# US bailout of mortgage giants sets stage for wider financial crisis

**Barry Grey**
**12 September 2008**

Since the Bush administration announced on Sunday the US government takeover of mortgage finance giants Fannie Mae and Freddie Mac, in the largest corporate bailout in American history, developments have underscored the profound and systemic nature of the crisis that precipitated the action.

A week of wild gyrations on US stock markets, fueled by fears of an impending collapse of the Wall Street investment bank Lehman Brothers and the country's largest savings and loan bank, Washington Mutual, demonstrates that the rescue of the government-sponsored mortgage companies is a stop-gap measure that does not begin to resolve the underlying crisis of American capitalism.

On the contrary, the bailout of Fannie Mae and Freddie Mac sets the stage for an intensification of the crisis in the coming months. At heart, the demise of the mortgage firms, which account for 80 percent of new home mortgages in the US and have a combined liability of $5.3 trillion in mortgage-backed securities which they own or guarantee, is a result of the collapse of the colossal credit bubble which sustained the super-profits of US banks and investment firms and the seven- and eight-figure salaries of their top executives.

It is the product of an economic system that has increasingly based itself on speculation and various forms of economic parasitism, while gutting the productive base of the country—at the cost of millions of jobs and the living standards of the American working class.

The decay of American capitalism has produced an economy that is drowning in debt and is dependent on massive inflows of capital from abroad for its survival. Now, the assumption by the government of the debt of the mortgage companies, carried out to protect the financial interests of banks and big investors, has placed a question mark over the solvency of the US government itself.

This threatens a curtailment of the inflow of international capital, a further erosion in the status of the US dollar and a drastic increase in the interest paid by the government to borrow money from its creditors. The US is already by far the world's biggest debtor nation, with a balance of payments deficit of $800 billion and an economy that is sustained by a yearly inflow of $1 trillion in overseas capital.

The quantum leap in the national debt and government budget deficits resulting from the bailout of Fannie Mae and Freddie Mac—and the further corporate bailouts that are all but certain to follow—must inevitably lead to a realignment of social conditions within the US in accordance with the actual, deeply eroded, position of the United States in the world economy. This means an even more drastic lowering of the living standards of the American people.

On Tuesday, the Congressional Budget Office (CBO) declared that as a result of the government bailout, the finances of Fannie Mae and Freddie Mac had to be "directly incorporated into the federal budget," and its liabilities added to the US national debt. This means, in effect, a near doubling of the US sovereign debt to a figure equivalent to the country's gross domestic product (GDP).

The *Financial Times* reported Wednesday that the bailout had already resulted in a sharp rise in the price of credit default swaps on five-year US government debt. Credit default swaps are private contracts to buy insurance against the default of various forms of debt.

As the *Financial Times* wrote, "... the price suggests the market believes the US government is more likely to default on its obligations than some other industrialised countries." It went on to cite a credit research strategist as saying, "The USA is now 'riskier' than Norway, Germany, Netherlands, Sweden, Finland, Austria, France, Denmark, Quebec and Japan."

The CBO statement on Fannie Mae and Freddie Mac accompanied its report on the US government budget deficit for the current fiscal year, which ends September 31, and its projections for fiscal 2009 and beyond. The CBO put the current deficit at $407 billion, more than double the $161 billion deficit for fiscal 2007.

It projected, on the basis of current tax laws, that the budget gap would rise to a record $438 billion in the 2009 fiscal year that begins October 1. However, as CBO Director Peter Orszag noted, that figure could easily climb to $540 billion if Congress acts in the coming months, as expected, to curtail the growth in the alternative minimum tax and extend a variety of expiring business tax breaks.

Orszag further noted that these figures did not take into account the full scale of government expenditures related to the bailout of Fannie Mae and Freddie Mac. Treasury Secretary Henry Paulson said on Sunday the government would commit up to $200 billion to prop up the companies. Given the continuing decline in home prices and rise in foreclosures, that figure is virtually certain to rise by tens, if not hundreds, of billions.

Orszag said that the deficit would remain at between 3 and 4 percent of the GDP for the next decade, resulting in a $7 trillion rise in the national debt. Even these dire projections assume that Bush's massive tax cuts for the rich will not be extended beyond their scheduled expiration in 2010.

Significantly, Orszag pointed to government health care spending—not the cost of corporate bailouts or the wars in Iraq and Afghanistan (which have to date consumed a combined sum of $850 billion)—as the main source of exploding deficits going forward. The CBO warned that Medicare and Medicaid spending, which currently account for an estimated 4.6 percent of GDP, could account for up to 12 percent of GDP by 2050.

The mounting financial crisis of American capitalism was further underscored by the Commerce Department's report Thursday on the US trade deficit, which surged in July by 5.2 percent to $62.2 billion, the highest level in 16 months.

The headlong rush of Lehman Brothers and Washington Mutual toward collapse—or new federal bailouts—within days of the government takeover of Fannie Mae and Freddie Mac has underscored the depth of the financial crisis.

The stock of the 158-year-old Wall Street investment bank collapsed this week after it was reported that Lehman's efforts to secure a capital infusion from the state-owned Korea Development Bank had collapsed. At the close of the financial markets on Thursday, the value of Lehman's stock—down by more than 90 percent since its peak last February—was about $2.9 billion. It stood at $37.2 billion at the start of 2008.

Once the biggest underwriter of mortgage-backed securities, the firm has seen its speculative investments collapse and would have already gone bankrupt were it not for the Federal Reserve's decision, taken at the time of the government-subsidized sale of Bear Stearns to JP Morgan Chase last March, to extend low-cost loans to investment banks and accept virtually worthless mortgage-related securities in return for highly rated Treasury securities.

It was reported Thursday that the firm was in talks with potential buyers, including Bank of America, for a buyout that would avoid bankruptcy or a government bailout—at the cost of billions in losses to shareholders and the jobs of thousands of Lehman employees. On Wednesday, when it announced a third quarter loss of $3.9 billion and a plan to spin off much of its business and shrink its operations, the company said it was slashing 1,000 to 1,500 jobs, its fourth round of layoffs this year.

Over the past year, US banks and brokerages have cut more than 110,000 jobs.

The collapse of both Lehman and the two government-sponsored mortgage giants starkly illustrates the immense dependence of American capitalism on overseas capital. Lehman went to ground after its bid for funds from a South Korean bank failed, and the government bailout of Fannie Mae and Freddie Mac was precipitated by the dumping of the firms' securities by central banks and major investors in Asia and Russia.

The stock of the giant savings and loan bank Washington Mutual, which has some $180 billion in mortgage-related loans, has fallen by 34 percent since Monday and 92 percent over the past year. This week it reported a $3.33 billion second quarter net loss and has said its mortgage losses could reach $19 billion through 2011.

Raising the possibility of another government bailout, Christopher Whalen, a managing partner at Institutional Risk Analytics, said of Washington Mutual, "If this goes on until the end of the year, the bank is either going to have to be sold or recapitalized by the government. Those are the only choices."

The *Financial Times* on Wednesday worried that the massive US budget deficits were limiting the ability of the government to continue propping up Wall Street with injections of hundreds of billions in capital. It wrote:

"Yesterday's new deficit projections by the Congressional Budget Office highlight the troubled state of US government finances as it embarks on a new stage of interventions to contain the chronic impact of the credit crisis....

"Some economists worry that as the Federal Reserve has spent much of its ammunition, and as fighting the credit crisis falls more to the government, weak public finances mean the government does not have unlimited ammunition either."

Noting that the Federal Reserve was seeking to conserve its capital for further corporate bailouts, the newspaper wrote, "Many Fed officials share this view, which is why the Fed is lukewarm on further fiscal stimulus, preferring to see the limited government funds spent on shoring up the financial system."

The response to mushrooming budget deficits and soaring national indebtedness, as well as the spreading crisis on Wall Street, by the next administration, whether headed by Republican John McCain or Democrat Barack Obama, will be a policy of brutal austerity directed against the working class.

One can safely predict that not long after the November election, the incoming president will announce that his transition advisers have shown him the country's financial books, that the dire state of the nation's economy makes inoperative any and all promises of health care reform or relief to distressed homeowners, and that a regime of discipline and "sacrifice" will have to be imposed in the "national interest."

Senator Kent Conrad, the Democratic chairman of the Senate Budget Committee, sounded just such a note when he said, in response to the CBO report, that "the next president will be inheriting a budget and economic outlook that is far worse than most people realize."

As the CBO report indicates, the next administration will be tasked with dismantling basic entitlement programs such as Medicare and Medicaid.