Hi everybody,

We’ve all been watching to see what the U.S. government will do about its quasi-official mortgage giants Fannie Mae and Freddie Mac, which are actually insolvent (though that term is mostly avoided). The U.S. government set up the first of these in 1938 as part of the New Deal, and in 1968 transformed both of them from government agencies into “private companies”, that is, into private companies intended to be profitable and to sell ownership shares to individuals like any other corporation. Thus from 1968 on they were supposed to be “on their own”, sink or swim.

Of course what happened is that they remained private as long as they were making money, and the profit belonged to those private owners. Now, however, they are on the verge of bankruptcy, and so—the U.S. government is expected to bail them out. And it will have to do so.

One major reason why the government will bail out Fannie and Freddie is that between the two of them they have backed up about half of all U.S. home mortgages—approximately $5.3 trillion worth! If the government were not to bail out these two giant entities, the entire U.S. and world financial system would likely totally collapse making 1929 look like a picnic.

The other major reason why the government will have to bail them out is brought out in the NY Times article below. Basically the “good credit” of the U.S. government depends on its willingness to do this—even though, technically, these two entities are supposed to be private corporations and not part of the government itself. The fact is that people (at home and abroad) have been led to believe that if necessary the government would bail these two giant speculative corporations out. And so now it must do so, or suffer the consequences. And the consequences could indeed be dire in the extreme.

There has been some speculation that the government support or bailout for Fannie and Freddie might only be partial. (That is one of the reasons why the stock in the two outfits has dropped so much.) But if that is what the government tries to do, it will still bring on disaster. (And probably it will eventually force them to bail out the two with additional hundreds of billions later on, perhaps in a series of giant infusions.)

* * *

The government has long been committed to bailing out the very biggest banks when they come close to bankruptcy, often by arranging for friendly takeovers by other banks (by guaranteeing those taking over the failing bank that they won’t lose money). Recently they extended this policy from commercial banks to investment banks (when they bailed out the big Wall Street firm of Bear Sterns). This method of bailing out failing financial institutions tends to reinforce the already extremely strong current toward
mergers and acquisitions which has already narrowed down the dominance of U.S. financial capital to just a very small number of giant companies. These are the companies that are “too big to fail”.

But now the government is just beginning to understand that every major component of the corporate/government financial morass is “too big to fail”. This includes, rather obviously Fannie Mae & Freddie Mac, but also a whole lot more behind the scenes which hardly anybody has faced up to yet. For example, the FDIC is supposedly a self-sustaining, self-financing agency of the government, which “guarantees” deposits at banks. But the FDIC itself has a finite fund (build by fees on banks); what happens in the middle of a major crisis when that fund suddenly gets wiped out? The answer will have to be that Congress (or the Federal Reserve) will just give them as many more billions as they need.

Then there are the massive amounts of investments (such as those held or created by Wall Street brokerage firms) which are only “guaranteed” by private insurance companies such as the Securities Investor Protection Corporation (SIPC). The SIPC was also set up by the U.S. government (in 1970), but it does not carry the claim of being backed by the “full faith and credit” of the U.S. government. So what happens if that fund goes broke? If the government says “tough luck” (as it should from a moral perspective) then this in turn might lead to general financial collapse. And so it goes.

The plain fact is that the U.S. government and the corporate financial complex in the U.S. are so interconnected that if any one part of it fails, the whole shebang is vulnerable to collapse. This is why the developing financial crisis is so tremendously dangerous.

So, maybe the government should just bail out all of the growing trillions of dollars of financial exposure, you say? Well, that gets us to the other problem that will then result, the complete collapse of the dollar and massive inflation or even hyperinflation. And that would also lead to a vastly greater loss of faith in the U.S. financial system. I think perhaps you may begin to see why the Fed and the Treasury Department have been in something close to a panic recently!

* * *

For some time I have been arguing that despite its many and growing economic problems the U.S. does still have some considerable financial reserves, and that this explains why the current economic crisis (which began, after all, way back in the early 1970s) has already been so prolonged, gradual, and drawn out. My guess is still that this is the case. But it is clear that things are developing more quickly and more wildly in the past 8 years or so, and that right now especially things look like they might be on the verge of some qualitative change for the worse.

I still don’t know for sure if that is about to happen. But I know it will eventually happen, and when it does the present situation of the U.S.—going in and out of recession, with only weak and shallow recoveries in between—will turn into something much worse. The U.S. and world economy are definitely skating on very thin ice, and the cracks seem to be getting bigger and developing faster.

And at the end of this whole process there is an intractable depression comparable to that of the 1930s. As I say, I still think we have a few years left before we sink into that. But, you know, as fast as things seem
to be moving right now, sometimes I wonder myself just how much time we have left.

Have a pleasant day.

Scott

New York Times
July 21, 2008

Trouble at Fannie and Freddie Stirs Concern Abroad

By HEATHER TIMMONS

For more than a decade, Fannie Mae and Freddie Mac, the housing giants that make the American mortgage market run, have attracted overseas investors with a simple pitch: the securities they issue are just as good as the United States government’s, and they usually pay better.

The marketing plan worked. About one-fifth of securities issued by Fannie, Freddie and a handful of much smaller quasi-governmental agencies, some $1.5 trillion worth, were held by foreign investors at the end of March. One out of 10 American mortgages is, in effect, in the hands of institutions and governments outside the United States.

Now that the two companies are at risk, how their rescue is handled will ultimately test the world’s faith in American markets. It could also influence the level of interest rates and weigh on the strength of the dollar for years to come, analysts say.

“No less than the international perception of the credit quality of the U.S. government is at stake,” said Richard Hofmann, an analyst with CreditSights, an independent research house with offices in London and New York.

Also at stake is Americans’ future ability to gain access to credit. If foreign companies and governments abandon United States investments, home, auto and credit card loans will be much more difficult to come by.

That helps explain why Treasury Secretary Henry M. Paulson Jr. is pressing American lawmakers for the authority to inject unspecified billions in cash into either company or both. The “blank check” nature of his request has raised concerns on Capitol Hill, but Mr. Paulson is betting that Congress is even more fearful of the consequences of doing nothing to rescue Fannie and Freddie.

On Sunday, in an appearance on the television program “Face the Nation,” Mr. Paulson said he was “very
optimistic that we’re going to get what we need from Congress.”

“Congress understands how important these institutions are,” Mr. Paulson said.

Asian institutions and investors hold some $800 billion in securities issued by Fannie and Freddie, the bulk of that in China and Japan. China held $376 billion and Japan $228 billion as of June 2007, the most recent country-specific Treasury figures.

In Europe, roughly $39 billion in Fannie and Freddie debt is held in Luxembourg and $33 billion more in Belgium, countries that are home to large investment management firms. Investors in Britain hold $28 billion, and Russian buyers hold $75 billion. Sovereign wealth funds in the Middle East are also believed to be big investors in Fannie and Freddie debt.

The trillions in securities issued by Fannie and Freddie and backed by American mortgages were never explicitly guaranteed by the United States government, but foreign and domestic investors alike have always believed, because of the companies’ integral role in the housing market and their marketing pitch, that the guarantee would be backed up if it were tested.

As the United States government’s debt, and the corresponding amount of Treasury securities, shrank in the late 1990s, foreign investors with currency reserves needed a safe alternative to park their cash. Fannie and Freddie stepped up their overseas marketing efforts and, with the help of Wall Street banks, sold billions of dollars in securities overseas.

Asian banks and insurers bought Fannie’s and Freddie’s paper because it gave a little more yield than a straight Treasury note – “the same risk at a better price,” said Deborah Schuler, an analyst with Moody’s Investors Service in Singapore.

Investment managers at Asian banks and central governments are “very comfortable with the idea of implied government support” because it is so prevalent in Asia, Ms. Schuler said.

Still, this week’s Congressional debate on the issue “is going to worry people,” Ms. Schuler said, though she, like most analysts, is confident that Washington will deliver, just as it has in past financial crises like the savings and loan industry bailout of the late 1980s and early 1990s.

Because America’s relations with a host of countries are intricately tied to Fannie and Freddie, the only realistic option open to lawmakers may be to hand the Treasury Department that blank check, analysts say.

The two housing agencies have always been fierce competitors, and they made no exception in their expansion into international markets. Top executives wooed governments, banks and insurance companies in Asia and Europe, and lent executives to help foreign governments, including Russia and Hong Kong, set up their own American-style mortgage markets.

Both companies often compared their product to United States Treasuries when they talked to
international investors, and adjusted the way that bonds matured and were priced so they looked and acted more like Treasury bonds.

In an interview with a London financial trade paper in 1999, Jerome T. Lienhard, Freddie Mac’s senior vice president of investment funding, said, “Investors that make the transition from U.S. Treasuries to our securities will be pleased with the performance.” Freddie Mac’s program is “designed to mirror that already used by the United States government,” he said.

The Treasury will not comment on Fannie and Freddie’s international marketing pitches, but in the past it has tried to rein in the two institutions.

In March 2000, Gary Gensler, then Treasury under secretary, proposed more oversight of Fannie and Freddie, testifying to Congress that the two agencies “receive no funds from the federal government, and the government does not guarantee their securities.”

The companies “have been promoting their debt securities as an alternative market benchmark” to Treasuries, he noted, particularly as the amount of Treasuries issued by the government shrank with the deficit. Mr. Gensler’s comments roiled mortgage markets, sending prices down sharply on traded Fannie- and Freddie-backed securities and on both companies’ stock. Ultimately, the controls he proposed were softened.

The bulk of investments related to Fannie and Freddie are in the form of mortgage-backed securities, often called agency securities or agency paper. This agency paper is considered of much higher quality than securities backed by subprime loans because Fannie and Freddie generally lend to borrowers with good credit histories and require higher down payments.

Prices on senior Fannie and Freddie securities, the highest quality, have not changed significantly since the end of last year, even as the two companies’ stock prices have plummeted, Moody’s noted. As of June 30, 2008, prices on a typical Fannie or Freddie security maturing in 10 years were off only about 2 percent from December 2007.

Questions about Fannie and Freddie have prompted individual institutions and governments in Asia and Europe to specify their exposure in recent days, but so far international concern has been limited. Ingo Buse, a spokesman for Zurich Financial Services, Switzerland’s largest insurer, said it held $8.3 billion in mortgage securities backed by Freddie Mac or Fannie Mae, and felt “comfortable with our position and asset allocation.”

Swiss Reinsurance, Switzerland’s largest reinsurer, said on Wednesday that it held $9.6 billion of corporate debt from Freddie Mac and Fannie Mae and $12 billion in mortgage securities backed by the two companies. Swiss Re’s holding of Freddie Mac and Fannie Mae shares is minimal, it said.

Hannover Re, Germany’s second-largest reinsurer after Munich Re, said it held 125 million euros, or $199 million, in securities issued by Freddie Mac and Fannie Mae. “We are not worried about the exposure,” said Stefan Schulz, a spokesman for the company, “because we expect the U.S. government to
step in if there is any problem.”

Julia Werdigier contributed reporting.