

Spreading But Not Eliminating Risk

Subprime Loans, Subsidized Land, and Manipulated Money

August 1, 2007

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The news media has focused on the subprime real estate loan problem, which has roiled stock markets around the world. These are loans made to borrowers with poor credit. The loans are often made with loose conditions. Buyers pay little or no money down, and the interest rate is adjustable, so it can rise if market interest rates go up. There is often an initial couple of years of low payments, then the payments jump up.

Politicians proudly proclaim that such lending has enabled millions of lower-income families to become homeowners. But that cruelly backfires as folks with limited financial knowledge find they cannot afford the rising mortgage payments and then have to give up their house.

The problem would not be so great if this was simply banks foreclosing on their delinquent loans. The US government has subsidized residential real estate loans by promoting a secondary market in mortgages. Two government sponsored enterprises, commonly called Fannie Mae and Freddie Mac, buy many of the mortgages from the originating banks. They package the loans into tradable securities and sell them to financial organizations such as insurance companies, pension funds, and hedge funds.

This secondary market spreads the risk among many players, but it does not eliminate the risk, and because the risk becomes deeply embedded in the international bond and stock markets, when there are massive defaults, the entire financial structure trembles.

The role of hedge funds has been prominent in the news. A true hedge is a reduction of risk. For example, if a farmer expects a harvest a few months in the future, but fears that the price of the crop will fall by then, he can hedge against that risk by pre-selling the crop in the futures market, with a contract to sell later in May but at the price set when he enters the contract.

However, many hedge funds are not hedging, but speculating, using leverage, i.e. borrowing. Suppose one can get a package of mortgages that pay 7 percent per year, and the fund can borrow money at 5 percent. The fund borrows \$100 million and buys \$100 million of the mortgage packages. It gets \$7 million per year in interest from the mortgages and pays \$5 million on its loan, leaving a profit of \$2 million. Capitalized at an interest rate of five percent, the market value of the hedge fund is \$40 million (\$2 million divided by .05).

But now suppose that two-sevenths of the mortgages become delinquent, as the borrowers don't pay the interest. Now the fund is only getting \$5 million from the mortgages but still pays \$5 in interest. The profit is now zero, and the value of the hedge fund collapses to nothing.

The problem is that it could be a bank or brokerage firm or other institution that has money in the hedge fund, and now the value of the shares of stock of the bank fall. They were speculating that the mortgage interest would keep flowing, but now delinquencies are piling up. Also, as bad loans are written off, a bank's assets decline, and it may fall below the required reserves. The bank then has to borrow from other banks, but they too are in a funk. The Federal Reserve came to the rescue, reducing its "discount rate," which is the rate paid by banks who borrow from the Fed. Some state governments are also stepping in to bail out some of the delinquent borrowers.

This action has stopped the panic for now, but there is a more fundamental problem than loose lending policies and uninformed buyers. The whole attempt to prime the pump of the real estate market is ultimately futile. The government-subsidized secondary market reduces mortgage rates, but that ends up raising the price paid for real estate. Tax breaks for real estate — deductible interest and property taxes, tax-free capital gains, fictional depreciation, low property taxes on land — also end up boosting real estate prices, so that new buyers have no net benefit.



What financial commentators are missing is that the whole tax and money system artificially pumps up land values to unsustainable heights. Government intervention and subsidies have penetrated the economies of the world down to the core so that we are as far away from truly free markets as the command economies of the USSR and China were from today's mixed-up economies. People think we have markets which fail, but in reality not just the commanding heights but the foundation of our economies — money, loans, and land — have been controlled by government personae who are both ignorant and motivated to please the moneyed interests who maintain over 34 thousand lobbyists in Washington DC.

Lots of people deplore that system, but few dig down to the ultimate cause: dysfunctional mass democracy. Voting in large groups creates the big demand for campaign funds, and special interests profit from supplying it. Government financing of campaigns will not stop that insatiable demand, but drive it underground and around the sides. The structural problems are so deep that radical remedies are needed. It is very strange that the fundamental problems are so little understood.

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FRED E. FOLDVARY, Ph.D., (May 11, 1946 — June 5, 2021) was an economist who wrote weekly editorials for [Progress.org](#) since 1997. Foldvary's commentaries are well respected for their currency, sound logic, wit, and consistent devotion to human freedom. He received his B.A. in economics from the University of California at Berkeley, and his M.A. and Ph.D. in economics from George Mason University. He taught economics at Virginia Tech, John F. Kennedy University, Santa Clara University, and San Jose State University.

Foldvary is the author of *The Soul of Liberty*, *Public Goods and Private Communities*, and *Dictionary of Free Market Economics*. He edited and contributed to *Beyond Neoclassical Economics* and, with Dan Klein, *The Half-Life of Policy Rationales*. Foldvary's areas of research included public finance, governance, ethical philosophy, and land economics.

Foldvary is notably known for going on record in the *American Journal of Economics and Sociology* in 1997 to predict the exact timing of the 2008 economic depression—eleven years before the event occurred. He was able to do so due to his extensive knowledge of the real-estate cycle.

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