

Bubble Bubble Mortgage Trouble

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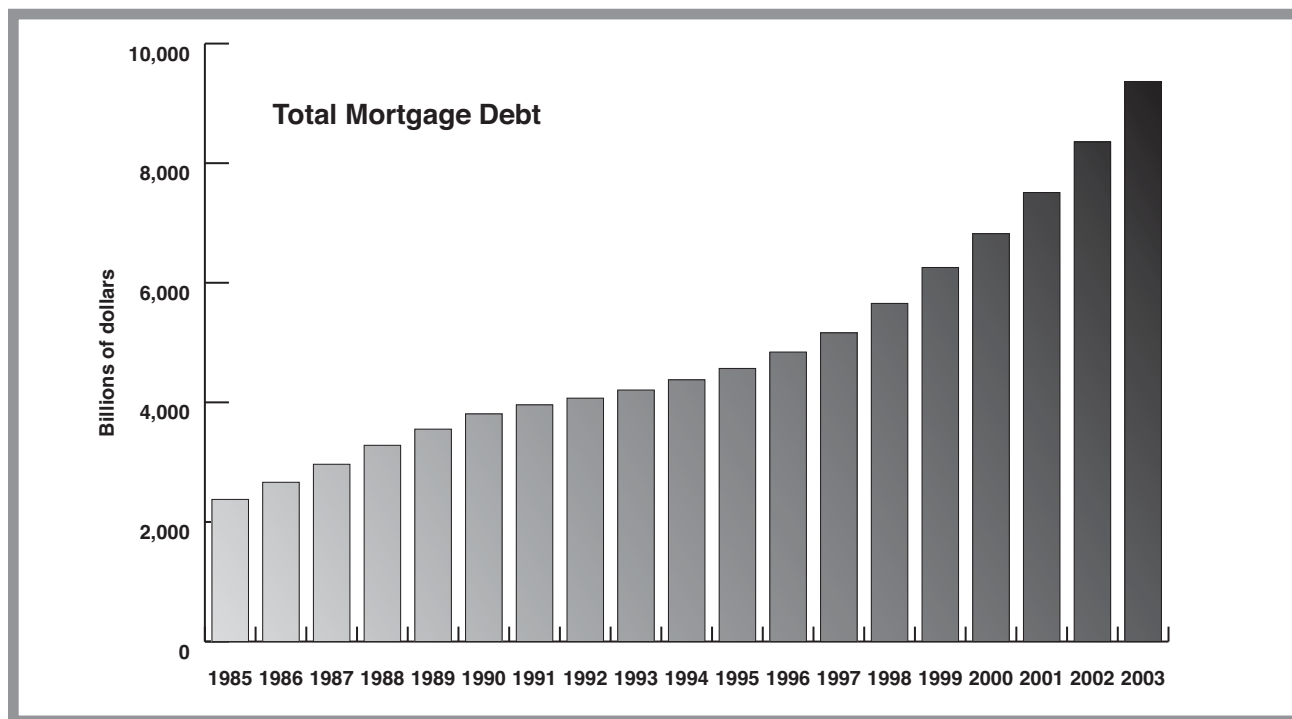
BY DOUG NOLAND

Have the GSEs created a clear and present danger to the U.S. financial system, the economy, and the dollar?

Back in 2000, I wrote an article for *The International Economy* titled "The Great Experiment." The focus of the analysis was the nuances of contemporary finance, in particular the ramifications for unchecked growth from the government-sponsored enterprises (GSEs). Four years later, sufficient data and observations from this "experiment" warrant an update and further analytical examination.

From January 2000 through May of this year, Fannie Mae and Freddie Mac's combined "books of business" (retained portfolios and guaranteed mortgage-backed securities sold into the marketplace) have ballooned 77 percent to \$3.66 trillion. Fannie and Freddie total assets have increased 186 percent to \$2.83 trillion since the beginning of 1997, with Federal Home Loan Bank System assets up 193 percent to \$857 billion. And according to Federal Reserve "flow of funds" data, total mortgage debt has increased 93 percent to \$9.62 trillion, jumping from 61 percent to 84 percent of GDP in seven years.

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Total mortgage borrowings expanded \$1.0 trillion or 12 percent last year, with 2004 on track to surpass 2003's record. For comparison, mortgage debt increased on average about \$200 billion annually during the first eight "pre-bubble" years of the 1990s. Total U.S. home sales are currently on track to surpass last year's record by 10 percent, with the dollar value of housing transactions up approximately 65 percent over three years and 100 percent from six years ago. The nation's average (mean) price of existing homes sold has increased 28 percent over three years and 48 percent over the past six years. In California, median home prices were up an astonishing \$97,530 during the past twelve months (through May) to \$465,160. Golden State home prices have surged 46 percent over two years, 81 percent over three years, and 129 percent over six years, in what has developed into one of history's spectacular asset inflations.

The GSEs have played the instrumental role in the development of a historic mortgage finance bubble. And while the GSE debate tends to concentrate narrowly on the values of the federal subsidy and the implicit government backing of agency debt, the broader—and crucial—issue of the consequences of a momentous expansion of mortgage finance is neglected, if at all recognized.

Reminiscent of the late-1990s manic stock market environment, the issue "Is housing a bubble?" has become a hot topic for the media, investment analysts, economists, and policymakers. Federal Reserve Bank of New York economists Jonathan McCarthy and Richard W. Peach recently published "Are Home Prices the Next 'Bubble'?" This research suggests

that, in spite of significant attention directed to the issue of asset bubbles, our central bank has made scant progress in comprehending or addressing either asset inflation or bubble dynamics.

Messrs. McCarthy and Peach concluded that "there is little evidence to support the existence of a national home price bubble." Yet, their article—and Federal Reserve research generally—ignores what should be the focal points of bubble

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analysis: credit growth, speculative finance, marketplace liquidity, and various financial and economic distortions.

Analyses of the GSEs and mortgage finance should begin with an appreciation for the extraordinary capacity of key lenders these days to issue unlimited quantities of new liabilities (chiefly, agency and asset/mortgage-backed securities) with no impact on the market's perception of these instrument's "Triple-A" quality status. Indeed, it is a defining characteristic of contemporary Wall Street "structured finance" that virtually inexhaustible quantities of risky loans can be transformed into perceived top-quality, safe and liquid securities. This alchemy is dependent upon a daisy-chain of explicit and implicit guarantees, credit insurance, liquidity agreements, and the expansive derivatives marketplace. The GSEs are very much the nucleus, while the market's faith in the Fed and Treasury to stand behind Fannie, Freddie, and the FHLB provides the backbone of this peculiar market structure.

From a theoretical perspective, financial evolution has attained a renown I will refer to as the "moneyness of credit"—a pinnacle achievement conceptually and an unexplored quandary in reality. Throughout history, faith in the relative safety of fiat money has left it inherently susceptible to over-issuance. And with the creep of monetary inflation comes the specter of myriad inflationary effects, currency debasement, and progressive monetary disorder. These days, GSE and Wall Street securities fabrication has supplanted the government printing press as the paramount source of monetary inflation. Total "structured finance"—combined GSE assets, along with outstanding mortgage and asset-backed securities—has over seven years mushroomed an astonishing 126 percent to \$7.46 trillion.

Traditionally, bank lending to fund business spending and investment provided the predominant source of finance. In the process, bank loans expanded the money supply through the creation of new bank liabilities/deposits. But no longer do banks and their deposit "money" hold sway over either the financial system or economy.

Financial systems have evolved profoundly. Especially over the past decade, this evolution has radically altered the character of lending and intermediation, along with the types of financial sector (in contrast to bank) liabilities issued. Importantly, non-bank asset-based lending is today the commanding mechanism, creating the liquidity that drives both financial markets and economies.

Total "structured finance" has jumped from 41 percent to 65 percent of GDP in just seven years. During this period, total bank loans and leases rose from 35 percent to 40 percent of GDP, expanding 60 percent to \$4.54 trillion (real estate loans accounting for two-thirds of bank loan growth). Examining the nature of lending, it should be clear that contemporary "money" is today increasingly comprised of agency securities and agency-related instruments, along with Wall Street structured products. "Money" is big business.

It is worth emphasizing the current historical anomaly that, domestically as well as globally, there is no mechanism, effort, or regulatory mandate to control either the quantity or the quality of contemporary money and credit expansion. As such, I would argue that there is today an overriding top-down predicament associated with contemporary finance: There exists a powerful dual capacity and propensity for debt to be issued in excess by myriad profit-seeking financial intermediaries. What's more, seemingly limitless profit potential will ensure that asset markets—both real and financial—will attract the lion's share of lending and finance. How can a limited universe of profitable investment opportunities compete for lender enthusiasm against those available from bountiful—and inflating—asset markets?

Throughout the lending process, the preponderance of financial-sector liabilities created—contemporary money and credit—will be perceived to be of the highest quality and liquidity. This "moneyness" attribute predicates virtually insa-

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tiable demand for the underlying debt instruments, which impels lending excess, over-issuance and self-reinforcing asset inflation.

Such inflation provides a boon to enterprising speculators, also enjoying unparalleled access to finance as they play a decisive part in advancing self-reinforcing asset bubbles. Mortgage finance bubble analysis includes two distinct facets of asset speculation: Exuberant borrowing to finance home and property purchases, as well as aggressive speculator leveraging in agency and mortgage-backed securities. “Speculator” in this context would include the expansive hedge fund community, securities broker/dealer proprietary trading, mutual funds, banks, insurance companies, corporate finance departments, pension funds, and various individuals and institutions (domestic and international) employing “carry trades,” “repos,” derivatives, and myriad leveraged strategies. Evolving insidiously over time, the liquidity created in the process of leveraged asset speculation emerges as a governing source of finance for both the markets and the general economy—i.e., the 1990s tech/telecom bubble and today’s housing/consumption bubble. To ignore asset inflation, speculative finance, and bubble dynamics is really to disregard the very essence of contemporary finance and economics.

The GSEs have enjoyed virtually unbounded capacity to finance expanding asset holdings through the issuance of perceived risk-free liabilities. Their liquidity-creating powers have on numerous occasions proven invaluable in ameliorating acute systemic stress. In reality if not by statute, the GSEs evolved to attain the all-powerful status of quasi-central banks. Their aggressive expansions during the 1994 bond market dislocation, the 1998 Long-Term Capital Management debacle, the 1999 Y2K scare, and the tumultuous 2000–2002 period were certainly invaluable in rectifying jeopardous market conditions.

Chairman Greenspan often asserts that the U.S. economy’s ability to persevere—and indeed excel—despite a series of shocks and setbacks is largely attributable to its extraordinary “productivity” and “flexibility.” Yet a strong case can be made that any accolades should be directed foremost to the Herculean resiliency of contemporary finance.

Above all, abundant and unabated credit and liquidity creation fueled home price inflation. The Federal Reserve collapsed rates and orchestrated a steep yield curve that, along with assurances of liquid financial markets, incited unparalleled leveraged speculation. Truly unprecedented system credit expansion underpinned buoyant asset markets: From the household and government sectors, on the one hand, and financial sector leveraging on the other. And asset inflation was certainly instrumental in stimulating demand to sustain the consumption and services-based American economy.

There is another critical facet to GSE market power and influence that goes unappreciated. As quasi-central banks intervening to stabilize the U.S. credit market, Fannie and Freddie have attained the prominence of “buyers of first and last resort” for speculators leveraged in mortgage-backed and other debt securities. Repeated aggressive market interventions over the years were instrumental in averting dislocations, and in the process enriched and emboldened the speculating community. Why not take full advantage of a steep yield curve by leveraging mortgage securities when Fannie and Freddie stand ready to aggressively purchase these holdings in the event of unfolding market stress? GSE market influence has been instrumental in nurturing the hedge fund and proprietary trading communities, and with them the ballooning global pool of speculative finance.

Furthermore, the GSE’s aggressive securities purchases—at critical junctures circumscribing interest-rate spikes and dislocation otherwise associated with speculative de-leveraging—have played a definitive, yet surreptitious, role in the explosion of derivative positions. Here as well, the GSE liquidity backstop has emboldened risk-taking and

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distorted the marketplace. The viability of much of the derivatives marketplace rests on the assumptions of continuous and liquid markets—specious premises thus far affected legitimate by unending and timely GSE expansion.

Mushrooming derivatives markets have, in turn, played an instrumental role in the historic ballooning of GSE and mortgage debt generally. The GSEs have accumulated more than \$1 trillion of short-term debt, while relying extensively on derivatives to hedge a potentially catastrophic asset/liability mismatch. On one hand, GSE interventions underpin marketplace liquidity. On the other, the GSEs and mortgage-backed securities holders are the largest buyers of derivative protection. Meanwhile, GSE counterparties rely predominantly on dynamic hedging strategies, with computer hedging models calculating the quantities of securities to buy or sell in the event of changing interest rates.

The major problem is that the larger GSE balance sheets, mortgage debt, speculative leverage, and derivative positions balloon, the less viable this entire hedging (“portfolio insurance”) mechanism becomes. It is simply not feasible for a large segment of the marketplace to move concurrently to hedge exposure in a rising rate environment. After all, marketplace liquidity would be inadequate to accommodate the enormous hedging-related selling into a faltering market. Moreover, rapidly rising rates render derivative traders and leveraged players increasingly aggressive sellers, competing for limited and waning liquidity. I am therefore left with the disconcerting view that the GSEs have evolved into the linchpin for a massive mortgage finance bubble encompassing endemic—and eventually untenable—financial sector leveraging, speculating, and derivative trading.

Yet the ramifications of the mortgage finance bubble are anything but confined to the financial arena. Indeed, the bubble’s effects on the real economy may very well prove the most intractable. Mortgage credit excess and asset inflation today foster household over-borrowing and over-consumption. Investment decisions are similarly distorted. About two million

residential units will be constructed this year, approximately 45 percent higher than the 1990s average of 1.37 million. The ongoing multi-year construction boom also includes retail, restaurant, hotel and gaming, sports venues, and other consumption-related structures. Regrettably, we are witnessing a replay of the late-1990s telecommunications and technology boom-and-bust experience, where a surfeit of speculative finance fosters destabilizing over-spending in the “hot” sectors.

It is the very nature of speculative finance that inflated boom-time profits seductively induce only greater speculative flows, and in the process evoke notions of New Eras and New Paradigms. The destabilizing torrent of finance assures systemic vulnerability to the inevitable reversal of speculative flows (i.e. the tech bubble’s stock and junk bond boom and collapse), exposing the extent of previous uneconomic investment. The abrupt adjustment of distorted boom-time spending patterns proves especially destabilizing—most economic agents are caught heavily exposed and flat-footed after extrapolating the boom far into the future. Bursting bubbles also invariably uncover significant waste and fraud. Indeed, a confluence of factors is set in motion that rectifies the divergence between perceived financial wealth and true economic wealth that had become so distended during the maniacal phase of the boom.

Today, the size of the pool of speculative finance is significantly larger than what fueled the tech bubble just a few short years ago. The housing and the consumer sectors have become the magnets for truly momentous financial flows. Asset inflation and associated spending and investment have evolved to become the driving force behind heady household income growth (rising at a 6.7 percent rate year-to-date through May!). And recalling how inflated boom-time technology profits were extrapolated to justify gross equities overvaluation (as well as over-borrowing), inflated household income growth is these days used to assert the reasonableness of both inflated housing values and surging consumer debt loads. A pernicious circularity is a work here, as sufficient purchasing power to sustain inflated asset prices and an unbalanced economic expansion is generated only through unrelenting and enormous mortgage borrowings.

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Bubble excesses, including over-consumption and mal-adjusted investment, have engendered an increasingly untenable trade position. Unrelenting U.S. current account deficits beget dollar weakness and a swelling pool of global dollar liquidity. Yet one is hard-pressed to glean analysis linking the GSE and mortgage finance bubbles to ballooning U.S. foreign liabilities and destabilizing global “hot money” flows. No less an authority than Alan Greenspan proclaims confidence that the market pricing mechanism will function over time to innocuously rectify U.S. imbalances.

Analysis of the nature of bubble dynamics, however, leaves one anything but complacent. Categorically, asset bubbles require ever-increasing quantities of credit expansion. As for housing, rising borrowings are necessary to finance booming transaction volume and maintain inflated values. This is most conspicuous currently with the hyper-bubble markets in California and along the East Coast. And liquidity emanating from the mortgage finance bubble these days fuels inflated and vulnerable financial asset prices. There is, as well, the critical issue of bubble economies, prolonged only by escalating credit creation. The consumption, services, and finance-based U.S. bubble economy—with huge trade deficits, scores of uneconomic enterprises, and myriad general imbalances—is an absolute credit and liquidity glutton.

Importantly today, inflating asset markets have evolved to become the key mechanism for generating liquidity and income growth system-wide, rendering the entire financial and economic system acutely vulnerable to any diminution of credit growth.

Current complacency is understandable. The U.S. economy has indeed overcome a series of shocks. Presuming that technology and the stock market were *the* bubble, the consensus view trumpets the resiliency of the “post-bubble” U.S. economy. The harsh reality, however, is that the tech and equity boom was only an appendage of a mammoth bubble progressing uninhibited throughout the U.S. credit system. Today, I would strongly argue that the credit bubble is in the midst of its “terminal” stage of excess. Credit inflation manifestations have turned increasingly destabilizing and difficult to manage.

It is worth contemplating that from the late 1990s through 2001, the U.S. economy and markets were the favored destination for global investors and speculators. The “king dollar” period was anomalous for the ease with which escalating U.S. current account deficits were recycled back to American assets. There have been, however, some rather momentous changes over the past couple of years. Not only have U.S. current account deficits ballooned to historic extremes, investor and speculator funds now flow enthusiastically to various non-dollar markets and asset classes. The environment for recycling dollar balances has abruptly inverted from extraordinarily favorable to increasingly problematic.

Central bankers will have no alternative than to weigh the competing risks associated with ongoing dollar support and resulting inflationary effects, versus a faltering dollar, unstable currency markets and U.S. financial and economic fragility.

Our nation’s annual current account deficit is approaching \$600 billion. The dollar has suffered a sharp two-year decline against the euro and most major currencies, with the dollar index sinking 25 percent since 2002’s first quarter. Arguably, only unprecedented central bank dollar purchases have extricated currency markets from the scourge of illiquidity, dislocation, and crisis. Global central banks expanded international reserve assets by approximately 27 percent the past year to \$3.25 trillion, with the major Asian central banks increasing largely dollar reserves in the neighborhood of \$545 billion, or 38 percent, to \$1.97 trillion.

The consequences of this unparalleled monetary inflation include an unwieldy boom in China and throughout Asia, rising global energy demands and prices, manic commodities markets with examples of depleting inventories, and generally heightened price pressures globally. Importantly, the global pricing environment has been transformed from “disinflationary,” to “re-flationary,” to the current distinctly inflationary. There is today, then, the issue of the consequences of open-ended massive foreign central bank dollar support and monetization. Going forward, central bankers will have no alternative than to weigh the competing risks associated with ongoing dollar support and resulting inflationary effects, versus a faltering dollar, unstable currency markets, and U.S. financial and economic fragility.

I made the case four years ago that uncontrolled GSE excess posed a threat to our policymakers’ strong dollar policy. I today advise that the U.S. mortgage finance bubble creates a clear and present danger to the stability of our financial system and economy, as well as the soundness of our currency. ◆