

# Fannie Mae-Backed U.S. Housing Bubble Is Set To Explode

by Richard Freeman

The so-called U.S. "housing boom," which has propped up consumer spending and a section of the U.S. economy for the last several years, and which itself is propped up by one of the biggest financial bubbles in the last hundred years, is now headed on a downward slide. The implications are ominous: A popping of the housing bubble would jolt homeowners, leading to a plunge in property values and a dramatic increase in the rate of housing mortgage defaults, and would also potentially wipe out trillions in housing-related financial paper, seizing up the U.S. financial system.

In particular, the popping of the housing bubble would directly affect the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corp. (Freddie Mac), which have issued trillions of dollars of housing-related paper in order to facilitate a large volume of home sales and home price inflation since 1993.

Housing has been one of the few sections of the U.S. economy that has not yet tanked, and the housing sector places orders for structural iron, wood, cement, glass, and other materials, holding up a limited section of the U.S. economy. Homes have also served as financial assets, against which consumers borrow funds to use for their increased spending. Now, this total process appears to be coming to an end.

## The Market's Rise And Fall

The housing bubble depended upon an interaction of rising home sales and rising home prices.

However, the Meyers Group, a real estate consulting firm, reported that in California during the third quarter, new homes sales fell 30% from the same quarter a year earlier. This is an enormous fall, in what had been the leading market for home sales in the United States. For the same period, the declines in new home sales were 35% in Washington, D.C., 19% in Philadelphia, and 31% in Baltimore.

The Commerce Department reported that sales of pre-existing homes in September fell by 12%.

As for home prices, during the post-1993 housing bubble, they had gone sky-high. Between January 1993 and May 2001, the *median* sales price of a new home in the United States shot up from \$121,500 to \$179,400, and the *average* sales price of a new home from \$144,100 to \$211,700, representing increases, respectively, of 47.7% and 46.9%.

But these national rates of increase, though substantial, understate the fact that in some areas home prices have increased even more explosively. These national rates combine two processes: those areas of the country hard hit by the physical economy's collapse, where home prices have fallen or stayed level, and those areas artificially propped up by the "New Economy," "Information Age," and speculative financial markets, where home prices have been white-hot. Of the latter, for example, since mid-1995, home prices leapt by 40% in Atlanta, 54% in New York City, 68% in Boston, 71% in Denver, and 100% in San Francisco. But the puncturing of the New Economy and speculative financial bubbles has caused a downturn in home prices.

The cumulative fall in home prices can be seen in the fact that, just between June and September of this year, on a national basis, the median home price fell from \$179,400 to \$162,400, and the average home price fell from \$211,700 to \$195,700. On an annualized basis, these represent rates of home price fall of 37.9% and 29.7%, respectively.

## Pumping Up A Bubble

The stakes in maintaining the housing bubble are high, because of how huge it has become.

From 1990 to the end of the second quarter of 2001, the volume of U.S. home mortgage debt outstanding has risen from \$2.53 trillion to \$5.14 trillion. Thus, during the ten and one-half years since 1990, housing mortgage debt outstanding rose by \$2.63 trillion. Of that increase, some represented the amount needed to finance the roughly 1 million new homes that were brought to market and sold each year. But most of that increase represented the financing of the increased prices of homes that were to be covered by mortgages, sales of both new homes and existing homes.

For the U.S. home mortgage bubble to have reached \$5.14 trillion, already poses a threat to the stability of the financial system. But there is another level of activity, in the secondary home mortgage market, which makes the situation far more dangerous:

The United States created Fannie Mae during the 1930s, to facilitate home sales. This was an appropriate decision. The system functions in the following way: Once a primary mortgage lender, such as a bank or savings and loan association, makes a home mortgage loan to a buyer, for, say, \$250,000, the primary lending institution can then sell this \$250,000 loan to Fannie Mae. As a result of that transaction, the primary lending institution now has received \$250,000 in cash from Fannie Mae, with which it can make a new home mortgage loan. Fannie Mae can either hold on to its \$250,000 mortgage loan until maturity, when it is fully paid back, or it can sell it to an institutional investor, such as an insurance company or a pension fund.

Fannie Mae raises cash by either issuing its own bonds, or selling off the mortgages it has bought, to an institutional investor. This system worked to provide liquidity to the home market, to finance home purchases at fair, reasonable prices.

## Inventing Mortgage-Backed Securities

But the system changed. From a government-sponsored entity, Fannie Mae became a private institution. It has more and more become concerned with building a housing bubble: Fannie Mae financed (by purchasing) over-priced home mortgages (though Fannie Mae has a limit of \$275,000 in the size of conventional home mortgages it can buy). Further, during the early 1980s—after Federal Reserve Board Chairman Paul Volcker raised interest rates into the stratosphere in October 1979—Fannie Mae effectively invented mortgage-backed securities, a form of a derivative, or speculative instrument. Through this process, Fannie Mae became a gigantic organization, concerned with making money off a rapidly expanding, speculatively driven home real estate market. In fact, its survival depended on the continuing expansion of this market.

Fannie Mae, Freddie Mac, and other institutions with a similar function, began issuing a ton of financial paper (bonds, mortgage pools, mortgage-backed securities) to finance the home mortgage market. By the end of the second quarter of this year, they had issued more than \$5.25 trillion of this paper. (In a future issue, *EIR* will present the full story of Fannie Mae.) Accordingly, the total amount of financial paper connected to the housing market, including U.S. home mortgage debt, plus the housing-related paper issued by Fannie Mae, Freddie Mac, etc., totalled \$10.39 trillion by the end of the second quarter of this year. This is an immense amount to be riding on the outcome of the U.S. housing market.

The top financiers, Fannie Mae, and the Federal Reserve Board of Governors have all reacted to this crisis frantically. Thus far, the Fed has cut interest rates ten times this year, which has consistently lowered the U.S. conventional mortgage rate, so that it is now 6.46%, the lowest rate in more than 25 years. This has created a surge in home mortgage refinancing, to take advantage of the low interest rates. Since Sept. 11, about 1 million people have applied for refinancing—six times as many as during the comparable period last year. By thus generating a new round of mortgage financing, this has kept the mortgage market alive.

But the bloated U.S. housing bubble cannot survive falling home sales and plunging home prices. A housing market bubble blowout that brings down \$10 trillion or more in paper values, will seize up the U.S. financial system.

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# Pakistan's Gwadar A Potential 'Great

by Mary Burdman

A serious casualty of the ongoing U.S.-U.K. war against Afghanistan, could be an infrastructure project which has the potential to help transform one of the poorest regions in the world. This is the proposed deep-sea port at Gwadar, on the coast of Baluchistan, the largest but poorest province of Pakistan.

Constructing a deep-sea port at Gwadar has been discussed for many years, but only in 2001, when the government of China agreed to be sole sponsor of the project, did its construction become possible. However, the all-out move of U.S. forces into the area since war was launched on Afghanistan on Oct. 7, is jeopardizing the project.

A look at the map will indicate why. Gwadar, a port since ancient times, and one of the main communication routes between West Asia (the Middle East) and the South Asian Subcontinent, lies in a most strategic position, near the mouth of the Strait of Hormuz, where the Gulf of Oman joins the Arabian Sea. Every year, some 60% of the world's oil is transported through the Strait of Hormuz.

Plans to be carried out by China and Pakistan, to eventually turn Gwadar into a "world class" 21-berth port which could serve as a regional hub for Pakistan, Iran, the Gulf states, East Africa, and, if planned road and rail connections are constructed, Central Asia and western China, have caused what one Indian newspaper called an "antsy" reaction in Washington, notably at the rabidly anti-Chinese spook-sheet, the *Washington Times*.

Circles in India have also expressed concern. Certainly, New Delhi has a legitimate basis to inquire about the intentions for such a project, given its relations with Islamabad, and the role Pakistan has played in various operations originating with the U.S. Carter-Brzezinski Administration and the Iran-Contra drugs-for-guns operations. These operations have reduced Afghanistan, and areas of Pakistan, to a breeding ground for drug-runners and terrorists, posing a threat to the entire region.

However, the essential issue is what could ever finally lift this region out of its current chaos.

Pakistan lies at the border of West Asia—the Mideast, the Gulf region, and Iran—and the Subcontinent, one of the two greatest concentrations of population in the world. Afghanistan, to the north, is one of the world's great historic passageways, linking Central Asia to the Subcontinent, West Asia,