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SEVEN LESSONS FROM MY BOOK ON GOVERNMENT CREDIT PROGRAMS

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Governments around the world are creating massive new credit programs or expanding existing ones, so it seems a good time to review some lessons from past programs. In 2011, I wrote a comprehensive book on the topic, *Uncle Sam in Pinstripes: Evaluating US Federal Credit Programs*. I wrote this as a scholar at the Brookings Institution, building on my years at the Center On Federal Financial Institutions, a think tank I founded that focused on federal lending and insurance programs.

Here are 7 lessons that I draw from the past to help guide the new government programs:

Government credit programs can be a very effective way to counteract market failures.

In this crisis, financial institutions and markets would find it very hard on their own to accept the risks associated with the current massive uncertainty. Lending rapidly to companies, especially smaller ones, in the middle of an unprecedentedly sharp recession induced by a pandemic is not a natural activity for private sector lenders.

Crisis response programs necessarily differ from steady state credit programs.

Normally, new credit programs should be designed carefully over a period of time and should place a premium on targeting the right borrowers and using risk-related interest rates to avoid a whole series of economic inefficiencies and risks. However, credit programs designed to respond to a severe financial or economic crisis generally must place a much higher value on speed and on scale in order to provide the necessary support and reassurance. There is definitely value in considering the proper design principles, but there will almost certainly be compromises of these principles in order to get the job done urgently.

Partnering with private sector financial institutions works well under the right circumstances.

Banks and other private sector financial institutions have the ability to move quicker than a start-up government institution and are generally more agile than government bureaucrats. They also have existing infrastructures to handle processing, credit decisions, compliance and risk functions. (In some countries, existing government-owned banks have the same advantages.)

However, partnering with the private sector requires the right incentive structures.

The private and public sectors share some objectives in the current crisis, but there is far from a perfect overlap. Therefore, governments must be careful to structure the programs to encourage the right kind of lending on the right terms. This can require tough political decisions. One of the biggest in this crisis is the extent to which governments want to support firms that may well go bankrupt anyway. On the one hand, deferring the attendant unemployment and losses for suppliers and investors may be worth a lot at the moment. On the other hand, this can be expensive in the long run and may cost more than direct payments, such as through unemployment insurance, or providing more fiscal stimulus. My own view is that there should be some level of credit underwriting, to minimize the creation of zombie firms. Japan's experience decades ago highlights the large economic costs of supporting hopeless companies.

Once the government has decided how lenient to be with credit standards, then careful structuring is required to incentivize financial institutions to make loans that meet these standards and avoid those that don't. Governments will likely need to guarantee 80% or more of the loan amount, judging by the experience of programs like America's Small Business Administration, in order to persuade banks to participate wholeheartedly. At the same time, the deal can't be too lucrative for the private sector or financial institutions may fail to exercise reasonable credit judgements.

Another possibility is to effectively guarantee against the tail risks in this very uncertain environment, by having the private sector keep the default risk up to a certain level for a portfolio of new loans, with the government stepping in after that. This effectively encourages banks to make loans on a more normal basis, with the knowledge that a real catastrophe, such as an even more severe recession than expected, would be covered.

The right government accounting rules can make a big difference.

America's Federal Credit Reform Act of 1990 has been a great help in forcing politicians to make intelligent trade-offs on government credit programs. Most countries still use the same accounting the US did prior to that act. They treat loan disbursements as expenses and loan repayments as revenues. This also encourages guarantee programs, since they avoid the initial outlays that would count as expenses, even though their net cost over time could be higher.

Instead, the US government accounting rules do an intelligent net present value analysis. Future inflows and outflows are forecast and their values brought back to today's dollars using government bond interest rates. If a program is set up to charge an economically fair price, then it would generally show no expense. If the interest rate is lower, then a subsidy would show up as an expense at the time the loan is made. On the other hand, if the government would have a net profit over time, then there is a negative subsidy as a revenue item. This approach also puts guarantees and loan programs on a level playing field. If their net cost over time is the same, then they look equally good or bad.

Government credit programs often live far longer than expected.

As someone once said, "there is nothing more permanent than a temporary solution." For government-supported credit programs, there will be many beneficiaries who will lobby for its continued existence. This could be particularly true for programs to support small businesses, since they always face serious challenges.

There are three ways to deal with this. The first would be to choose some clear, reasonable, and objective criteria for when the program would end. Future politicians could still overrule this, as is their right, but it would be less likely. The second would be to partner with central banks or other bodies with a degree of political independence. (The Fed's emergency programs in the Global Financial Crisis essentially all terminated.) The third would be to try to design a program that would be fit for purpose well after the pandemic and its associated recession is over. Different programs might fall naturally into different of these categories, depending on their purpose.

The terms of long-lived credit programs virtually always become worse for taxpayers over time.

One reason to try to ensure these emergency programs do not last long after the current crisis is that experience shows that the beneficiaries of government credit programs tend to be very effective at lobbying for more favorable terms over time. America's student loan program is a prime example, with multiple switches between fixed and floating rate bases, depending on which turned out to work better in retrospect for borrowers. It is too politically difficult not to respond to people who would have been better off under the other approach.

CONCLUSIONS

There are many lessons to be learned from past government credit programs in the US and elsewhere. As we ramp up huge new programs, it is well worth reviewing those lessons. There is a great deal more information in my book, for those who wish to dive deeper.

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