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ECONOMIC NEWS UPDATE

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With investors having lost the odd billion in recent weeks (but remember: share prices are still 14% higher than they were at this time last year), the hunt for a scapegoat is on. Washington pundits are not famous for their kindness to politicians, regulators and other out-of-power figures to whom they no longer crave access. So it should come as no surprise that Alan Greenspan has been nominated as the culprit, and that the process of chipping away at the pedestal on which he stands has begun.

It seems that the recent volatility in share prices, the tightening of credit that has made several proposed private equity deals uneconomic, the collapse of the subprime mortgage market and with it several hedge funds, and the decision by Wells Fargo to raise its interest on 30-year fixed mortgages in excess of \$400,000, are due to -- you guessed it -- the former chairman of the Federal Reserve Board.

The first attack on Greenspan was one of those indirect, by-implication-only assaults in which government officials specialize. William Poole, President of the Federal Bank of St. Louis, used a speech to real estate

(property) professionals to unburden himself of some thoughts on the non-prime mortgage market.

That market, Poole pointed out, matters to the Fed because of the importance of the housing industry to the overall economy, and the Fed's regulatory responsibility for banks and practices in the mortgage market. He therefore finds it "odd" that the Fed and lenders did not realize that low interest rates in the 2002-04 period could not be maintained. Yet sub-prime borrowers were encouraged to take out adjustable rate mortgages (ARMs), many of which are now in default as a result of higher interest rates, leaving a trail of foreclosures and chaos in the market for mortgage-backed securities. For most of these players Poole has little sympathy: "This year's markets punished mostly bad actors and/or poor lending practices... The market's punishment of unsound financial arrangements has been swift, harsh and without prejudice."

Poole emphasizes that we are now dealing with a non-trivial problem. About 25% of the over \$10 trillion in outstanding mortgages do not qualify for "prime" rating. And of the 50 million mortgages outstanding in America, 7.5

million are the obligation of subprime borrowers. It is the “relatively unsophisticated borrowers” for whom the regulators should have sympathy; they were inadequately protected from fraudulent and deceptive practices of greedy mortgage brokers and lenders.

What does all of this have to do with Greenspan, who is nowhere mentioned in Poole’s rather elegant analysis? Fast forward one week, to the New York Times and columnist Floyd Norris. Norris points out that in 2004 -- a time when Poole argues any knowledgeable observer knew that interest rates were due to rise, the then-Fed chairman told Credit Union executives, in Norris’ version, that “recent research within the Federal Reserve suggests that many homeowners might have saved tens of thousands of dollars had they held adjustable rate mortgages rather than fixed rate mortgages during the past decade.”

Unfortunately, Norris fails to include the final phrase in the sentence he cites, or even to indicate the omission with the traditional ellipses. Greenspan concluded his report of the Fed’s research with the comment, “though this would not have been the case, of course, had interest rates trended sharply upward.” In short, Greenspan, who critics accuse of hostility of fixed rate mortgages, did indeed relate the savings from the use of ARMs to the low interest rates prevailing at the time of the Fed studies and his talk.

Greenspan’s main point was that, “American consumers might benefit if lenders provided greater mortgage product alternatives to the tradition fixed-rate mortgage.” That has certainly been the case, as Poole points out,

“...The bottom line is that more people have access to mortgage credit now than ever before.... Despite its limitations and flaws, the non-prime market has served a large number of borrowers very well.”

In short, the situation is roughly this. Mortgage brokers, who earn their income from commissions for initiating mortgages, made homeownership possible for many families for whom this American dream would otherwise have been denied. Some of these brokers failed to advise their unsophisticated customers of the dangers inherent in ARMs. Bankers then compounded the problem by bundling these relatively high-risk debts into packages that, they thought, magically turned a basket consisting of separate bits of high-risk paper into one package of low-risk paper. Which would have been the case had not all of the components been subject to the same risk -- an increase in interest rates.

Now the market is giving the over-optimistic lenders their comeuppance, while institutions such as Freddie Mac (a client), Fannie Mae, and other government agencies search for ways to relieve the plight of those among the over-extended homeowners who did not engage in fraud in order to obtain mortgages.

Meanwhile, analysts are coping with the broader question of measuring the skill of various Federal Reserve Board chairmen in managing monetary policy -- not merely as an historical exercise, but for clues to how competent the incumbent, Ben Bernanke, is likely to be in seeing America through the current period of volatile share prices, an ailing housing industry, and the turmoil in the financial sector as investors price risk more realistically.

Ray Fair, a fellow at the International Center for Finance at Yale University, in a paper that carries academic impenetrability to new heights, has compared the performance of the past five Federal Reserve chairmen. In perhaps the only clear statement in a jargon-laden, highly technical paper, Fair concludes, "Greenspan looks good..." in comparison with his four predecessors. Which should come as no surprise to those of us who watched him pilot the economy through the collapse of Long-Term Capital, the ruble, Asian developing economies, and a recession.

Fortunately, Bernanke, after an early loose-lipped stumble at a dinner party with CNBC's "Money Honey", Maria Bartiromo, and a bit of problem communicating his intentions to the markets (Bernankean clarity does not always trump Greenspanian opacity), has been demonstrating a similar deft touch. With "fear ... sweeping through the financial markets," as Goldman Sachs puts it in its latest advisory, he faces a new, tougher test.



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