing market reached bottom. Although Fannie and Freddie tend to guarantee higher-quality, prime, fixed-rate mortgage-backed securities, they also invested in certain subprime mortgage-related securities, which have suffered the sharpest value declines, through their investment portfolios. In the end, the Treasury felt it had no choice but to rescue the companies before they toppled, because the risk of their failure to the overall economy was too great.

Potential Budget Implications. To avoid the systemic risk that would result from the insolvency of Fannie and Freddie, Congress granted the administration broad authority, through 2009, to provide financial assistance. On 7 September 2008, the Treasury brought the two GSEs under conservatorship. This means the Federal Government has taken control over their operations, has replaced certain executives, and has assumed decision-making from the Board of Directors and shareholders.

The Congressional Budget Office [CBO] initially estimated the authorizing legislation would cost $25 billion, and CBO has since concluded Fannie and Freddie should be reflected in the budget. The administration’s Office of Management and Budget, however, has announced plans to continue treating the GSEs as off-budget entities.

Regardless of how they are treated in the Federal budget, the Treasury’s actions to rescue Fannie and Freddie will have a cost to the taxpayer.

The American International Group
(16 September 2008)

The Government’s Actions. Just last week, the government took measures to rescue the American International Group [AIG], one of the world’s largest insurers. In taking these steps, the administration said a “disorderly failure” of the company would add significantly to current financial market turmoil and further weaken the economy.

Under the terms of the arrangement, the Federal Reserve has the authority to lend AIG up to $85 billion in emergency funding. In return, the U.S. government will receive an equity stake of 79.9 percent in the company. AIG’s issuance of stock to the U.S. government (in the form of equity participation notes) will dilute the equity of current shareholders. The government also gains the right to veto dividend payments to common and preferred AIG shareholders.

The Fed’s loan, which has a 2-year term, comes at a price. The interest rate charged on this emergency loan will be 8.5 percentage points (i.e. 850 basis points) above the benchmark London Interbank Offered Rate [LIBOR], which translates into more than 11 percent at current market rates – nearly on par with some credit card debt. The loan will be backed by all of AIG’s assets and those of its primary non-regulated subsidiaries. AIG is expected to repay the borrowed funds by selling off its assets, most likely its operating companies. According to *The Financial Times*, the Fed is expecting an orderly liquidation of AIG, though there is a chance that the company could survive as an ongoing business.

Potential Budget Implications. Because this action was undertaken by the Federal Reserve – an off-budget entity, as noted previously – no cost is recorded in the budget. Nevertheless, the government is exposed to a potential loss of $85 billion on this loan, though that loss is unlikely. First, it is not clear that AIG will borrow the full $85 billion (as of last week, it had borrowed slightly less than $30 billion). Second, AIG has a number of profitable subsidiaries and desirable assets, which it can sell off to repay the loan. Given the rates of interest on the loan, AIG has every incentive to repay any loan quickly and completely. If AIG repays any loan in full with interest, the government would end up making money.

THE ROLE OF THE FEDERAL RESERVE IN RECENT FINANCIAL SYSTEM RESCUES

Although the Federal Reserve is an agency of the U.S. government, it is not included in the Federal budget, as noted previously. It acts as an independent entity, insulated from executive and legislative actions. The Fed produces earnings from its portfolio of securities. After subtracting for the costs of its operations, the Fed turns its profit over to the Treasury, on a weekly basis, and they are recorded as receipts to the Treasury.

The Federal Reserve's primary function lies in monetary policy. The Fed implements this function by setting a target level for the federal funds rate (the benchmark interbank lending rate in the U.S.) at its Federal Open Market Committee [FOMC] meetings. When that decision is made, the New York Fed conducts open market operations (buying and selling U.S. Treasury bonds with its so-called "primary dealer" banks) to increase or decrease the aggregate money supply until its interest rate target is reached.

Apart from setting the direction of monetary policy at its FOMC meetings, the Fed also has a responsibility to ensure the smooth functioning of the financial system in times of acute market stress or disruption. For instance, over the past year, the Fed has often acted as the "lender of last resort," injecting short-term funding into the markets when liquidity had dried up. To do so, the Fed can deploy its considerable balance sheet – valued at roughly $800 billion prior to the market turmoil last year – to provide temporary funding to market participants while accepting collateral in return. These targeted balance sheet transactions are not aimed at changing the Fed's overall monetary policy stance (i.e. they have not changed the aggregate level of credit supply in the economy).

It is important to note that in its financial interactions with Bear Stearns and AIG, the Fed has agreed to provide funding in return for collateral. In other words, the Fed exchanged loans for bundles of assets. Each transaction, at least in concept, is similar to the Fed's discount window operations in which it offers short-term funding against highly-rated collateral (mainly Treasury securities) to depository institutions. The problematic feature in both the Bear Stearns and AIG cases (apart from whether they should even have access to Fed borrowing) is that the value of the collateral is unclear and the horizon of the loan is well beyond short term.

Though the Fed's actions are not reflected in the budget, there is a concern that if the Federal Government's obligations substantially increase in the current crisis, there could be a temptation on the part of the central bank to add to the money supply – to simply "print money," or "monetize" the debt it is racking up. Increasing the supply of money would lead to a sharp increase in inflation.