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ONGOING CREDIT CRISIS / MORTGAGE MELTDOWN TOO BIG TO FAIL --- TOO SMALL TO MATTER

In spite of very busy schedules, we were compelled to post an update on the ongoing issues with the credit crisis. While we will be publishing a more traditional newsletter in a couple of weeks, we felt that it was necessary and fitting to share the following.

Too Big to Fail ---- Too Small to Matter

Too Big to Fail

Beginning in July 2007, when Bear Stearns announced heavy losses in two of their mortgage related hedge funds, the Federal Reserve Board of Governors (Fed), through its Federal Open Market Committee (FOMC), has been focused non-stop on staunching the credit crisis. They achieved this by pumping tens of billions of dollars of credit into the financial system on any given day- above and beyond their normal operations focused on system optimization.

The Fed has been quick to respond to problems in the financial markets, going so far as to purchase non-government mortgage backed securities (MBS), actions that have not occurred in over forty years. With the outright failure of Bear Stearns and sell-off of assets to JP Morgan, the Fed pledged to continue to work to keep the financial markets from further calamity.

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How is it that an industry that paid $38 billion in bonuses in 2007 is now in need of such an enormous bailout?

"That money ($38 billion), split among about 186,000 workers at Goldman Sachs Group Inc., Morgan Stanley, Merrill Lynch & Co., Lehman Brothers Holdings Inc. and Bear Stearns Cos., equates to an average of $201,500 per person, according to data compiled by Bloomberg. The five biggest U.S. securities firms paid $36 billion to employees last year."

November 19, 2007-Bloomberg
http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=ahE8xVisWsbE

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Too Small to Matter

Since the FOMC's first response to the credit crisis in September 2007, the Fed has lowered its Fed Funds Target Rate from 5.25% down to the current 2.25%, (and will likely drop it, further).

In several issues of this newsletter, we have been warning about the "collateral damage" caused by the Fed's policy of credit tightening that led to this credit crisis, specifically and pointedly since January 2006, but in reality, it's been on our radar since mid 2004, when the Fed began ratcheting up the Federal Funds Target Rate from 1.00%.

The problem boils down to the resetting of adjustable rate mortgages, triggered by indexes based on short-term interest rates, ultimately affected by the Federal Funds Rate.

Well before the Bear Stearns meltdown in July 2007 (BNP Paribas in August 2007, etc.), millions of American homeowners with adjustable rate mortgages were feeling the pain of artificially high interest rates driven by the Fed policy. Homeowners began falling behind on their mortgage payments; many of those were, and continue to be driven to foreclosure.

In the face of collapsing home prices and rising foreclosures rates, the Fed failed to act quickly enough in lowering the Fed Funds Target Rate to protect those too small to matter. It was only after the financial institutions, the too large to fail piece of the puzzle, were affected, that the Fed began to respond.

DATELINE WASHINGTON: MARCH 14, 2008

The Fed is buying time for the financial community…good news for Wall Street

The Federal Reserve Board of Governors published the following press release:

"The Federal Reserve is monitoring market developments closely and will continue to provide liquidity as necessary to promote the orderly functioning of the financial system. The Board voted unanimously to approve the arrangement announced by JPMorgan Chase and Bear Stearns this morning."

http://www.federalreserve.gov/newsevents/press/monetary/20080314a.htm

"Bernanke and the four Fed governors voted yesterday to become creditors to Bear Stearns Cos., a securities firm that isn't a bank, by invoking a law that hasn't been used since the 1960s. **Three days earlier, the Fed said it would swap Treasury notes on its balance sheet for privately issued mortgage-backed securities held by Wall Street firms**."

http://www.bloomberg.com/apps/news?pid=20601087&sid=aY2RvFA.yO_Q&refer=home

"The Federal Reserve responded swiftly to pleas from Bear Stearns that its coffers had "significantly deteriorated" within a 24-hour period. The bank, which had made a fortune in mortgage-backed securities, has ran up $2.75 billion in write-downs since last year, and faced a possible collapse without some kind of lifeline."
http://news.yahoo.com/s/ap/20080314/ap_on_bi_ge/bernanke_housing;_ylt=ApEmoROW3.HlOWCP6y0y4RTv5rEF

Resetting adjustable rate mortgages...just more bad news for homeowners on Main Street

"U.S. home foreclosure filings jumped 60 percent and bank seizures more than doubled in February as rates on adjustable mortgages rose and property owners were unable to sell or refinance amid falling prices.

About $460 billion of adjustable-rate mortgages are scheduled to reset this year and another $420 billion will rise in 2011, according to New York-based analysts at Citigroup Inc."

http://www.bloomberg.com/apps/news?pid=20601103&sid=ap2K3X5hzfQ8&refer=news

The financial community responds to the largesse of the Fed...

"The mortgage rate isn't down as much as it should be because the banks are in desperate straits and they need to maintain a larger spread than they normally would,'' said Alan Nevin, chief economist with the California Building Industry Association in Sacramento. "The banks need to generate income and the easiest way to do that is to broaden the spread. If they pay 3.5 percent and charge 6 percent, that's a lot of money."

Over the past 10 years, the average spread between 10-year U.S. Treasuries and 30-year fixed-rate mortgages has been 1.75 percent. Last week, the spread was 2.83 percent. That means a homeowner's mortgage costs are more expensive now than they have been.
http://www.bloomberg.com/apps/news?pid=20601087&sid=aMaXTX_3tq9w&refer=home

As a reminder, in 2006, Wall Street received $36 billion in bonuses and $38 billion in 2007: Bonuses averaged $200,000 and Compensation was in excess of $340,000 --- total Salaries average $540,000

http://www.bankersball.com/2006/11/06/2006-bonuses/

2006 Bonuses					
Ranking	Goldman	Morgan Stanley	Merrill Lynch	Lehman Brothers	Bear Stearns
Total Comp	$16.9	$14.0	$16.1	$8.7	$4.4
Bonus Pool	$10.2	$8.4	$9.7	$5.2	$2.6
Employees	25,647	54,349	55,300	24,775	13,000
Average Comp	$658,946	$257,594	$291,139	$351,160	$338,462
Average Bonus	$397,707	$154,556	$174,683	$210,696	$203,077
Total comp & bonus pool in billions. Source: Bloomberg					

THE ANALYSIS – WHAT WAS THE FED'S ROLE IN ALL OF THIS?

The following was from:

Economics Symposium at Macomb Community College University Center – Center Campus, January 19, 2008

The Fed and the Collapse of the Mortgage Market

Presented by
Donald R. Byrne, Ph.D.
Prepared in conjunction with
Edward T. Derbin, MA, MBA

"Here's another nice mess you've gotten me into."
Oliver Hardy to Stan Laurel
--- uttered in many Laurel and Hardy movies

To paraphrase this in our contemporary economic setting – now look at the mess your have driven us into, Federal Reserve System (FED).

It seems the FED believes that the U.S. economy is far better off when it is flirting with a slow growth or even a recession than when it is growing at an above average growth rate which in times past may have been causing a flirtation with inflation. This is what is known as an occupational hazard for central bankers in the more westerly portion of the developed world.

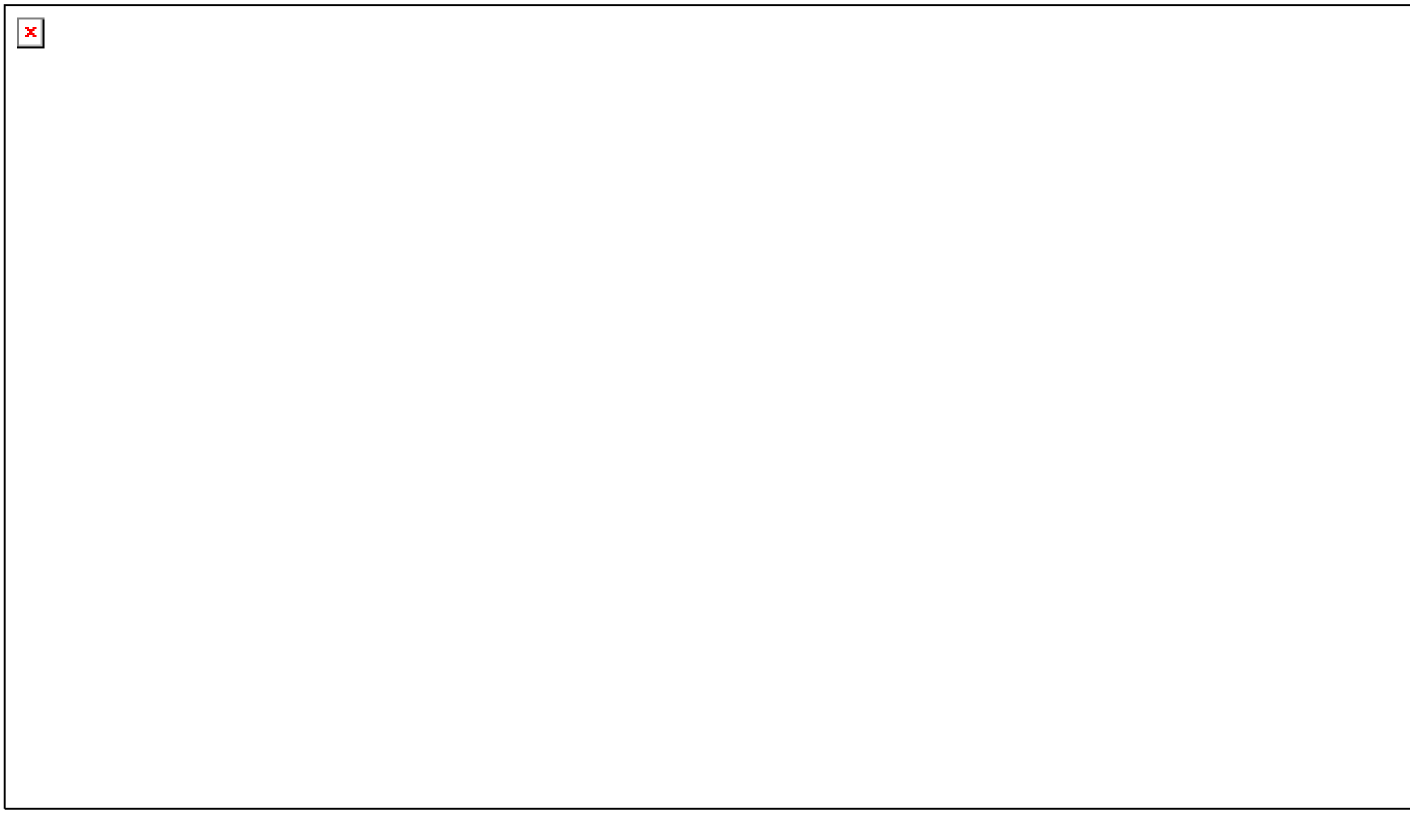
As I have been pointing for at least the past decade in my classes, newsletter and symposia like this one today, the U.S. economy has gradually been losing its twin biases toward recession and inflation since the Second World War, as the forces of competition have gradually strengthened. The visionaries of the classical-neoclassical tradition like Adam Smith and Jean Baptiste Say, saw the benefits of competition to the economy both in its microeconomic and macroeconomic dimensions, but jumped the gun a bit and proclaimed economic Nirvana was a fact of economic life. At least that was the message of Say's Law of the Markets. We were either in a condition of prosperity or prosperity was just around the corner, as his intellectual grand children were espousing even as the Great Depression dragged on.

John Maynard Keynes, benefiting from the tutoring of Alfred Marshall, finally recognized that the many markets were not very competitive and because of that lack of competition, led market economies toward a recessionary bias. After the Second World War, his disciples amended this to include an inflationary bias. Thus began the Keynesian Revolution and it urging to central governments to be poised to intervene and manage aggregate demand in order to eliminate inflationary and recessionary gaps.

Fine-tuning had reached puberty.

Because of the near horrific problem of escalating inflation in the late 1970s and the FED's failure to slow it down until 1980, the American economy and its financial system changed forever. The FED's corporate memory, had burned into it, a paranoid fear of inflation and a deep-seated guilty conscience for waiting too long a time before acting. Since then, preemptive actions have increasingly replaced proactive or reactive policy changes.

They have become scrupulous and will err if necessary on the side of economic collapse and even a recession **if necessary**, in order to avoid another late 1970s–like episode.



The preceding graph shows the quarterly changes in real Gross Domestic Product from over a decade ago to the present. Please note the period from the fourth quarter of 1999 to the third quarter of 2000. You will see very clearly, one of the sharpest declines in our economic history. For you Bush II Bashers, read it and weep. Billy Boy was the President when it occurred and not Georgie Porgy.

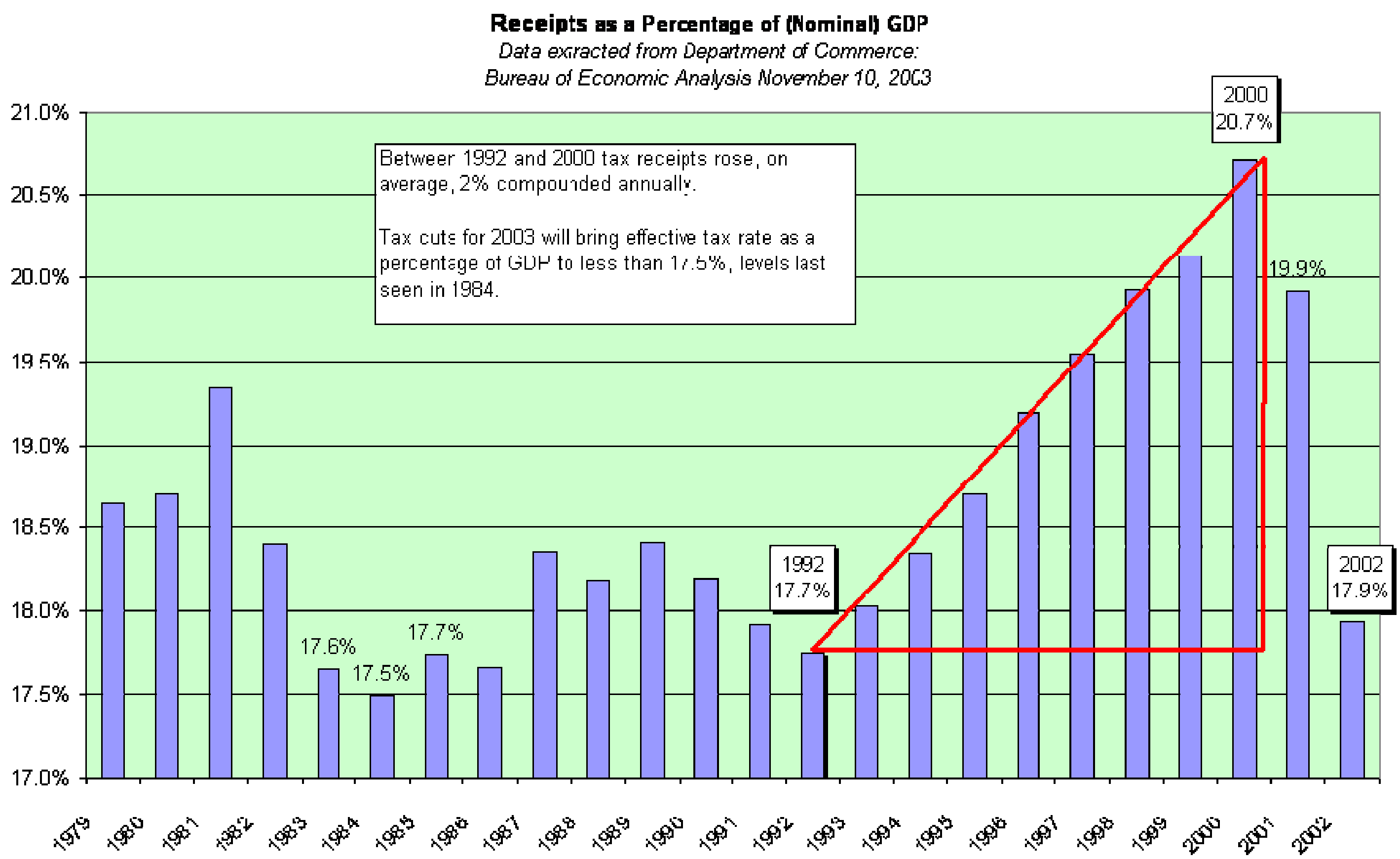
What caused this collapse? Three primary causes wreaked this economic havoc in 2000

The first cause was the series of tax increases beginning in the early 1990s through the rest of the decade

In the name of eliminating the federal budgetary deficit and to achieve some other ideological goals (e.g. Rubinomics) , the stimulant of a Federal deficit was replaced with the economic restraint of a growing Federal budgetary surplus approaching $120 billion by the collapse in the third quarter of 2000, not 2001. Also, note that there were no two consecutive quarters of negative growth in real GDP, which had been the long-standing definition of a recession. Nonetheless, the all-wise National Bureau of Economic Research declared a recession occurred in 2001.

The second cause of this collapse of 2000 was the rapidly increasing trade deficit

Its roots can be found in the FED's response to the roaring inflation of the late 1970s when the inflation rate peaked at an annual rate of nearly 20% in the last two months of 1979 and appeared headed for hyperinflation



status in coming years. In defense of the FED, it was ill-equipped, as it is still ill-equipped, to combat cost-push inflation pressures; in this case, stemming for the two oil shocks in 1973 and 1978. Oil prices reached heights not seen again until this year, 2008, when a recartelized American oil industry, aided and abetted by environmental pressures to preclude construction of new oil refineries, went along with OPEC and joined in raising oil prices in excess of $100 per barrel. Usually cartel actions self-destruct after a year of two. This time around, it seems that short of a worldwide recession, those lofty prices will continue to be with us. (Perhaps this is why the FED seems relatively nonchalant about growing fears of recession). When the inflation problem is of the cost-push variety, such as an oil shock or bad weather causing sharply rising food prices, the FED is ill-equipped to cope with it as the economic costs of monetary restraint are much greater than if the cause was one of the demand pull variety.

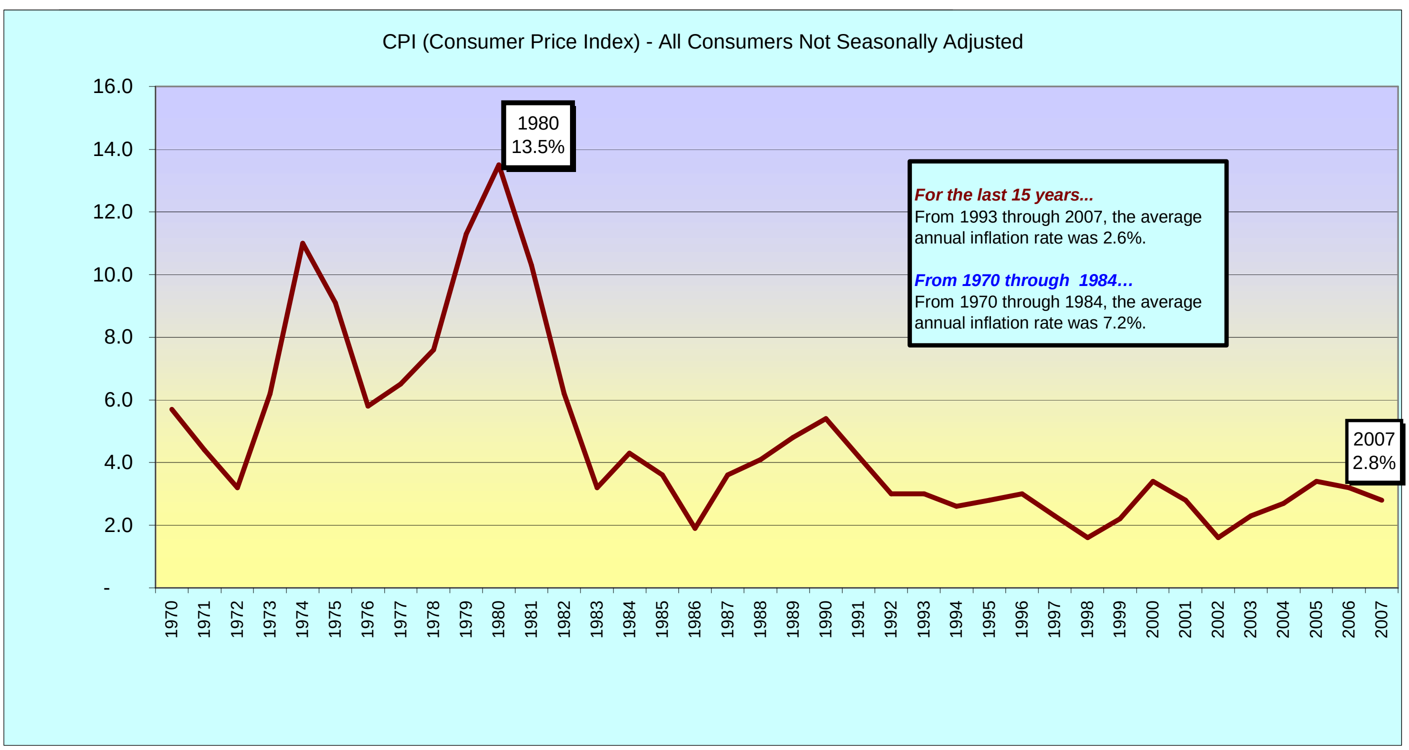
Inflation has tamed considerably since the 1970s & early 1980s

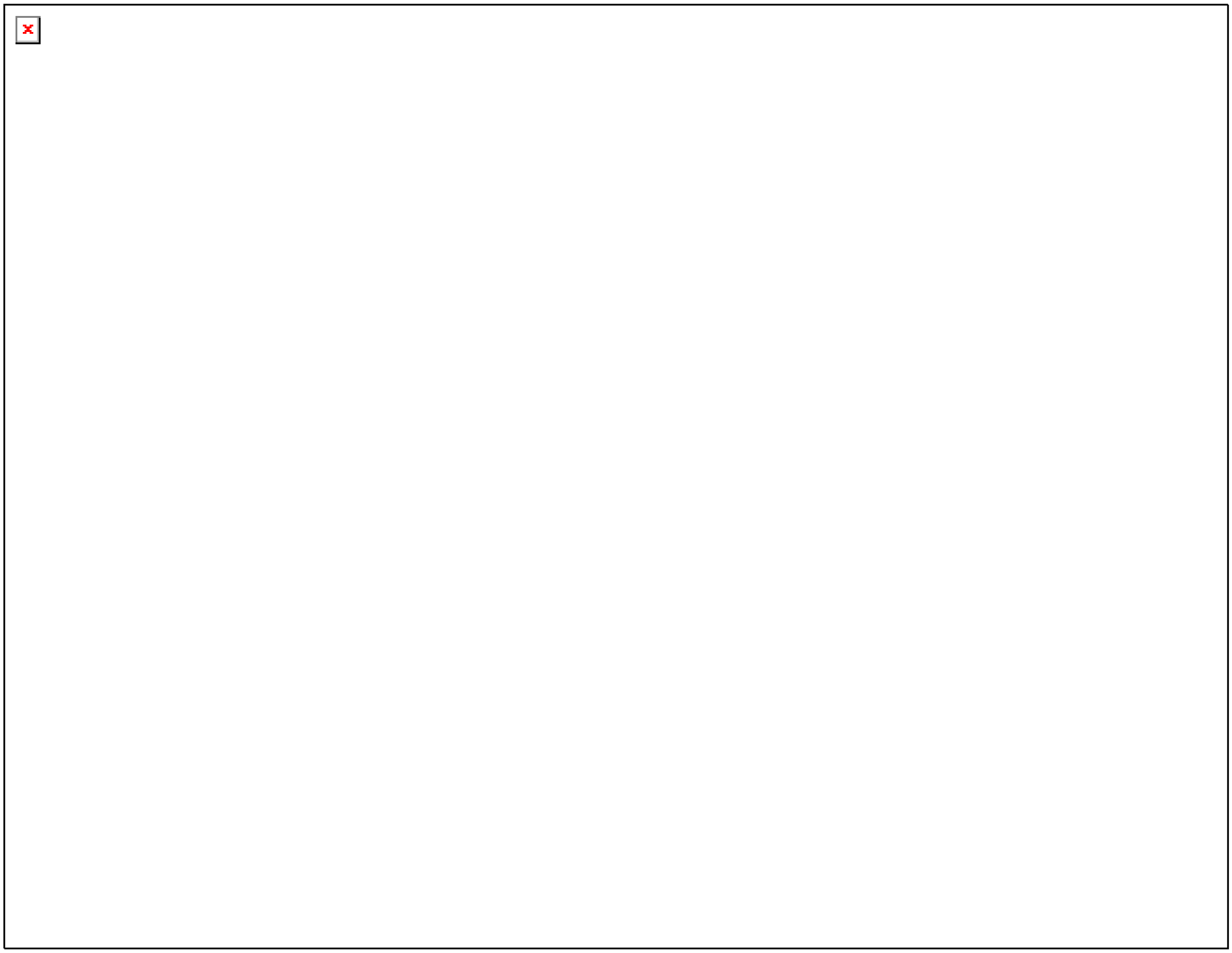
Annual Percentage change in CPI

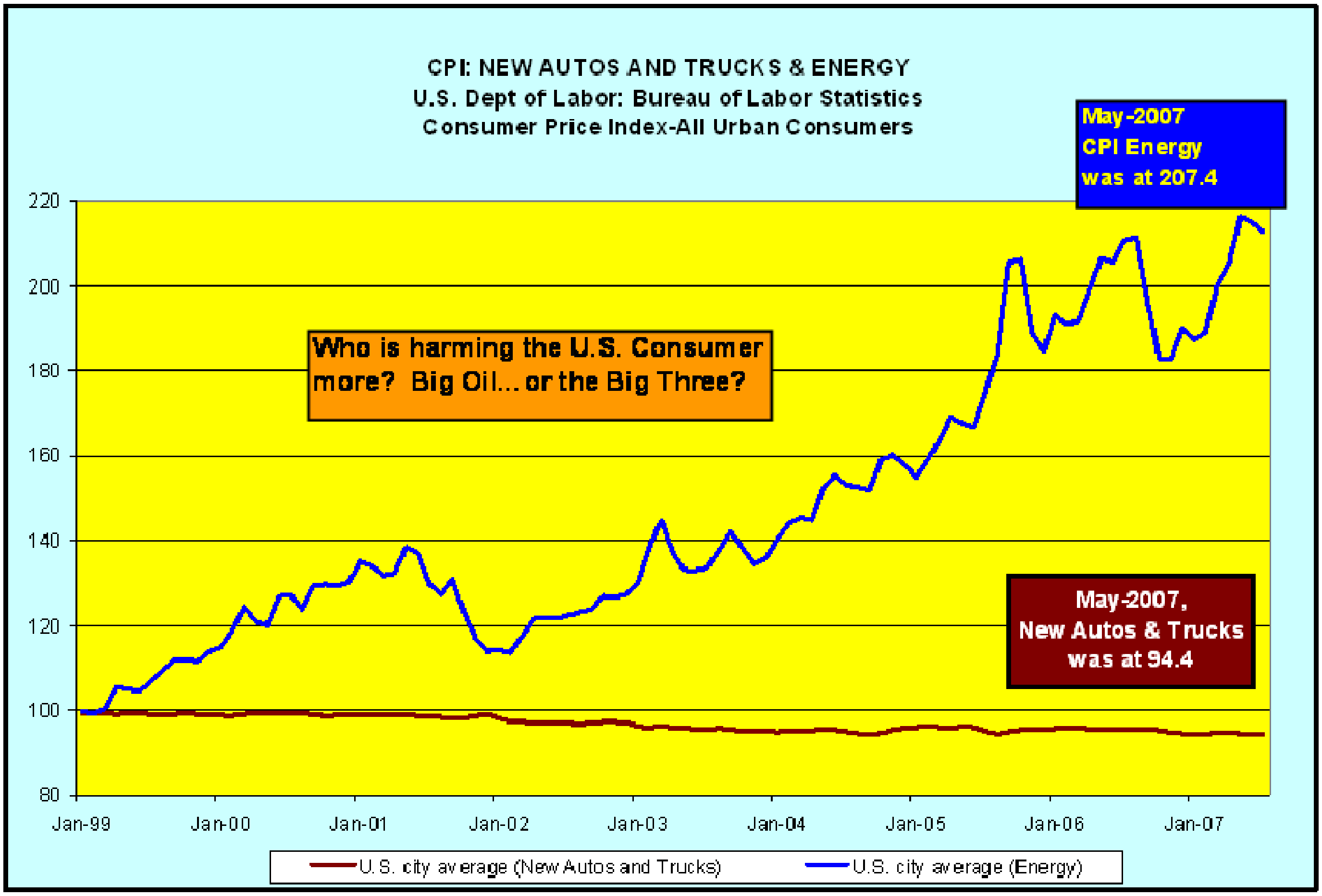
Bureau of Labor Statistics (Dept of Labor)
Consumer Price Index - All Consumers
Annual Data (not Seasonally Adjusted)
Today is: 1/18/2008

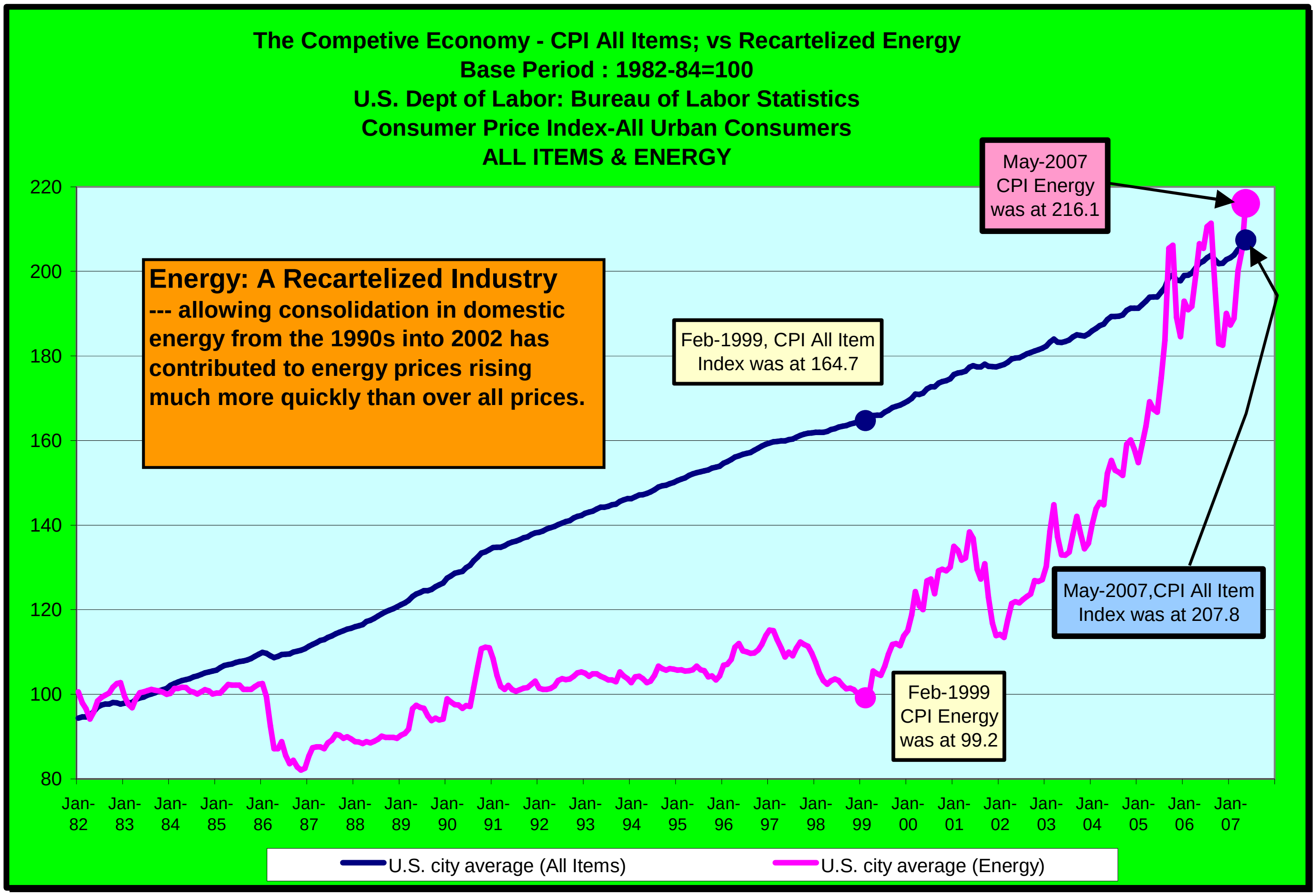
	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
CPI (Annual Data - Not Seasonally Adjusted)	5.7	4.4	3.2	6.2	11.0	9.1	5.8	6.5	7.6	11.3	13.5	10.3	6.2	3.2	4.3	3.6	1.9	3.6	4.1

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
CPI (Annual Data - Not Seasonally Adjusted)	4.8	5.4	4.2	3.0	3.0	2.6	2.8	3.0	2.3	1.6	2.2	3.4	2.8	1.6	2.3	2.7	3.4	3.2	2.8






CPI: NEW AUTOS AND TRUCKS & ENERGY
U.S. Dept of Labor: Bureau of Labor Statistics
Consumer Price Index-All Urban Consumers
May-2007
CPI Energy
was at 207.4
Who is harming the U.S. Consumer more? Big Oil... or the Big Three?
May-2007,
New Autos & Trucks
was at 94.4
220
200
180
160
140
120
100
80
Jan-99
Jan-00
Jan-01
Jan-02
Jan-03
Jan-04
Jan-05
Jan-06
Jan-07
U.S. city average (New Autos and Trucks)
U.S. city average (Energy)



The collateral damage, resulting from the Fed combating cost-push inflation is always substantially greater than if the problem came from what is technically called, demand-pull inflation. The more efficient solution in addressing these cost-push inflationary pressures would have been to seek a reversal of the FTC's (Federal Trade Commission) policy and force a break up of the newly cartelized US oil industry.

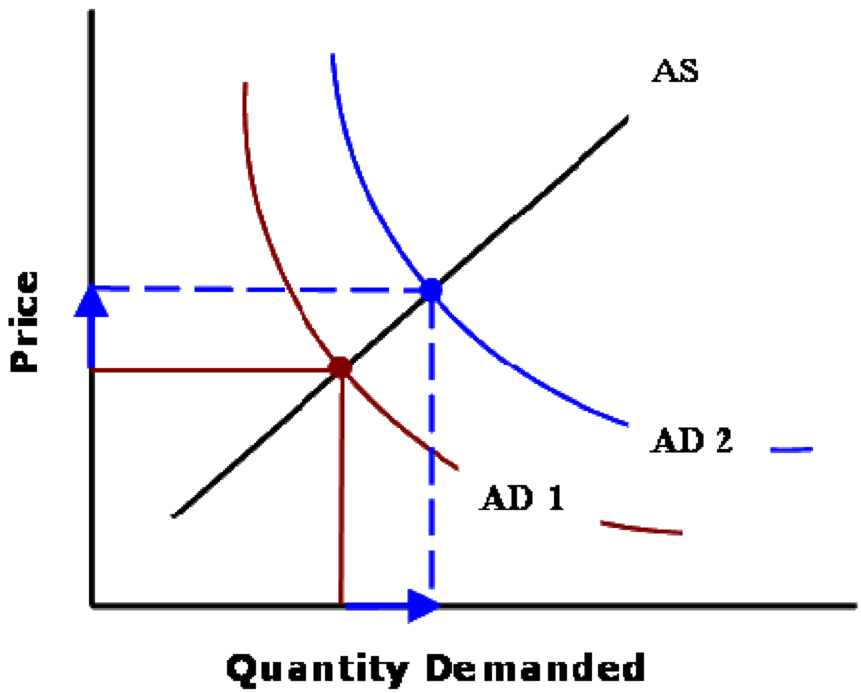
The Fed's Challenge in Dealing with Inflation: Demand-Pull versus Cost-Push

Problems in the Fed's monetary policy: 2004 – 2007
In the presence of competition, **demand-pull** inflation is much less likely to occur than in the past (inflation, due to rise in Aggregate Demand).

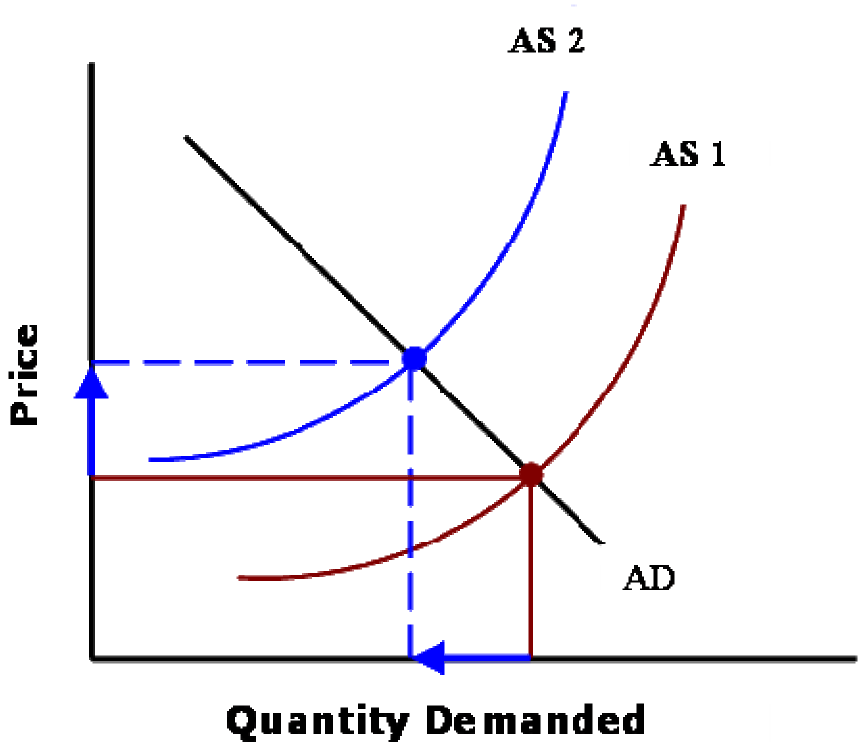
The Cost-push variety of inflationary pressure is derived from specific sector(s) in economy --- e.g., wage rates; raw materials such as oil.

The Fed has never successfully tamed cost-push inflation
1) Two oil shocks in the 1970s
2) Engineered collapse of the economy in 1980 – 1982
3) A job better suited for the Anti-Trust Division of the Justice Department or Federal Trade Commission

Demand Pull Inflation: A rise in Aggregate Demand (overall), translates into a rise in prices (overall)



Cost Push Inflation: A reduction in Aggregate Supply (overall), translates into a rise in prices (overall)



The source of this oil shock can be laid on the doorsteps of the Anti-Trust Division of the Justice Department and the Federal Trade Commission. Their inaction allowed 12 large U.S. oil companies to become four, sealing the economies doom to these record oil prices.

>>>>Notable US oil mergers of the last ten years<<<<

- **Ashland Oil combines most assets with Marathon Oil**
- **British Petroleum (BP) acquires Amoco**
- **Pennzoil merges with Quaker State Oil**
- **Exxon and Mobil join to form Exxon Mobil**
- **British Petroleum (BP) acquires ARCO (Atlantic Richfield)**
- **Chevron acquires Texaco to form Chevron Texaco**
- **Conoco merges with Phillips**
- **Royal Dutch Shell acquires Pennzoil-Quaker State**

Even with these record oil prices, the core rate of inflation currently is around 2.5%, not far from where it was nearly 4 years ago when the FED started its ill-advised policy of monetary constraint. FED research has pointed out, that due to the quality blindness and inability to catch the substitution effect displayed in consumer behavior, the burden of inflation is overstated by one percent or so in the PPI and especially so in the CPI. This leaves an inflation rate of 1-1.5% hardly worth destroying the residential housing market and its mortgage market counterpart. In spite of all this misery from the collateral damage from FED policy, oil prices are still around the $100 per barrel level. Remember when the FED stated this policy of monetary restraint, the price of a barrel of oil was around $35 and the core rate in the CPI was around 2%.

This very mild inflationary behavior would not have triggered the resetting of adjustable mortgage rates, as we shall consider shortly.

1970s & 80s Revisited

The FED's response to the cost-push pressures of the 1970s was to pursue a high inflation rate strategy for several years (1973-1979) to avoid even higher unemployment rate than was already being experienced. The rapidly accelerating inflationary spiral and the appointment of Paul Volcker as FED Board Chairman in very late 1979 triggered the Fed in the spring of 1980 to reverse its policy, making a 180-degree turn by massively crunching the economy. This caused a two and one-half year recession that while shorter, was nearly as severe as the Great Depression of the 1930s.

In mid-1982, the FED announced that they were easing, but would finish the job of eliminating inflation over the next few years, but with a soft-landing policy (no recession). Recall that at the peak of this FED induced recession, the unemployment rate rose to above 10% and by mid- 1980, three-quarters of the peak inflation rate had been eliminated.

This forever etched into the corporate memory of the FED a paranoid fear of allowing another such serious outbreak of inflation. This paranoia still continues as strongly today as back then, though it happened nearly a quarter of a century ago. In fact, the FED has gone from reactive and proactive policy changes to one of pre-emption. Unfortunately, the analytical skills of the FED (and to a significant extent, the academic institutions that churn out those hired by the FED), totter on the brink of being in the category of anachronisms. They seem to have failed to detect the evolutionary changes that have been occurring in the American microeconomy. Those changes that have been occurring since the Second World War, while gradual, are nonetheless profound. At the last symposium in the fall of 2007 (held here at the Macomb University Center), I spelled out that profound evolution and the implications of those changes, and called them the ***New Paradigm***.

The result of this paranoia concerning inflation and the adoption of a policy strategy of pre-emption, is reflected in the Trade and Current Account deficits in the U.S. Balance of Payments, beginning around 1982-83. The FED allowed nominal interest rates to fall from their lofty levels of 1980 but at a rate slower than the fall in the inflation rate. This means that the real or inflation adjusted interest rates did not fall as fast or as far as the nominal interest rates. This made the dollar investments by the rest of the world in the U. S., very attractive. While nominally a lot lower than their peak levels, the real, risk-adjusted rates of return did not fall as far, causing a substantial net inflow of financial capital from the rest of the world into the U . S., as reflected in the huge combined Capital Account surplus Balance in our Balance of Payments Accounts. (By definition, this is the inverted or mirror image or our Current Account Deficit, which is mostly a result of the Trade Deficit). This condition continues on today, with some signs of shrinking.

Being able to earn relatively higher real, risk-adjusted rates of return on investments in the U.S., the foreign demand for the Dollars in the foreign exchange markets exceeded the dollars supplied by U.S investors desiring to invest abroad. This shortage of U.S. Dollars in the foreign exchange market caused the foreign currency price of the Dollar to rise. This is what is what we mean by the term, appreciation of the Dollar. Foreign currencies become cheaper in Dollar terms and the Dollar becomes more expensive in terms of foreign currencies. This in turn caused our U.S. imports to increase relative to our more expensive exports due to the increasing cost of the Dollar to foreign buyers.

THEY HAVE TO INVEST THEIR DOLLARS SOMEWHERE – Foreign Investment in the U.S.

1. Foreign holdings of U.S. securities, by type of security, as of selected survey dates

Billions of dollars

Type of security	Dec. 1989	Dec. 1994	Mar. 2000	June 2002	June 2003	June 2004	June 2005	June 2006
Long-term securities	**847**	**1,244**	**3,558**	**3,926**	**4,503**	**5,431**	**6,262**	**7,162**
Equities[1]	275	398	1,709	1,395	1,564	1,930	2,144	2,430
Debt	572	846	1,849	2,531	2,939	3,501	4,118	4,733
U.S. Treasury	333	464	884	908	1,116	1,426	1,599	1,727
U.S. agency	48	107	261	492	586	619	791	984
Corporate	191	276	703	1,130	1,236	1,455	1,729	2,021
Short-term debt	**n.a.**	**n.a.**	**n.a.**	**412**	**475**	**588**	**602**	**615**
U.S. Treasury	n.a.	n.a.	n.a.	232	269	317	284	253
U.S. agency	n.a.	n.a.	n.a.	88	97	124	150	147
Corporate	n.a.	n.a.	n.a.	92	110	147	168	215
Total long-term and short-term	**n.a.**	**n.a.**	**n.a.**	**4,338**	**4,979**	**6,019**	**6,864**	**7,778**

Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2006
Department of the Treasury and Federal Reserve Bank of New York
Board of Governors of the Federal Reserve System (May 2007)

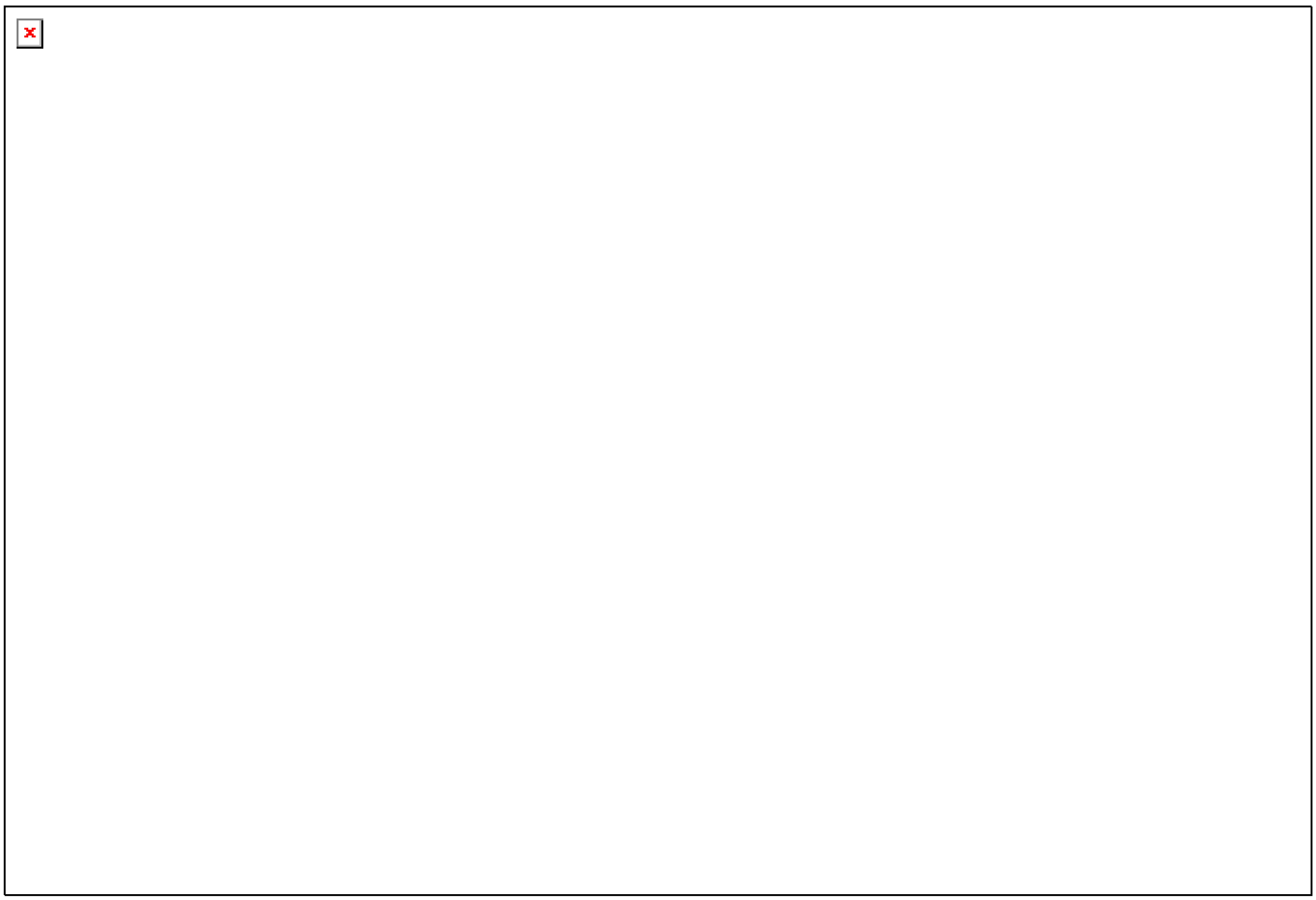
There were other contributing factors. One significant factor in the large Trade and Current Account deficits with mainland China resulted from the Chinese intervening in the foreign exchange market and increasing the supply of the Yuan (this was called "currency dumping" in the 1930s and was responsible for the IMF fixed exchange rate system after WW II). This caused the Dollar price of the Yuan to drop from about $0.50 in 1984, to about $0.125 (or a fall of 75%) by 1994 (Jan 2008: $1.00 = 7.247 Yuan, or $0.138 per Yuan).

This occurred back in the 1980s and is another reason why, in addition to FED policy, we have such large *Trade and Current Account deficits* today, with mainland China. It is also a major reason Wal-Mart has such a large presence in China.

This brings us to the third cause of the collapse of the U.S. economy in 2000

While our huge and growing trade deficit was a direct result of the ***FED's anti-inflationary policy*** adopted in 1980, they played a more apparent role in the 1999 – 2000 collapse by embarking on a more typical policy of monetary constraint by slowing down the growth of money and credit. This began after the federal tax structure was changed to increase a variety of effective tax rates, leading to a federal budgetary surplus, which, in conjunction with the growing trade deficit, resulted in depressed domestic levels of economic activity.

Beginning in 1999 (and repeated in 2004) through open market operations, the FED (FOMC) began to make legal reserves relatively scarce, triggering a rise in short-term interest rates. This was the weakest of the three damaging factors and I like to refer to it as the coup de grace. The growth rate of the American economy had been mortally wounded by the Federal Budgetary surplus and the Trade Deficit, so the FED obligingly put their pistol to the horses head and pulled the trigger of monetary constraint.



Keep this in mind: *In three quarters, from 4th quarter 1999 to the 3rd quarter of 2000, the GDP went from 7.3% annualized real growth rate to -0.5% growth...one of the most severe drops in real output occurred in the history of the U.S. economy!*

Fast forward to 2004

We still had a depressing trade deficit…

The U.S. Trade Deficit (billions)

2003	2004	2005	2006	2007
$496.9	$612.1	$714.4	$758.5	$708.5

The collapse of the economy quickly ended the Federal budgetary surplus.

The U.S. Federal Budget Deficit (billions)

2003	2004	2005	2006	2007
$303	$280	$318	$248	$162

Several tax rate cuts resulted in the Federal Budget going into deficit but by much less than the critics and pundits predicted (shades of Arthur Laffer). These offsetting factors led to an economic recovery and expansion that has continued until now, a period of about 25 quarters and still counting.

Enter the FED in 2004

Now, cloaked in paranoia concerning inflation and still on a guilt trip emanating from the late 1970s when they failed to stem accelerating inflation, they shifted to a pre-emptive strategy instead of a reactive or proactive one. The FOMC (Federal Open Market Committee), the real focus of the FED's authority and power, divined that with any significant growth, inflation could not be far behind.

Despite deflationary effects of significant growth rates in productivity, paranoia drove the FOMC to slow the economy. Asset prices became a topic of interest for FED officials, among them Alan Greenspan. Housing prices were especially of concern to the former chairman.

"Our forecasts and hence policy are becoming increasingly driven by asset price changes. The steep rise in the ratio of household net worth to disposable income in the mid-1990s, after a half-century of stability, is a case in point. Although the ratio fell with the collapse of equity prices in 2000, it has rebounded noticeably over the past couple of years, reflecting the rise in the prices of equities and houses."

Remarks by Chairman Alan Greenspan
Reflections on central banking

At a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming

August 26, 2005
http://www.federalreserve.gov/Boarddocs/Speeches/2005/20050826/default.htm

Someone should tell Alan Greenspan that his policies have been a roaring success in collapsing home values.

You should know that the price of homes fell 15% on the average in California in 2007.

"The median price paid for a home last month was $402,000, down 2.9 percent from $414,000 for the month before, and down 14.8 percent from $472,000 for December a year ago. The median peaked last March/April/May at $484,000."

Dataquick
http://www.dqnews.com/RRCA0108.shtm

Foreclosures up 100%

November 2007

"Foreclosure Actions Filed Against More Than 446,000 Properties

Activity Up Nearly 100 Percent From Q3 2006"

http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=3567&accnt=64847

- The cause of this mortgage/housing crisis is not caused by subprime loans, but by monetary policies of the FED, beginning in 2004. Subprime loans are usually less than 20% all mortgages.

- It is the adjustable rate mortgage portion of the market that is subject to resetting mortgage rates and rising monthly payments.

- ARMs are typically less than a quarter of all mortgages.

- The term 'subprime' is grossly misleading, since it primarily refers to the characteristics of the loan, rather than the credit quality of the borrower.

  "The term "**subprime**" refers to the credit characteristics of individual borrowers. Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies." http://www.fdic.gov/about/comein/background.html

- Whether they realize it or not, many folks with superior credit are holding subprime loans…

  The confusion here is the fact that the payment on his mortgage is interest only, which the FED defines as a subprime loan. In a recent discussion with mortgage bankers led to my ascertainment of many "better than average" borrowers with "better than average" credit standing are just as likely to get a 10% or 0% down home loan than are those with substandard credit ratings.

This confusion is reflected in media reports that mortgage lenders have violated – to a great degree, their performance of due diligence in making loans to borrowers that are clearly impending financial disasters. This confusion has led the media and FED officials to sound like Ebenezer Scrooge in Charles Dickens' Christmas Carol before Jacob Marley paid Ebenezer a visit. The critics are saying that these people have no right buying homes and should never have been given credit by these reckless mortgage lenders. As Ebenezer said, before his conversion, BAH HUMBUG --- have we no workhouses, or as his compatriots would say --- put them in debtor's prison. I thought these ideas died with Victorian England.

Recall also from "It's a Wonderful Life," when George Bailey tells the antagonist, "Just remember this, Mr. Potter, that this rabble you're talking about... they do most of the working and paying and living and dying in this community. Well, is it too much to have them work and pay and live and die in a couple of decent rooms and a bath?"

Onward

The Fed pounced on the economy and over the course of about 39 months, drove the Federal Funds rates up by 425 basis points or from 1.00% to 5.25%. If you know how the money market works and how depository institutions respond to a FED tightening in a growing economy, you would know that the pressure originally on the Fed Funds rate quickly spreads to the repo rate, the Eurodollar rate (LIBOR), short-term treasury security rates, etc.

LOOK OUT ADJUSTABLE RATE MORTGAGE MARKET.

Trouble if not ruination is a coming.

WE WARNED YOU

The Adjustable rate mortgage market --- fair warning in our newsletter (we first cited the ill-advised policy in 2004, just a few months after the FED began tightening credit)

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(Volume 2006: Issue 1) January 6, 2006)
(The Killing Fields: Weak links in an otherwise strong economy)

http://byrned.faculty.udmercy.edu/2006%20Volume,%20Issue%201/2006%20Volume%20Issue%201-b.htm

RISING MORTGAGE INTEREST RATES

In addition to the rising energy costs and insecurity in the labor markets, households are now facing an additional burden of rising interest rates, affecting their mortgages. As short-term rates are driven up by the Federal Reserve actions in the Federal Funds rates, it influences other short-term interest rates to rise as well.

In the area of variable rate mortgages (ARMs), the Fed's actions are gradually triggering the adjustment clauses in these mortgages. This increases the monthly payments, reducing further the disposable income available to purchase other goods and services and also reduces the cushion protecting homeowners from defaulting on mortgages.

The second area of concern is the rise in fixed rate mortgages, both for new homebuyers and those attempting to refinance from variable to fixed rates. The real question is are these short-term rates of interest, and some longer term rates of interest like 15 and 30 year fixed rates, higher because of real supply and demand factors in the market, or because of the Fed's actions.

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Let us fast-backward, so to speak

Let us go back to the inflationary period of the 1970s that changed the American financial landscape for all time. Dominated by the experience of the stable price era of 1952-64, the financial markets had been lulled into a behavior pattern of complete illusion or close to it. Since there were no price level changes to speak of for nearly 12 years, nominal or market rates of interest were real. This means that the principal of the debt in this case, was not being eroded by a loss of purchasing power due to inflation. Remember that inflation reduces the purchasing power of a dollar and hence its real value falls as compared to its nominal or apparent value.

Inflation began to occur and creep slowly upward, primarily due to the Wars on Pollution, Poverty, Southeast Asia, etc. The Federal deficits began to mount and the FED was more than willing to monetize the debt. This is the modern way that the Federal Government runs the printing press. The monetary base and legal reserves increase and the depository institutions like commercial banks utilize this new capacity to create more money and credit. **It is the depositories in this modern era of privatization that create the important money (checkable deposit part of M-1 money) and not the Federal Government!** They have not run the printing presses, in the traditional sense of the term, in this country since the end of the Civil War, over 140 years ago.

Wrap-up

What I have been trying to explain/illustrate to you is that the responsibility for this current mortgage/residential housing crisis lays squarely at the doorstep of the Federal Reserve System. Their post-1980 paranoid policies, many analysts think, are pushing us in the direction of a recession that should never occurr. Finally it appears that the new chairman of the Fed, Ben Bernanke, is catching on to the dangers of this ill-advised and ill-conceived policy that has persisted over three years. Apparently, this will be reversed – at least that is what has been plainly portrayed in the media of late. Continuing his departure from the previous chairman, Alan Greenspan, he is saying that the targeted fed funds interest rate will continued to be rolled back significantly and also recommended that immediate tax cuts be made. He is distancing himself from the former Fed chairman.

As you can see, from looking at my newsletter of two years ago, and the most recent statements of Dr. Bernanke, more attention should be paid to and credence placed upon the words of the ivory-towered academicians – and less on the shoulders of investment bankers, the stock jocks of the financial system. Why waste all of the money on so-called experts from the financial services industry, when you get a much better and certainly less expensive analysis from the ivory tower.

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(Opinions expressed on this web page are those of a faculty member or employee and do not necessarily reflect the position of University of Detroit Mercy)