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RAHN: One piece of the coming disaster

Fed is feeding Fannie and Freddie's inflation vortex

By Richard Rahn - December 31, 2012

You may have been reading how the Federal Reserve has been buying huge quantities — almost a trillion dollars' worth — of "mortgage-backed securities" (MBS). There is a relatively high probability that this program is going to end in disaster — and here is why.

The Fed has said the reason it is buying the MBS is to push down interest rates in order to prop up home prices, reduce the number of foreclosures, and enable more people to buy homes. This is being done in order to encourage more home construction and related employment.

Assume you acquire a new mortgage or refinance your existing mortgage at a rate close to 3 percent through your local bank. Chances are the bank will decide not to hold on to your mortgage because, after inflation and servicing costs, there is little or no profit — the bank made its money on the origination fees. The two large government-sponsored mortgage companies, Fannie Mae and Freddie Mac, buy many mortgages from banks and other financial institutions. If Fannie Mae buys your mortgage from your bank, it will then combine it with other mortgages to create a MBS and then sell these bonds to buyers around the world.

The Fed has become the largest single purchaser of MBS from Fannie and Freddie. The Fed pays for the MBS by creating money — that is, Fannie sells your mortgage and the others in the MBS and receives a credit on its account at the Fed for the amount of the MBS. The asset side of the Fed's balance sheet is increased by the value of the MBS, and the liability side of the balance sheet is increased by the amount of new money the Fed issued to pay for the MBS.

Now remember that the Fed is a government institution, fully owned by citizen taxpayers. The dollars it creates only have value to the extent people believe that the Internal Revenue Service can extract real wealth from taxpayers to equal the value of the new dollars being created. Either Congress will have to vote for more taxes (or engage in less spending) to obtain the wealth to cover the new money, or the Fed's printing of money will cause inflation, thereby reducing the value of the money that individuals and businesses have or receive in exchange for the government bonds they have purchased.

The Fed claims that once the economy revives and housing has rebounded, it will sell back the MBS to banks and other private purchasers. If there is little inflation between the time the Fed buys and then sells the MBS, it may suffer only a small loss or perhaps even make a small profit. What happens if major inflation revives? There are many reasons why inflation could suddenly surge and the Fed would lose control.

One can come up with many inflation scenarios, including the appearance of hyperinflation, where the value of money is being reduced by 50 percent or more per month. Johns Hopkins University professor Steve Hanke has identified 56 hyperinflations in various countries over the last two centuries. However, for the purposes of understanding the consequences of a big jump in inflation, one only has to go back to the late 1970s when inflation at one point was running as high as 14 percent in a single quarter and annual inflation was 13 percent and the prime rate was 21 percent.

If you have a large mortgage and little in savings, and if your income keeps up with inflation after taxes, you may come out a winner because the real value of your mortgage has fallen. As an example, assume that inflation averages 12 percent per year for six years. If your mortgage is $100,000, the purchasing power of that $100,000 is only $50,000 at the end of the six years of inflation. If a private individual or financial institution holds your mortgage, they now have an asset worth half as much in real terms. If your income has doubled over the six years (just keeping up with inflation), you benefit because of the drop in the real burden of your mortgage.

If the government owns your mortgage (by Fannie Mae having bought it from your bank, and then, in turn, selling to the Fed) you still benefit from the drop in the real value of the mortgage. It is a win for you, but you are also a taxpayer. The drop in the real value of the mortgage due to inflation and rise in interest rates means if the Fed sells the mortgage, it will receive far less than it paid for it. (Remember, bonds drop in price as interest rates rise and vice versa.) The loss on your mortgage that the Fed suffers is eventually passed on to the U.S. Treasury, which means that the budget deficit gets bigger. The bigger deficit will either cause the Fed to print more money, meaning more inflation, or the government will increase taxes. Either way, the taxpayer gets hit and is made poorer. This is only a piece of the financial disaster that is about to engulf us all.

Happy New Year!