

Vague promises give way to hard public cash

Author: Guha, Krishna

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Abstract (Abstract): Greater clarity on the outlook for Fannie and Freddie and the fate of their various securities should remove one big source of instability in financial markets. Fannie and Freddie shares, preferred stock, subordinated debt and senior debt are widely spread within the global financial system.

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Moreover, if the Treasury and their regulator direct the companies to exploit their strengthened government backing to bring down fees and other charges on the mortgages they guarantee, there could be a material reduction in mortgage rates. These rates went up by more than half a percentage point from late May as the problems at Fannie and Freddie mounted.

Full text: Outlook ; Pledges of support having failed to move the markets, Krishna Guha asks whether a state takeover will work

When Hank Paulson announced the initial -version of the Fannie Mae and Freddie Mac rescue in July - seeking authority to support them financially if necessary - the market called his bluff.

Funding costs for the mortgage financiers remained high, elevated interest rates on the loans they guarantee did not budge, investors particularly abroad continued to shun their paper, and their stock prices not only failed to revive but went into a tailspin.

Mr Paulson is hoping that this time will be different. By taking decisive action and committing actual government funds, rather than offer a contingent backstop to be triggered in ill-defined circumstances, he hopes to win market backing.

This seems plausible. Fannie and Freddie are now more clearly in government hands - with government credit more clearly standing behind their debt - than at any point in the past, though questions remain about their long-term roles.

This should help to bring down their funding costs and ease mortgage rates on the loans they guarantee - the only functioning part of the US home loan industry following the freezing up of the subprime and jumbo (large denomination loan) markets.

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Yet while sorting out Fannie and Freddie was a necessary condition for stabilising financial markets and improving the economic outlook, it is not a sufficient condition. The problems weighing down on the markets and the economy extend far beyond.

The credit crisis fever has worsened again in recent weeks, with further deleveraging by financial institutions, reports of mass redemptions from hedge funds, increased risk aversion manifested in higher margin

requirements, and a renewed "margin spiral" of forced selling by financial institutions obliged to liquidate holdings because they cannot obtain funding.

For the authorities, it looks as if systemic risk has increased again, and the system certainly appears under greater strain than in the midsummer, when pressure built on regional banks.

The core dynamic of the credit crisis - financial sector weakness causing economic weakness that in turn feeds back to aggravate financial sector weakness - has again intensified.

With financial institutions again pulling in their horns and seeking to minimise risk exposures, while showing little appetite for raising more equity at current low stock prices, the credit squeeze could worsen in the months ahead.

Meanwhile, the macroeconomic outlook has again deteriorated, with some revival in the tail risk of very bad economic outcomes. This heightened economic uncertainty makes it very difficult to stabilise the financial sector.

Some experts draw comfort from the experience of the past 12 months, which suggests that the US economy might not be too vulnerable to bouts of financial fever. But the risks are not only manifest in the financial sector. The US consumer might finally be buckling under the strain of tight credit, falling house and stock prices, rising unemployment and still high commodity prices. Consumer spending fell in real terms in July, retail sales were weak and unemployment shot up to 6.1 per cent.

This raises the danger of a more conventional recession that would hit a financial system already battered by losses on housing-related securities with a second round of losses.

Moreover, growth in non-US industrialised economies appears to have taken a sharp turn for the worse, with the UK, eurozone and Japan all at risk of at least a mild technical recession.

With even the big emerging markets slowing a little, the lifeline provided to the US from strong exports looks likely to weaken in the months ahead.

If these pressures continue to gather in force the US government might at some point have to consider much more extensive intervention - potentially to socialise a larger share of the losses and help recapitalise large parts of the private financial sector.

All in this together, Page 8 Wolfgang Munchau, Page 11

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