



Government Bailout

Oftentimes in life, a little bit of something is beneficial, sometimes even necessary. But just because a little bit is good, it doesn't always follow that more is better. Many times, that just makes things worse. A classic example is government. Some government is necessary, in order to secure our rights and protect us from the harmful actions of others. But history shows that too much government leads to the abuse of power and the violation of our God-given rights to life, liberty, property, and the pursuit of happiness.



Consider the consequences of the legislation that Congress recently enacted (The American Housing Rescue and Foreclosure Prevention Act of 2008), to bail out two mortgage lending institutions: the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). The story behind these two Government Sponsored Enterprises (GSEs) provides convincing evidence that they are a corruption of free-market financing. It turns out to be another classic example of what 19th-century French economist Frederic Bastiat referred to as "concocting the antidote and the poison in the same laboratory," to describe the problems caused by government interventionism (the poison) and how a government exploits these problems and prescribes more interventionism (the antidote) as a strategy to enhance its power.

Developing Crisis

Our story begins during the Great Depression of the 1930s, when Fannie Mae and Freddie Mac were created, as products of President Franklin Delano Roosevelt's so-called New Deal. Their mission was to provide financial support to thrift and savings banks and to fund mortgage loans insured by the Federal Housing Administration, in order to make home ownership more affordable. All of this occurred during a time of great financial instability and was felt to be the remedy needed. As with virtually all government programs aimed at solving various crises, Fannie Mae and Freddie Mac outlived their initial purpose but continued to operate by changing their focus in order to justify their existence.

As American soldiers returned home from World War II, Fannie Mae was empowered to start purchasing loans guaranteed by the Veterans Administration. With the notion of a right to home ownership by means of government subsidies becoming firmly implanted in people's minds, Fannie Mae was destined to grow. Accordingly, as part of President Lyndon Johnson's social engineering schemes collectively referred to as "The Great Society," Fannie Mae was converted into a private corporation in 1968, and stock was sold to investors. Freddie Mac eventually did likewise, becoming a company in which investors could buy shares of stock in 1989.

While those institutions have been "privatized," they still remain connected with the federal government in some very important ways. For one thing, Fannie Mae and Freddie Mac have access to a guaranteed line of credit with the U.S. Treasury. This guarantee allows them to borrow money at less cost than their private-sector competitors. Secondly, they are exempt from state and local income taxes. Thirdly,



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they are not required to file audited financial statements with the Securities and Exchange Commission. Finally, they have enormous influence on Capitol Hill.

Initially, Fannie Mae and Freddie Mac bought home loans from banks and then pooled them to form investment securities, which they sold to investors in the form of bonds, thus passing on some of the financial risks to the bondholders. But they shifted away from this activity during the early 1990s, when management decided that they could generate higher profits by holding mortgages in their own investment portfolios, rather than by just securitizing them through issuing bonds. As with any investment, however, a higher return usually requires accepting a greater risk of loss. Since most of the mortgages they bought paid a fixed rate of interest, any change in interest rates could significantly affect the value of the portfolio.

Since 1990, Fannie Mae's and Freddie Mac's investment portfolios have grown from \$135 billion to \$1.4 trillion. The portfolios contain mortgages at different rates of interest and with different durations, further complicating the task of managing interest-rate risk. However, since interest rates were generally declining during the 1980s and 1990s, profits more than covered losses. (When interest rates decline, the value of bonds and mortgages increases; when interest rates rise, the value of bonds and mortgages decreases.) On top of that, the special government privileges extended to these GSEs led many investors to believe that both were immune from normal business and financial risks.

As the Federal Reserve dropped short-term interest rates from 6.5 percent in January 2001 to 1.0 percent in June 2003, mortgage rates followed suit, launching a massive refinancing of homes, as well as igniting a boom in the housing market. The rising demand for homes drove up house prices, generating a wealth effect (the tendency for people to spend more when their assets rise in value) even greater than the wealth effect of stocks during the mania of the late 1990s, due to the fact that home equity makes up a greater proportion of most people's net worth.

The rise in home values and the belief that real estate prices could only go up led homeowners to take out equity loans on their homes, in order to invest in more real estate, or the stock market, or to ramp up their lifestyles. Relative debt levels were driven to record highs, with the blessings of then-Federal Reserve Chairman Alan Greenspan, who stated that cashing out the equity in homes was helping the economy. At a time when interest rates were lower than they had been in two generations and seemed to have nowhere to go but up, Greenspan actually encouraged new home buyers to take out adjustable rate mortgages!

As the long-term downtrend in interest rates bottomed out during the early 2000s and the boom in the housing market started coming to an end, the earnings of Fannie Mae and Freddie Mac began to take a beating. And then, in 2004, the Office of Federal Housing Enterprise Oversight, which is charged with regulating the activities of those two GSEs, revealed that they had been cooking their books, reporting, "Senior management manipulated accounting, reaped maximum, undeserved bonuses, and prevented the rest of the world from knowing." Fannie Mae's CEO, Franklin Raines, was ousted but, unlike the Enron-scandal executives, did not go to prison. In fact, he left with a \$25 million retirement package and is reported to be currently serving as an adviser on housing and mortgage issues to the Obama campaign!

From 2001 to 2005, the stock prices of Fannie Mae and Freddie Mac dropped more than 50 percent. To address the crisis, Congress came up with a piece of legislation entitled "The Federal Housing Finance Reform Act of 2005." In a speech on the House floor that seems clairvoyant in retrospect, Rep. Ron Paul explained why he was opposed to the bill:



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Ironically, by transferring the risk of widespread mortgage defaults to the taxpayers through government subsidies and convincing investors that all is well because a "world-class" regulator is ensuring the GSEs' soundness, the government increases the likelihood of a painful crash in the housing market. This is because the special privileges of Fannie and Freddie have distorted the housing market by allowing Fannie and Freddie to attract capital they could not attract under pure market conditions. As a result, capital is diverted from its most productive uses into housing. This reduces the efficacy of the entire market and thus reduces the standard of living of all Americans.

Despite the long-term damage to the economy inflicted by the government's interference in the housing market, the government's policy of diverting capital into housing creates a short-term boom in housing. Like all artificially created bubbles, the boom in housing prices cannot last forever. When housing prices fall, homeowners will experience difficulty as their equity is wiped out. Furthermore, the holders of the mortgage debt will also have a loss. These losses will be greater than they would have been had government policy not actively encouraged over-investment in housing.

Perhaps the Federal Reserve can stave off the day of reckoning by purchasing the GSEs' debt and pumping liquidity into the housing market, but this cannot hold off the inevitable drop in the housing market forever. In fact, postponing the necessary and painful market corrections will only deepen the inevitable fall. The more people are invested in the market, the greater the effects across the economy when the bubble bursts.

Nevertheless, the measure passed by a recorded vote of 331 to 90, although it never became law because it never came to a vote in the Senate.

Those who took out adjustable rate mortgages while interest rates were in the process of bottoming during the period 2002-2004 got a rude awakening, as interest rates started climbing over the next few years. From June 2004 to September 2007, the Federal Reserve raised the Fed Funds rate (the cost of overnight loans between banks) from 1.0 percent to 5.25 percent. Those with adjustable rate mortgages saw their monthly payments rise dramatically. Exacerbating the problem was that many mortgage brokers had been aggressively marketing home loans for more than the assessed value of the property and requiring no down payment. In many cases, buyers did not even have to provide proof of the income they claimed on their loan applications. Fittingly enough, they became known in the business as "liars' loans."

Political correctness also helped to push Fannie Mae and Freddie Mac into the mess they face today. To understand how, it is necessary to go back to a time when banks were careful to whom they loaned money, basing their loan decisions on the amount of risk involved. Common sense often dictated whether a loan would be made or not. So, too, in our own personal lives, common sense leads us to take sensible precautions in order to lower the chances of harm to ourselves, such as avoiding some neighborhoods. Likewise, banks have always known that places where it is dangerous to go are also places where it is dangerous to send your money. But the practice of not lending in some neighborhoods became demonized as "redlining" and the revelation that "only" 72 percent of minority applicants were approved for mortgages, versus 89 percent of white applicants, was considered to be overwhelming evidence of discrimination by the mainstream media.

The moral outrage whipped up throughout the media resulted in a campaign to get Congress to pass laws forcing lending institutions to loan money to people they would otherwise not lend to and in places



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where they would otherwise not put their money. Congress ultimately passed The Community Reinvestment Act in 1977, which forced lending institutions to grant mortgages to people whose income, credit histories, and net worth would previously have disqualified them from getting such loans. These so-called "sub-prime" loans, brought about by federal government intervention, have contributed mightily to the present financial fiasco. Ironically, we are now being told that more government intervention will save the day.

What Now?

Everything Rep. Ron Paul predicted has been playing out. Millions of people who had no business getting a mortgage loan have been defaulting on their monthly payments. Hundreds of thousands of homes are now in foreclosure. The housing market is crashing and there is every indication that we are nowhere near the bottom, as the economy continues to slow and unemployment continues to increase. That was painfully obvious to investors earlier this year and that induced them to dump shares of Fannie Mae and Freddie Mac, driving down their stock prices more than 80 percent between March and July.

In a knee-jerk response to the crisis, Congress swung into action. On July 23 the massive American Housing Rescue and Foreclosure Prevention Act of 2008 was approved in the House of Representatives by a vote of 272 to 152. Three days later it sailed through the Senate by a margin of 72 to 13, and on July 30 it was signed into law by the president. A close reading of the bill does not inspire confidence. The Congressional Budget Office estimates that the total cost of the bailout will be \$25 billion. However, the bill raises the federal debt limit by a whopping \$800 billion, indicating that the final cost is likely to be much higher.

Once again, Rep. Ron Paul has offered the best commentary on the situation:

Some mistakenly identify the falling home prices as the disease instead of merely a symptom — which they plan to fix with more easy credit and more liquidity to push more unqualified buyers back into the market for homes they still cannot afford. This is akin to the drug addict identifying withdrawal symptoms as his problem and searching for another fix as his solution. The cycle continues and the problems compound themselves. The addiction deepens.

Addicts are told the first step to recovery is to admit their problem. To cure this addiction to intervention we have to honestly admit the problem and once and for all, kick the habit. That will involve some pain, without a doubt. There is no easy, painless solution to the mess the disastrous economic interventions of the past have wrought. The question is — do we allow some lending institutions to collapse, or do we allow the dollar to collapse? To extend the metaphor, do we endure the temporary discomfort of withdrawal, or do we continue on until there is a fatal overdose? We can delay the agony, but only for a little while, and then we will all end up paying the price for the mistakes of a few.

With the final passage of the Housing Bailout Bill quietly on a Saturday in the Senate, and the President's signature, our government has unfortunately chosen the latter.

When Treasury Secretary Henry Paulson presented his rescue plan for Fannie Mae and Freddie Mac in July, he claimed that the pledge of government support for the two GSEs would restore market confidence, making it easier for them to raise capital and to continue borrowing at favorable rates. Since then, however, what was left of the two mortgage giants' market capitalization has almost evaporated and they are being forced to pay higher interest rates on their bonds.



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As housing prices continue to fall, Fannie Mae and Freddie Mac stand to lose billions more, giving them virtually no chance to raise enough private capital to rebuild their dwindling resources. Furthermore, if they cannot borrow at more favorable rates and pass those savings on to home buyers, then the very reason for their special status as GSEs is brought into question. Warren Buffet, arguably history's most gifted and successful investor, even chimed in recently to warn, "The game is over."

Fannie Mae and Freddie Mac own or guarantee almost half of the \$12 trillion U.S. mortgage market. Financial institutions all over the world hold their bonds. Therefore, Congress has given Paulson authority to keep them operating with government support because they are considered too big to be allowed to fail. Hence, the U.S. Treasury announced a massive bailout at the end of the trading day on September 5 because prolonging the agony will only serve to increase the final cost of the rescue. Ultimately, the federal government will seize control, wiping out the investments of the existing shareholders.

Lessons Learned

So, what lesson have we learned, or perhaps I should say *relearned*, from this financial disaster? It is that when government "encourages" something, it is all too often as much to be feared as when government is hostile towards something. In the case of granting credit, government operates by different standards, compared to the private sector, making loans to people who could not get them from private lenders. In other words, government lenders will take risks with the taxpayers' money that private lenders will not take with their own money. This is a classic example of the concept known as "moral hazard," whereby people will be tempted to behave recklessly because they know that they will be bailed out if things go wrong.

But there is another consequence to such a policy that may not be so obvious, namely, that it leads to an inefficient use of the limited capital in the economy. Government lenders will put capital into dubious projects, in pursuit of some politically correct social or economic goal, such as "creating employment," oftentimes through inefficient, make-work schemes. In the end, government loans reduce economic productivity, compared to private loans. Government loans provide immediate benefit to certain privileged groups, while depriving capital to other groups, resulting in a net loss to the nation as a whole.

Likewise, government-guaranteed loans and mortgages, especially when a little or even no down payment is required, inevitably lead to more bad loans than otherwise would be the case. Such loans force the taxpayer to subsidize the bad risks and to defray the losses. They encourage people to buy houses that they cannot really afford. The increased demand for housing stimulates residential construction, raises the cost of building materials, and eventually misleads the building industry into a costly overexpansion. In the end, government-guaranteed loans and mortgages encourage malinvestment, leading to booms and busts, which undermine the general welfare of the nation.

It is worth remembering that the government does not lend or give anything away that it does not first take from someone else. The government does not produce wealth; it seizes it from the private sector through taxation. When the government makes loans, or guarantees mortgages, it is effectively taxing successful citizens and businesses, in order to support unsuccessful citizens and businesses. Clearly, this does not sound like a formula that encourages a favorable outcome, in the long run. The Fannie Mae and Freddie Mac fiasco is proof positive that it isn't.

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