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TheDC analysis: America's hidden debt

By Joe Tauke - The Daily Caller 8:54 AM 08/28/2010

On New York City's Avenue of the Americas, tourists can find a mathematical landmark that has grown in infamy as it has grown in digits. It is the National Debt Clock, and it has served as a publicly-displayed meter of the federal government's spending habits for more than a decade. But as economists and politicians debate the merits of recognizing the future outflows of Social Security and Medicare as part of the debt, two different entities have already made the clock obsolete — Fannie Mae and Freddie Mac.

The aftermath of the housing bubble is causing Washington's twin lending giants to apply much more immediate pressure to the federal balance sheet. Combined, they have over $5 trillion in liabilities that government officials have repeatedly insisted are not obligations of the taxpayers. With Fannie and Freddie debt trading at prices nearly identical to Treasury debt, however, the markets assume that the taxpayers are on the hook, which means that somebody has to lose big.

Investors still expect to receive future payments for a reason. By guaranteeing more than 90% of all U.S. mortgages in tandem with the Federal Housing Administration, GSE (government-sponsored enterprise) losses replace losses to major banks. And by issuing over $1.6 trillion in corporate debt on top of those guarantees, the public-private hybrids have pumped the financial system full of assets supposedly worth that same amount. Fannie and Freddie are not just too big to fail — they are all that's keeping the balance sheets of corporate America too rigged to fail. The withdrawal of significant taxpayer support would be tantamount to pulling the bottom out of a house of cards already deemed untouchable.

The Obama administration acknowledged this reality last Christmas Eve, when it eliminated the $400 billion cap on the GSE bailout. But with the executive branch's Office of Management and Budget persisting in its recognition of only the cash infusions given to the mortgage zombies to meet immediate obligations amounting to less than $200 billion, the White House is effectively dismissing its own action and pretending that Fannie and Freddie won't even make it halfway to their former limit. Moreover, the OMB's 2011 budget estimates that those infusions will only cost a paltry $5 billion in the next fiscal year after adding up to $56 billion in 2010. The countless billions needed to shore up long-term debt? Nonexistent.

"The Treasury and White House do not want to recognize the losses that are there," said Mark Calabria, director of Financial Regulation Studies at the CATO Institute, in an interview with The Daily Caller. "With the public mood about deficits, they don't want to add another trillion to the national debt. But someone has to take those losses. It's highly

unlikely that the debt holders will take the hit. There's a chance that they won't get 100 cents on the dollar, but even that's not very likely."
Such an event is unlikely because it would render much of the rescue of the financial system pointless. Dr. Calabria estimates that over 100 banks and a similar number of money market mutual funds would immediately go under if taxpayers failed to cover even 10% of the GSE tab. That would require the FDIC, already in the red, to ask the Treasury for the cash necessary to handle those bankruptcies, and would deal a body blow to any potential recovery and its accompanying tax receipts—defeating the very purpose of not paying off the debt.

Yet despite the sobering mathematical truth of a system dependent on government-sponsored zombies and the administration's own declaration that no bill is too large for Americans to pay, the OMB refuses to accept what Wall Street and foreign central banks already regard as fact. Even the Congressional Budget Office has attempted to address the issue, projecting that Fannie and Freddie will ultimately cost over $200 billion more than what is listed on President Obama's budget. By law, however, the CBO is required to only account for what it considers to be definite taxpayer obligations, which still exclude trillions of Fannie and Freddie debt. In fact, most of the discrepancy between the OMB and CBO numbers is found in spending that has already happened. In its January publication of the next decade's expected budgets, the CBO estimated that Fannie and Freddie would require $13 billion in 2011, $10 billion in 2012, and less than $10 billion in all other years.

The CBO is also hampered by the necessity of advertising moderate projections as its best guess. "What the CBO puts out is a medium estimate," explained Calabria. "Think of all the possibilities like a bell curve. What you get from the CBO is the top of the bell curve."

Comparing previous CBO expectations to actual events shows how large the gap can be. Its forecasts of enormous surpluses fueled by the tech bubble were as much of a swing and a miss as its mid-2000's predictions of continued growth, no Great Recession, and deficits counted in billions instead of trillions. As recently as July 2008, former CBO Director Peter Orszag told Congress that a bailout of Fannie and Freddie could cost as much as $25 billion through 2010. Now the office reports that adding a 0 to that number isn't enough, even when ignoring real liabilities and clinging to an economic outlook that contains no double dip and average growth of 4% per year from 2012 to 2014.

In other words, while the CBO is at least slightly more realistic than the OMB, the bottom line is that neither budgetary entity has addressed the five trillion-pound gorilla in the room. The situation is perhaps best summarized by the twin stances of Orszag, who left the CBO to become Director of the OMB. In 2008, CBO Orszag wrote, "Fannie Mae and Freddie Mac should be directly incorporated into the federal budget." In 2009 and 2010, OMB Orszag refused to do exactly that.
So how much money will ultimately be needed to make Fannie and Freddie whole? That depends on how much their assets are actually worth. In June, the *New York Times* reported that the enterprises were taking an average loss of over 40% every time they

sold a property. The government hopes that by extending its life support operations indefinitely, more and more Americans will eventually be able to pay their bills and the GSEs will be able to simply hold most of their assets to maturity, many years down the road. But hope is not a budget item, and deteriorating economic conditions suggest that total losses will continue their march towards the imposing trillion-dollar mark that publications including Bloomberg and Business Insider have said could be breached.

Such a price has been given an appropriate label by Edward Pinto, a former chief credit officer at Fannie Mae. Addressing the possibility of a full commitment to cover every last cent owed by Fannie and Freddie, Pinto said simply, “It is the mother of all bailouts.”