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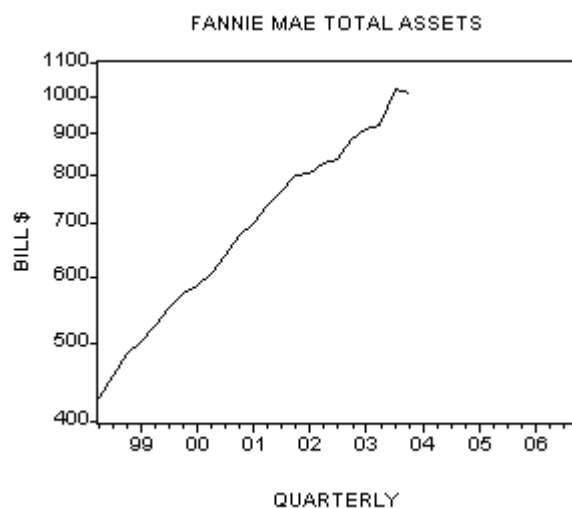
Sunday, March 07, 2004

Who Made the Fannie and Freddie Threat?

By Frank Shostak

[Posted March 5, 2004]

On Tuesday February 24, 2004, the chairman of the Federal Reserve, Alan Greenspan, in his [testimony](#) to the Senate Banking committee, issued a warning that Fannie Mae and Freddie Mac—the two giant mortgage buyers—have grown so large that they pose a threat to the entire financial system. To reduce this threat the Fed chairman recommends that Congress cap their size. In this regard, in Q4 the assets of Fannie Mae stood at over \$1 trillion.



According to Greenspan, because the public regards these institutions as having the full support of the government, they can borrow in the market at a subsidized interest rate, so to speak. This in turn enables them to pay higher prices to originators of mortgages than potential competitors can pay. In short, both Fannie Mae and Freddie Mac are monopolizing the mortgage market.

Fannie Mae's outstanding mortgage backed securities (MBS) stood at \$1.3 trillion in Q4. The yearly rate of growth of Fannie Mae's outstanding MBS jumped to 26.3% in Q4 from 22% in the previous quarter.

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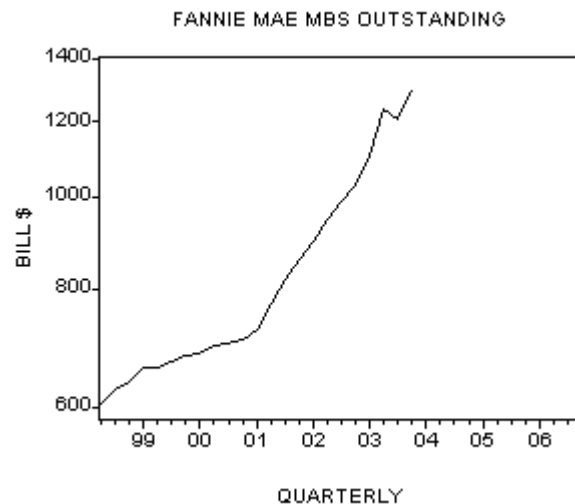
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The fact that a large portion of mortgages is currently concentrated in few hands poses a greater risk to the financial system, so it is held, than if ownership was widely diffused. Hence, according to Greenspan, if the real estate market should suddenly weaken this could pose a serious threat to the financial system and to the economy.

Furthermore, according to Greenspan, because of their size both Fannie Mae and Freddie Mac know that the government will not allow them to go belly up. It is this that makes them less prudent in accumulating massive amount of debts and assets: the moral hazard at work.

But this is not only applicable to Fannie and Freddie, it is also applicable to most large U.S. banks. In fact the entire banking system is built around the ongoing support provided by the Fed's monetary pumping. So why single out Fannie and Freddie? Now, even if we didn't have such institutions as Fannie and Freddie, due to the Fed's loose monetary policies we would still have undesired symptoms regarding the housing market.

Curiously, while identifying government sponsored enterprises as a major risk factor behind a possible real estate market plunge, Alan Greenspan had nothing to say about the role of the Fed in all it.

As a result of loose monetary policy, which aims to "protect" the financial system, financial institutions always receive the new money first. Obviously this gives rise to an expansion of activities of the earlier receivers of money. An early receiver of money can afford, so to speak, to become more of a risk taker and undertake various risky activities.

In reality however, the new money leads to an exchange of nothing for something. It leads to the enrichment of the earlier receivers and to the impoverishment of the late or nonreceivers of the new money. Money and credit out of thin air leads to a redistribution of real wealth.

There is no doubt that the spreading of risk across an economy as a whole is much better than having it concentrated in a few large institutions like Fannie and Freddie. So when Greenspan complains about this state of affairs he shouldn't blame the GSE's for it but rather the Fed's loose monetary policies which prevents an even distribution of risk.

In fact, the uneven risk spread is the structural manifestation of the loose monetary policies of the Fed. This is because the first receivers of money can undertake larger risks while the late receivers, on account of their resulting impoverishment, can only

afford to take less risk. This is the source of the 'skew' that leads to the resulting imbalance.

Greenspan is absolutely correct that once the size of Fannie's and Freddie's assets and debts become too large there is the risk of a financial accident. However, this accident never emerges out of the blue, but rather as a response to and effect of the erosion of the pool of real savings brought about by the loose monetary policies of the central bank. The erosion of the pool of funding undermines real growth and the formation of real wealth, which in turn triggers the burst of the bubble. With real wealth falling people's capacity to support their liabilities diminishes.

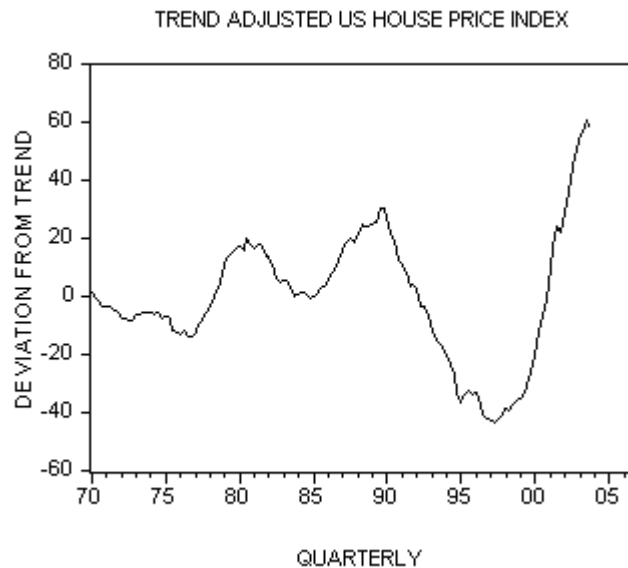
Can then a stricter regulation of GSE's, as suggested by Greenspan, eliminate the risk of a plunge in the real estate market? As long as the Fed continues with its loose monetary policies, it will not be possible to eliminate this risk. Once loose monetary policy is activated it immediately sets in motion the process of a false economic boom, or financial bubble, which sooner or later must be liquidated because it is unsustainable. The longer the false boom, the more liquidations will be required. Loose monetary policy gives rise to various higher risk activities that prior to this policy would never have been considered. Hence, once the flow of money slows down the existence of these activities is threatened.

It is for this reason that the Fed continues to maintain its low interest rate stance: in order to keep various artificial forms of life going. However, this policy cannot be pursued successfully for an indefinite period. At some stage the Fed becomes nervous about the size of the false creature it has created.

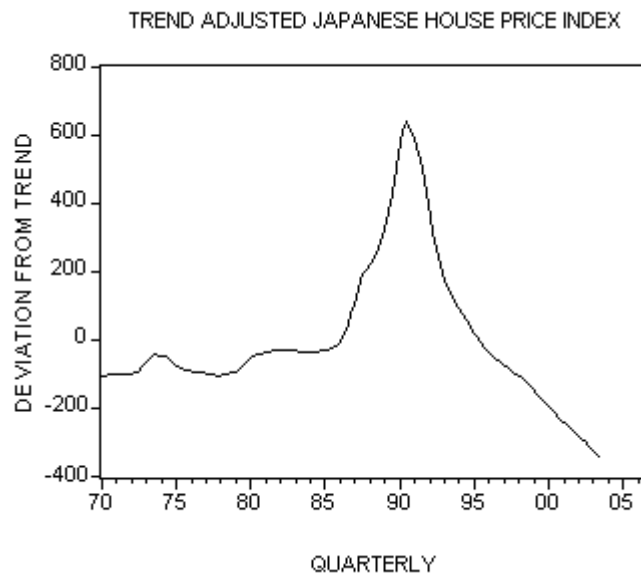
Consequently, the attempt to rein into the size of the monster leads to an economic bust. Now, contrary to conventional wisdom the bursting of the bubble is the beginning of economic healing. It arrests the bleeding of real wealth generators and puts things into a proper perspective.

It seems to us however, that Greenspan is already preparing the public for the likely bust of the housing market. This in turn means that he is likely to fight off the burst of the housing bubble by an aggressive monetary pumping. However, if the pool of funding is already in trouble, which is most likely the case, given the present level of indebtedness in the economy and shrinking savings, then monetary pumping won't be able to "revive" the economy.

There is a strong likelihood that the U.S. housing market bubble has already reached dangerous dimensions. The trend adjusted house price index has been following an explosive growth path. After falling to -44 in Q2 1997 the trend adjusted house price index jumped to +60 in Q4 2003.



There are a lot of similarities in this regard with Japan in the 1980's and early 1990. During that period the trend-adjusted price index followed an accelerating growth path. A major reversal in this growth path took place after 1990 with the trend adjusted house price index plunging to -350 in Q3 2003 against a peak of +640 in Q3 1990.



It seems to us therefore that the Fed is barking up the wrong tree. It is not possible to fix the housing market problem by fixing symptoms. What is needed is to restrain the Fed from its reckless monetary policies, which structurally distort the economic environment and give birth to various ugly symptoms.

Frank Shostak is an adjunct scholar of the Mises Institute and a frequent contributor to Mises.org. He maintains weekly data on the AMS for subscribers through [Man Financial, Australia](#). Send him [MAIL](#) and see his outstanding Mises.org [Daily Articles Archive](#). Shostak wishes to express thanks to Michael Ryan for his useful comments. Comment on this article on the [Mises Economics Blog](#).

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- [Wealthy Beyond a Reasonable Doubt](#) In one of its news dispatches following the trial, CNN declared that the Martha Stewart case was part of the government's "crackdown on corporate corruption." This is ridiculous, write William Anderson and Candice Jackson. Stewart was not a "corrupt" executive, nor did she break the law when she sold her shares of the temporarily doomed ImClone stock. No, Stewart apparently committed the "crime" of being wealthy and well-connected.
- [Who Made the Fannie and Freddie Threat?](#) So Greenspan says that Freddie Mac and Fannie Mae are so big and so out of control that they represent a threat to the whole financial system. Well, asks Frank Shostak, just how does Greenspan think they got to be that way? Might it have something to do with a central bank that guarantees the life of not only these two institutions but every bank in the US?
- [Inflation Leads to Protectionism](#) Current account deficits are not necessarily a bad thing, writes Stefan Karlsson, if they reflect greater investment opportunities. But the current American current account deficit reflects a very low savings rate depressed by negative real interest rates and massive deficit spending by the federal government.
- [Health Care in Prison](#) Not even Krugman advocates an economic system akin to what we see in North Korea or the former Soviet Union. Yet, as William Anderson points out, we are now left with a perplexing question: If socialism does not deliver the goods like bread and automobiles in large numbers and in high quality, why does anyone believe that the practice of medicine is an exception?
- [The Real Churchill](#) With his lack of principles and scruples, Churchill was involved in one way or another in nearly every disaster that befell the 20th century, writes Adam Young. He helped destroy laissez-faire liberalism, he played a role in the Crash of 1929, he helped start WWI, and by bringing in America to help, prolonged the war and created the conditions for the rise of Nazism, prolonged WWII, laid the groundwork for Soviet domination, helped involve America in a cold war with Russia, and pioneered in the development of total war and undermining western civilized standards.
- [Proud to be a Replacement Worker](#) Ryan Ford says he is glad to do the work others are unwilling to do at the going market wage. When one looks at the grocery workers who are striking for higher pay, their tactics and principles, he asks: is this consistent with freedom? Is this what free and fair trade is? To use coercion to force others to trade under your conditions is folly.

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