“The Follies of Fannie and Freddie:
How To Be a Political Success and an Economic Failure”

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Fannie Mae and Freddie Mac have long outlived any usefulness they may have had yet Congress and the administration continue to support these institutions rather than recognizing their failure and phasing them out. This is quite a tribute to Fannie’s and Freddie’s great political clout, especially in light of their inability to create value. It’s quite a sordid tale, but the bottom line is we ought not to be thinking of ways to sustain these institutions but rather how to eliminate them.

Fannie Mae was created during the turbulent times of the Great Depression, with unemployment persistently over 15% and even 20%, five and ten percent annual reductions in real GDP, and tumultuous housing and credit markets to match. Such times are very difficult to imagine now, but they brought forth a set of sweeping legislative measures to try to deal with them. Fannie Mae was one.

I and many others would argue that there were far superior ways to address the calamity of the Great Depression than the creation of Fannie Mae (and many other New Deal institutions). But the appropriate question is what to do with Fannie and its cousin Freddie Mac in the here and now. My conclusion is that they are intensely political institutions which, along with over ill-conceived policies, have caused much economic harm. But, unfortunately, bad economics too often make good politics.

Fannie and Freddie constitute much of the secondary mortgage market, i.e., they buy mortgages from banks and other financial institutions that originate them. They raise the money to buy the mortgages by selling securities on financial markets. Because Fannie and Freddie are government sponsored, their securities are backed implicitly by the full faith and credit of the U.S. government. This implies several things. One is that they can raise funds less expensively than private sector institutions because their securities are essentially insured against bankruptcy by the U.S. government. Second, the government support makes it impossible for the private sector to compete with Fannie and Freddie, thus they monopolize the secondary mortgage market. The evidence is that this enables them to make plenty of profit, though part of their subsidy-based cost advantage is passed along to customers. Finally, the government guarantee makes the U.S. taxpayer liable in the event of financial failure of Fannie or Freddie.

From an economics standpoint, this whole idea is not sensible right from the get go. Financial markets in the U.S. have been broad and deep for a long time. While they are imperfect, they generally function well and there’s no reason to have a government monopoly take over a large segment of these markets. Fannie and Freddie bear no resemblance to a poverty program, either. Most mortgages they hold are from middle class customers and they guarantee mortgages for over $600,000. You can't tell me that to help poor families who seek housing that you have to guarantee loans of $600,000 or more. And of course the taxpayer is on the hook if they hold enough bad loans to produce red ink. This risk was laughed off for years because the consistently strong housing market made this possibility look trivial . . . until now.

But this bad idea made for good politics. Fannie and Freddie get the comfy and profitable position of monopolists and the hardly perceptible cost of absorbing risk was foisted little by little onto millions of taxpayers. And our Fannie and Freddie monopolists were happy to "help out" supporters in Congress who favored maintaining the status quo. Perfect interest group politics . . . huge benefits concentrated on a small, cohesive group and small per capita costs (but collectively large) for millions of unorganized citizens.

It all begins to unravel with the subprime crisis. Though the subprime crisis has a number of causes, one of its taproots is . . . you guessed it . . . government policy. The Community Reinvestment Act of 1977 was an attempt to revitalize inner cities. They surely needed it . . . and many still do. However, rather than address the subpar schooling systems, lousy infrastructure, and heavy taxes of many inner cities, the Community Reinvestment Act pressured banks to write more mortgages and other loans in inner cities. This act was liberalized in 1995 and its agenda pushed hard in the early 2000s. Though the Act did not require all financial institutions to improve their lending records in inner cities, the political handwriting was on the wall. And guess who was held up as a paragon of virtue by Fannie Mae for all its efforts in making loans in inner cities . . . Countrywide. Many of these loans were high risk and heavily dependent on rising housing values. When that failed to materialize, the virtuous loans began just bad loans. And Fannie and Freddie bought a ton of them.

So now we have the peculiar situation that the institutions and laws we've created have encouraged making what are essentially bad loans, with taxpayers as the unwitting parties who are being held liable. Rather than just fess up to the whole convoluted mess and trying to extract ourselves from it, we still are trying to prop it the institutions that caused it and deflect blame elsewhere.

Blame game target number one is predatory lending. Unfortunately, predatory lending does occur and we need good anti-fraud laws to avoid it. However, the volume of subprime mortgages written is not explained by any uptick in predatory lending. The Community Reinvestment Act, related political pressure, and the implicit support of Fannie and Freddie established strong incentives to write high risk loans. So let's not be surprised when we get them. Another recent blame game target for Fannie and Freddie financial troubles is speculation in their stock via short sales. Short selling, of course, is a way to gain if a stock price is expected to fall. However, short sales are just the messenger. If your company has a lot of folks selling your shares short, *you've* got problems, not the speculators.

The troubles in the housing and mortgage markets are truly unfortunate and we ought to have a sensible social safety net to protect those genuinely in need. But we also need to face up to the important causes of the problems in these markets and rid ourselves of them. This means nor longer propping up Fannie Mae and Freddie Mac, but phasing them out in an orderly but decisive way.