How Did the Cure Work?

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In the June, 2008, issue of this magazine we presented a short analysis of the actions by the Fed in trying to stem the Real Estate Mortgage losses that financial organizations were experiencing. With the steep decline in the stock prices for both Freddie Mac and Fannie Mae, the panic was becoming intense and the Treasury Department felt that *something* had to be done. These two quasi-public/private corporations were created to make housing more affordable for the smaller income buyer. They did this by guaranteeing loans by reason of their being chartered by the Federal Government that meant the loans were viewed as actually being backed by our Treasury. This implied guarantee enabled the two to undercut their competitors in obtaining capital funds to loan.

When it became clear that Fannie and Freddie were in the same distress as other financial institutions because of the repudiation of so many marginal loans, members of the Democrat-controlled Congress got involved. They insisted the Treasury do *something*. What Treasury did was to lift Freddie and Fannie's portfolio caps and reduced their capital reserve requirements. These two things plus the stimulant bill Congress passed (which demonstrates that Congress has learned nothing from the crisis) nearly doubled the size of the loans the two companies could purchase, package, and guarantee. The result is that the two companies now handle almost 70 percent of all new mortgages. Yet by almost any measure both companies are insolvent. To bail them out the Treasury Dept. granted them access to the Fed Discount Window (like chartered banks) where they could borrow any amount needed. Previously Freddie and Fannie had to obtain new money to loan by packaging mortgages and selling them on the market. By embracing the obligations of Freddie and Fannie the Treasury has, in effect, increased our National Debt from 7+ trillion to over 10+ trillion dollars. Is there any way to pay off a debt of this magnitude except through inflation?

The illusion that the companies were doing something for the "little guy" made it possible to ward off needed regulation. When their losses were brought up, the two companies always blamed their need to provide their service, even at the ill effect for their stockholders. Now that their debt has been acknowledged by the government there is little wonder that with losses socialized and gains privatized the two have gambled their way into financial catastrophe.

This should have been a perfect time for Republicans to demand real accountability and reform. Dick Armey in a *Wall Street Journal* article said "Freddie and Fannie are like Enron on steroids." He pointed out that there is a well-documented history of Freddie and Fannie accounting corruption designed to benefit senior management and politicians. It makes no sense that Congress didn't bar Fannie and Freddie from paying dividends if they receive loans from the Fed. Last year Freddie paid $1.6 billion and Fannie paid $2.5 billion in dividends. The government should not be providing money in the front door while the companies pay dividends out the back.

One of the main effects of the liquidity binge was the plunge of the dollar's value worldwide. This was reflected in the spike in all commodities' prices but especially in the price of oil. Only a year ago the price of oil was $70 per barrel but it exploded as the Federal Reserve slashed interest rates to shield Wall Street from the troubles.

To a casual observer the results of the Fed's expansive policies look like they have been a success in light of the recent recovery of the dollar and the lowering of oil prices. It is a sign of how much we have been "conditioned" by the general feeling that $3.50 gas is "cheap." But what has really happened is that currency traders have shifted their concerns to signs that Europe's economy is slowing, as well as worries that Japan is back into a recession. The dollar has strengthened somewhat on the expectation that maybe the Fed's bender is over. This recent gain really shows that with a little more guts displayed by Treasury and the Fed when the crisis began, the commodity spike could have been avoided. And, because of the huge increase in the U.S. debt, the future outlook for our economy is still not very pretty. The inflation component associated with the increased debt has barely started.

The disclosure that the problem is moving to Europe, and the euro reminds one of a pan of water sloshing back and forth as the tilt goes from left to right. The problem has not really gone away; it merely has "sloshed" over to the euro side. Perhaps the only reason for optimism is that the low U.S. tax rates are still in place, and polls have shown that people are finally coming around to the proposition of increasing the energy supply.

The U.S. economy is quite resilient but is still a long way from its peak. It has become clear that the job market has declined. New unemployment claims have surged to recessionary levels, and over 3 million people have been drawing claims for a week or more, the most since 2003. Most of the job decline has occurred in manufacturing, construction, and retail that have lost over 650,000 jobs so far this year. What the country needs now is financial and regulatory discipline for charter banks, stable money, lower taxes, and some policy decisions that will result in lower energy prices through increasing supply. Hold onto your hat; we are probably in for a very rocky ride. Ω