Yet Another Domino Falls

The Fannie and Freddie crisis is a great illustration of how interconnected the world of finance has become.

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The recent travails of Fannie Mae and Freddie Mac, America's two largest mortgage companies, have created new reasons for global markets to be nervous. These two government-created and -supported organizations buy residential mortgages that are extended by banks and then securitize and sell them in global markets. Given that there's already a housing crisis in the United States and that Fannie and Freddie together hold about half of the country's $12 trillion in mortgage debts, their ability to keep borrowing at low rates is critical to the pricing of mortgages going forward. That borrowing, in turn, will have a lot to do with Washington's ability to keep mortgage prices from rising, causing the housing market to weaken further. And that will be key to keeping consumer spending from collapsing and clobbering U.S. trading partners.

The Fannie and Freddie crisis is a great illustration of how interconnected the world of finance has become. According to the U.S. Federal Reserve, foreign entities now own about $1 trillion of the securities held by Fannie and Freddie. Owners include central banks in China, Russia and Saudi Arabia and big financial institutions such as Mitsubishi UFJ in Japan and Swiss Re in Zurich. It's hard to know if these securities became dangerously concentrated in any one country or institution, although rumors of problems have rattled markets in Japan and Taiwan.

The short-term future of Fannie and Freddie is fairly secure since there is no chance that the U.S. Treasury and the U.S. Federal Reserve will fail to provide all the capital the two institutions need to stay afloat. Nevertheless, there are reasons for global concerns down the road. The U.S. economy is sufficiently weak that housing prices may well continue their descent. That will put more pressure on Fannie and Freddie, requiring Washington to shore up the institutions' equity bases. This action could add tens of billions of dollars to the U.S. debt, weakening the dollar and consequently pushing up oil prices and raising the cost of imports. Both of these factors contribute to America's inflation problem. If inflation continues to rise, the Fed could be forced to raise interest rates and further restrict U.S. growth—and, by extension, global GDP.

There is also a chance that Washington could decide to approach foreign sovereign wealth funds to help recapitalize Fannie and Freddie. The SWFs have already been burned by investing in firms like Merrill Lynch and Citigroup. But it is possible that the Treasury could devise some sort of security that is a hybrid of equity and debt to protect SWF investments.

Of course, the Fannie and Freddie situation could further erode the confidence of foreign lenders and investors in the management of U.S. financial markets. The subprime mess revealed an egregious lapse in regulation and morality on Wall Street and in Washington. What has happened to Fannie and Freddie is a result of that subprime disease. But the crisis at these two institutions is an even worse reflection on U.S. capitalism since the seeds of the GSE's problems were sewn many years ago, when Washington decided to make these bodies into instruments of social policy—using them to facilitate homeownership—while preserving the façade that they were private-sector banks. This policy led to today's mess because it allowed the shareholders and executives of these enormous banks to gain from any profits, while passing on losses to taxpayers. In fact, Fannie and Freddie were always political institutions as much as banks. But by turning them into vehicles for crony capitalism, Washington has given foreign lenders and investors one more reason to think about reducing their exposure to the dollar and to the U.S. market.

One consequence of all this is that it will now be a long time before any U.S. official will be in a position to tell other governments how to manage their finances. They'll be too busy fixing their own system. Standing behind Fannie and Freddie's debts and injecting some equity is only a stopgap measure. The two companies will need to be massively restructured: probably broken up and either fully nationalized or fully privatized, but nothing in between. That will be a
delicate operation while so much debt is outstanding and while markets follow every twist and turn in the Washington debate, and it will take many years.

In the meantime, other governments that have had qualms about Washington's arrogant, free-market fundamentalism will feel free to make their protests known. In the past, when U.S. officials met with their equivalents from, say, China, it was the Americans who preached about how to cut banks loose from the government corset, why the yuan was mismanaged, how and when Beijing should further open its markets and so on. Last month, at the semiannual meeting of the two countries' highest-ranking economic and financial officials, it was the Chinese officials who scolded the United States for its lax regulation and the virus it set loose in financial markets. That's no small irony—and a sign of the massive international changes now underway.

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