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## Should homeowners worry?

By James C. Miller III

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Over the coming decade, Americans will create more than a million new households each and every year. Add to that the historical increase in homeownership rates and the rise in the price of housing (partly from the gradual upgrading of homes), and it is clear we will need about \$1 trillion more each year to fund new mortgages. Where will the money come from?

Enter a world market for capital and the efficient U.S. arrangements for housing finance, which attract low-cost capital in all economic environments with low transaction costs. As UCLA's Richard Roll has stated, "The U.S. mortgage market is the envy of every other country." Why is this so?

One reason is that Freddie Mac's and Fannie Mae's debt- and mortgage-related securities have become a prime choice for many foreign investors. These two government-sponsored enterprises (GSEs) have transformed the American mortgage — especially the long-term, fixed-rate, low-down-payment and freely prepayable mortgage that Americans cherish — into simple, transparent and easy-to-price securities. In so doing, Freddie Mac and Fannie Mae have made our national supply of mortgage credit more liquid, stable and affordable.

They have also converted a large part of our current account deficit (the amount by which the value of imports exceeds the value of exports) into a powerful engine to generate capital for mortgages for American families.

We all know of the gloomy statistics about the current account deficit. For example, on Dec. 16, the Department of Commerce announced that for the third quarter it had risen to \$165 billion, an all-time high. But the flip side of the trade deficit in goods and services is the trade surplus in capital. That is, the inflow of capital from abroad makes up the difference between imports and exports, and this inflow, plus our own domestic savings, provides the capital we need for investments here at home.

Where this capital from abroad goes is critically important. Much of it goes into investments in plant and equipment. But a lot of it enables people to build and buy homes — one of the reasons why the U.S. economy held firm over the last three years despite the loss of \$8 trillion in stock market wealth and other shocks following the terrorists' attacks of September 11, 2001. Aided by the Federal Reserve's commitment to low interest rates, the secondary mortgage market created by Freddie Mac and Fannie Mae — its size, strength and flexibility — proved a bulwark of economic strength and stability when the U.S. needed it most.

The rather standard, highly-liquid and low-risk securities offered by Freddie Mac and Fannie Mae have been essential pillars. What these two GSEs do is bundle mortgages and create "mortgage-backed securities" (MBS) that are then traded on the open market. When investor appetite for MBS dwindles, the GSEs issue similarly liquid and transparent debt securities that are especially attractive to foreign investors who may be unfamiliar with the nuances of MBS.

The system works well. Gone are the days of mortgage credit crunches and exorbitant mortgage rate spreads. American homeowners — present and future — are assured of a steady, liquid and generally affordable supply of mortgage credit. And investors, both domestic and foreign, are provided a flow of debt- and mortgage-related securities that are highly liquid, transparent and secure.

Freddie Mac's and Fannie Mae's securities have proven so attractive to foreign investors that those securities routinely "insource" between 20 percent and 25 percent of all the dollars our current account deficits send abroad. In part because of Freddie Mac's and Fannie Mae's operations, foreigners invest their dollars in one of the most important and productive sectors of the U.S. economy, providing more and better housing than domestic investment alone could provide — and, according to numerous studies, enabling a reduction in social costs such as crime and teenage pregnancies.

Of course, the two GSEs must hold sufficient capital to protect their mortgage portfolios against real economic risk, and they must account for their assets and liabilities in a transparent fashion that assures both regulators and investors. But the model is sound and provides very large benefits to homeowners, investors, and the global economy.

*James C. Miller III is Chairman of the CapAnalysis Group. Previously, he served as chairman of the Federal Trade Commission (1981-1985) and as director of the Office of Management and Budget (1985-1988).*

