# Fannie, Freddie, Hank, Ben and the Dollar

Over the past year, officials and investors have been wrestling with a three-pronged threat: a profound crisis in the financial markets and the circuit of capital, the loss of economic momentum, and inflation pressures, largely but not wholly a function of higher food and energy prices. Nearly every country is experiencing these threats, though the potency of each individual threat and the institutional capacity to address the challenges varies widely.

The US conceit is its flexibility and the current crisis has seen this flexibility exercised. The Federal Reserve cut rates fairly early in the crisis and fairly aggressively. They innovated with new liquidity provision facilities, though seemingly felt compelled to wait until after a large failure (Bear Stearns) was threatened. In an unusual step, the Fed took some of Bear's assets onto their balance sheet. Fiscal policy has also been deployed. It is striking that the charge for tax rebates was led by the US President who is a lame-duck as is the Vice President. Efforts for a second round of fiscal stimulus is making its way through committees, but given the summer recess and the November elections, barring a significant deterioration of the US economy in the coming months, it is difficult to see it passed over Bush's opposition.

What appears to be a rolling financial crisis—sub-prime, real estate, commercial paper, high yield bonds, leveraged loans, auction rate bonds—raised concern about the viability of Fannie Mae and Freddie Mac. Once again US policy makers demonstrated willingness and capability to innovate. The Federal Reserve indicated it would allow the government-sponsored-enterprises to borrow from it at the discount rate. What follows from having access to the Fed's funding, is that one must be also more subject to Fed oversight. This seems to be what will happen in this case as well, though regulatory overhaul will more likely have to wait for the next Administration.

The Treasury's innovation was even bolder than the Federal Reserve's. The actual status of government-sponsored agencies relative to the government's obligations has always been murky. Fannie Mae and Freddie Mac bonds trade at a modest interest rate premium to Treasuries, which is part of the reason the money market funds and foreign central banks are significant holders of agency paper. The power of the Treasury's commitment to prevent the collapse of these key agencies, whose paper has become part of the inner core of the international financial system, is the product of its capability and credibility. In addition, the same considerations that prompted some large investment houses to bailout some of their off-balance sheet entities, even when there may not have been a legal obligation to do so, with reputation issues being a powerful even if under-estimated motivation, may also be a source of pressure for the US Treasury.

Treasury Secretary Paulson wanted to underscore the government's commitment and he argued he would be even willing to nationalize (i.e. buy an unlimited amount of their stock and/or bonds) if necessary. It surely has the capability, what about credibility? Some in Congress seem to be balking at giving the Treasury Secretary a blank check that he could use at his discretion. There are other objections as well, but with modest adjustments, Paulson will likely get the essence of the authority he seeks and as early as next week. And if not, look for the financial tensions to escalate again.

From another level of analysis, there is something else also taking place that may have far-reaching implications for the ownership society—another one of US conceits. Even before the current Administration, the US promoted home ownership (through various programs and agencies as well as tax policy) and equity ownership (through 401k and IRA schemes). And yet, through the current crisis, including Bear Stearns, as well as through the Treasury's contingency plans for Fannie Mae and Freddie Mac, the home owner and equity owner are taking significant haircuts, while creditors (lenders) are making out like bandits, getting paid for risks that the government underwrites or is willing to assume.

Ironically, finance capital has rarely been so stressed and the Federal Reserve and Treasury's actions which have circled the wagons around the creditors, seems, in a perverse way, to illustrate its power still. It is precisely

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these activities that prompt observers, including at least one US Senator, to bemoan the abandonment of capitalism in favor of socialism. While this seems to be largely hyperbole, it does raise important questions about fairness and moral hazard issues. But more importantly, if not careful, officials may undermine the value of an ownership society.

This appears to be taking place in other countries, especially where an equity culture is in a nascent stage and the appreciation that markets go down as well as up is less understood. The danger is that new middle classes that are being created in part from the incredible transfer of wealth taking place in the world, and in part from the economic development occurring, see their life savings, or a good part of them, wiped out. This may trigger a backlash against banks and markets, and capitalism in general.

For its part, the dollar was sold off hard on fears that Fannie Mae and Freddie Mac were insolvent as a former Fed official and now a member of the libertarian Cato Institute claimed. Bernanke also signaled a retreat from the Fed's assessment in late June that the risks of a sharp contraction of the US economy had diminished. This in turn encouraged the market to reassess the trajectory of Fed easing. The swing in the pendulum of market expectations can be illustrated in a number of different ways. Consider, for example, that the December Fed funds futures contract rallied almost 30 bp in the first half of July or that the 12-month overnight index swaps went from implying 85 bp of tightening in June to only 30 bp as financial anxiety hit a fevered pitch in the middle of July. That day, July 15, also corresponded to the day the euro set a new record high.

As the world appeared to edge closer to the proverbial abyss, the dollar suffered, equities suffered and bonds drew safe haven bids. The purchases of the yen and Swiss franc seemed to be the foreign exchange expression of the heightened risk aversion. As the world appeared to breathe a collective sigh of relief, the equities markets roared back and the dollar found better footing and the yen and Swiss franc gave up the lion's share of their gains.

In the coming days, the foreign exchange market will likely continue to be driven by other markets, like oil, equities and the general perception of system risk. The next string of data will likely confirm that the US housing market remains weak and the euro-zone economy continues to weaken. This contrast will be brought into stark relief when the US reports that Q2 GDP (July 31) probably expanded at a faster rate than Q1 (with optimists suggesting close to twice as fast), while Germany and Japan stagnated or worse (their preliminary Q2 GDP figures are due out in mid-Aug).

In our view, the dollar bottomed nearly 8 months ago against half the G7 currencies (sterling and the Canadian dollar) and the yen 4 months ago. The dollar has also bottomed against a number of emerging market currencies. Yet the dollar continues to bounce along its trough. It may be difficult for the dollar's base to broaden further to include the euro (where its recent record high was not confirmed by the Swiss franc), until investors have greater conviction that interest rate differentials are going to move in the US direction.

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