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A Cautionary Tale

For the past six months, the S&P has effectively moved sideways after a spectacular rally from the March low. There is concern that after a stimulus-induced recovery in GDP and corporate profits the domestic economy is slipping into a sub-par growth rate that provides neither job creation nor further material gains in profitability. How can this be, given the fact that nearly $11 trillion in government commitments (guarantees, loans, and investments) have been put in place? Why do we have so little to show for it? Government officials talk about jobs saved rather than job creation. The Congressional Budget Office and forecasters at the Federal Reserve are all forecasting an extended period of high unemployment and low economic growth. Could it be that too much of the monetary and fiscal pump-priming was squandered?

Even John Maynard Keynes' emphasis was on private sector investment as the key to sustainable growth in jobs. He did not advocate investment in a particular asset, like housing. Instead, his suggestion that government "prime the pump" by spending during recessions was intended to ignite the "animal spirits" in the private sector, which could be incentivized to make the kind of investments necessary for a robust and self-sustaining recovery. Spending for spending sake was not his goal. Indeed, full employment by government could be achieved by hiring workers to dig holes and fill them up again. Since this obviously has no economic benefit, this solution would fail in the long-run. In short, even Keynes saw government as a means to an end, and not a long-run solution. Current actions, including putting Fannie and Freddie in conservatorship, extending aggressive loan practices via the FHA, and other government programs for subsidizing housing investment are potentially diverting resources from more viable private endeavors in favor of underwriting additional malinvestment.

Subsidies Are Not Free

Indeed, the mortgage crisis that began with subprime borrowers has moved up the ladder to the Federal Government. Policies geared toward perpetuating housing and mortgage subsidies, such as government guarantees of mortgages, do not come without a cost. Consider that implicit in the terminology "full faith and credit" is a vague notion of unlimited government resources to meet direct or contingent liabilities. History is replete with examples of this not being the case. Over-committed governments (Germany in the early 1900s, Latin America in the 1980s, and Greece, Portugal, and Spain today) ultimately can impose huge burdens on citizens through taxation on incomes and property, and with inflation (which is essentially a tax on money). Government has no resources of its own. Therefore, any subsidy provided to one group is a transfer from another. In the case of government-sponsored mortgage guarantees, they involuntarily transfer risk from private borrowers and lenders (who have visibly organized lobbying groups representing their interests) to society (who are largely unaware of the longer-term costs and who are not well organized).

While some may be tempted to believe that such guarantees only convey benefits with no cost, consider that for every visible subsidized loan, there is a less visible cost imposed upon some other group within the economy. Because of the subsidy, savers are forced to accept a lower rate of interest on savings. Entrepreneurs and investors are potentially denied funds that are being redirected via the subsidy. New homebuyers are forced to pay a higher price in the purchase of a home than they might otherwise. Future generations may inherit more debts along with a less productive economy should resources end up being diverted away from more productive uses in the process. All of this means a lower standard of living. The key point is that there are two sides to the ledger when it comes to government spending and subsidies. The obvious benefits come first and become the talking points for those in political office. The myriad of costs that inevitably follow are always more difficult to assess, but are no less real.

Public Initiative vs. Private Incentive

Then there are the questions about what can happen when government initiatives undermine incentives in the private sector. This is evident in the case of the growing tendency for “upside-down” homeowners to default on their mortgage. According to a recent article in *The Wall Street Journal*, 11 million families are “upside-down” in their homes – meaning that they owe more than the house is worth. For 5 million of these families, they are underwater by more than 25%. The article goes on to say that one in five mortgagees in California, one in three in Florida, and one in two in Nevada are in such a condition. Not surprisingly, these mortgagees are more likely to default on their mortgages – especially if home prices fail to recover quickly. How did it come to be that homeowners had such little “skin in the game” in the first place? A bit of history here might prove instructive.

In 1933, before the creation of the Federal Housing Administration (FHA), the typical down payment on a home was 40%, with the remainder paid for in either 5 or 15 years utilizing a conventional mortgage at prevailing market rates. After the creation of the FHA, the minimum down payment fell to 20%, with the balance typically financed with a

traditional 15- or 30-year fixed rate loan. Now, a 3% down payment is available for qualified buyers under FHA's ever easier loan standards. If less collateral down weren't enough, Federal Reserve member banks and Government-Sponsored Agencies began to offer more exotic financing options, like option-ARM, interest-only, and bullet mortgages. Government-sponsored Fannie Mae still issues interest-only loans (although they announced their intention to stop such offerings in September) despite the delinquency rates on those mortgages having risen to 19%. They still continue to guarantee adjustable rate mortgages, despite those delinquency rates being near 13%.

Fannie Mae continues these business practices despite posting their 10th straight quarter of losses, and despite their request to Congress for aid of approximately $80 billion. It seems clear that efforts to boost home ownership by essentially eliminating down-payment requirements, while financially engineering lower (but less certain) payments, undermines private incentive to stay in a home. Once this private incentive is gone, the risk to continuing the strategy is obvious. Government policies to foster homeownership, and promote upward mobility, become conflicted with those same goals. A government initiative that is not supported by private incentives runs a greater risk of imparting only limited benefits despite unlimited costs.

Fed's Role

Besides the government's fiscal response to the current housing crisis, we should also be mindful of the Federal Reserve's role in subsidizing borrowers through their setting of short-term interest rates during the bubble. Through the Federal Reserve's Open Market Committee, the central bank fixes the price of loanable funds between member banks. This Fed Funds rate becomes the key rate "anchor" for all other interest rates in the economy. Should the Fed choose a rate that is lower than what market forces would produce on their own, the effect is similar to that of a price ceiling, with economy-wide implications. Such a price ceiling could promote an excess supply of loanable funds and debt compared to the supply that would be available if no ceiling existed. Since the Fed is responsible for setting this rate, it seems reasonable that they also be accountable for any imbalances in debt and credit that might result from their actions. Compounding matters, in our view, is the possibility that the Fed is willfully blind to asset bubbles, since they choose to ignore asset prices in assessing inflation.

Milton Friedman, a noted monetarist, said that "Inflation is always and everywhere a monetary phenomenon." Interest rates set by the Fed are, in large part, dependent on an accurate assessment of inflation. We believe that inflation should be viewed in its broadest sense. However, the Fed has adopted a narrow definition of inflation tied just to consumer prices, rather than all prices, which would include assets. Irving Fisher, who preceded Friedman and who developed the Quantity Theory of Money used by most monetarist economists, looked not just at consumer transactions, but also intermediate and capital purchases (homes, stock prices) in order to get the broadest possible measure of the price level in assessing inflation. This broader measurement concept was lost over the years, particularly in 1983 when the Bureau of Labor Statistics dropped housing prices from the calculation of the price level, and substituted a conceptual alternative measurement called owner's equivalent rent,

which failed to capture the increase in housing prices during the last cycle. This was a major change, since housing accounted then, as it does now, for over 40% of the consumer price index. If that change hadn't been made, we estimate that the CPI would have been rising between 6-8% during the boom. Such a reading would almost certainly have prompted the Fed to consider raising rates, thus limiting the expansion of debt, and credit. Inflation in home prices would have been curtailed, and the level of malinvestment and defaults would have been much less. And what would be wrong with that? No bubble, no bust.

But the most deeply troubling aspect of this is the Federal Reserve's balance sheet. If you take a moment to look at the footnotes on the balance sheet, you will see that the collateral backing our money (Federal Reserve notes) is about 50% mortgages. A couple years ago, it was mostly Treasuries and gold. Several decades back, it was predominantly gold. We are still in the early stages of experimentation with a monetary system that has no anchor in any commodity. The financial system has become completely untethered from the discipline imposed by a linkage to a finite and scarce commodity. Unlimited issuance of debt-backed money, with declining collateral quality, is inherently destabilizing for any society. The distortive effects of social agendas further confuse the price system and result in poor resource allocation, so that, in the end, everyone suffers. The idea of "full faith and credit," "too big to fail," and "risk free" rates of return only add to the wrong perception of "free lunches," which encourages excessive leverage, risk taking, malinvestment, and "moral hazard." Financial markets are growing wary of the current free lunch. Caution is advised.