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There's No Such Thing as a Free Bailout

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PIMCO's William Gross is now calling for a fiscal policy bailout for the U.S. housing market debacle rather than a monetary policy bailout (see ["Where's Waldo? Where's W?"](#)). On the surface, Gross's arguments seem to make sense – *on the surface*. Gross argues that even a cut in the federal funds rate of several hundred basis points might not lower reset rates on adjustable-rate mortgages enough to prevent the massive looming foreclosures. In addition, Gross argues that such an injection of Fed-created credit could be the catalyst for a run on the dollar, which, in turn, would probably prevent 15-year or 30-year fixed rate mortgage yields from falling enough, if at all, to prevent massive foreclosures. Moreover, Gross argues that a large cut in the federal funds rate would perpetuate Greenspan's moral hazard policy and would encourage further leveraging in the global financial markets. So as an alternative, Gross recommends that some federal government agency, either an existing one such as the Federal Housing Administration (FHA) or a newly-created alphabet soup, bailout those current home"owners" who otherwise are soon-to-be renters.

I believe that Gross makes some valid points about the implications of a Greenspan-magnitude cut in the fed funds rate. But I do not believe that a fiscal policy bailout of prospective defaulting mortgagees would be "free," economically speaking.

Let's assume that the FHA guarantees the refinancing of the approximately \$683 billion of subprime and Alt-A mortgages that are scheduled to reset in the six quarters ended 2008:Q4 (dollar amount according to Merrill Lynch). An FHA guarantee is a full-faith-and-credit guarantee of the federal government. So, the market for these new FHA-guaranteed mortgages would overlap with the one for U.S. Treasury securities. That is, FHA-guaranteed mortgages and U.S. Treasury securities are close substitutes. Thus, all else the same, U.S. Treasury security interest rates would rise as investors shift out of Treasuries into FHA-guaranteed mortgages. But because the FHA would be guaranteeing massive amounts of subprime and Alt-A mortgages, market participants would anticipate higher defaults on these mortgages going forward, which, in turn, would cause market participants to expect higher Treasury borrowing requirements going forward to make buyers of these FHA-guaranteed mortgages whole after defaults. So, interest rates on Treasury debt would rise not only because of the substitution effect, but because a greater *future* supply of Treasury debt would be anticipated. In fact, the interest rates on all other fixed-income securities would rise because FHA-guaranteed mortgages are, to varying degrees, substitutes for other fixed-income instruments.

So, the current federal deficit would rise because of higher interest costs on the public debt. In addition, expected *future* federal deficits would rise because of higher anticipated defaults on FHA-guaranteed mortgages. Private borrowers would cut back on their borrowing and spending because of the higher interest rates they now have to pay in order to obtain funding. Other private – and perhaps public – spending, then, would be "crowded out" by the increase in FHA guarantees on mortgages. The cost of funds to private equity syndicates would increase, so the dollar volume of "deals" would decline from what it otherwise would have been. This would reduce the amount of shares being bought from households, which, in turn, would reduce an important source of household deficit spending. (For a discussion of the impact on household spending of private equity buyouts and corporations' stock buybacks, see

["Wall Street and Main Street Are Joined at the Hip"](#)). Again, other spending would be crowded out by the increase in FHA guarantees of mortgages.

It is not even clear that the U.S. dollar would not come under downward pressure with a fiscal policy bailout of subprime and Alt-A borrowers. As alluded to above, private spending on research and development and business capital equipment would be crowded out by the government guarantee of less-than-prime mortgages. Slower growth in these types of private spending implies slower *future* growth in the U.S. economy. Slower future real growth in the economy implies slower growth in our standard of living, especially if we have to devote part of our future production/income to servicing our foreign debt. With the U.S. already a gargantuan net debtor to the rest of the world and with the bulk of our debt denominated in U.S. dollars, foreign creditors might wonder if political pressure would be brought to bear on the Federal Reserve to crank up the currency "printing press" in order to help make principal and interest payments on the debt owed to these creditors. The anticipation of this, of course, would induce investors – both foreign and domestic – to reduce their exposure to U.S. dollar-denominated financial assets, thus causing the dollar to depreciate vs. other currencies.

For the FHA to guarantee the refinanced mortgages of subprime and Alt-A borrowers, a moral hazard policy still would be perpetuated, just not by the Fed. Subprime and Alt-A lenders would be bailed out by the federal government, thus reinforcing the notion that some form of government safety net would likely be there to mitigate the potential losses of investments in risky assets.

So, there is no free bailout to the predicament we have gotten into as a result of Greenspan's cheap credit and moral hazard policies. For those that think there are free bailouts, I suggest that they read the writings of Frederic Bastiat, a 19th century French political economist, who preached that in economic analysis, one must take into account not only what is seen, but what is *not* seen. In other words, employ *general* equilibrium analysis, not just *partial* equilibrium analysis.

****Paul Kasriel is the recipient of the 2006 Lawrence R. Klein Award for Blue Chip Forecasting Accuracy***