Bailout creates real opportunities for the next president

In the first debate between John McCain and Barack Obama, moderator Jim Lehrer pushed, pulled, and pleaded with the candidates to say how the proposed $700 Billion financial markets bailout might affect their policy priorities as President. The candidates demurred, sticking doggedly to their prepared scripts. This may be smart politics, but it's poor policy. The current crisis creates a massive opportunity for the next President to shape America's housing policies for the 21st century.

The United States government is about to become the largest investor in the global market for US mortgage-backed securities. This is actually a reasonably conservative response to an epic financial crisis. One would expect no less from staid banking economist turned Federal Reserve Chairman Ben Bernanke. The intervention might have gone little noticed outside the financial press had the Federal Reserve possessed sufficiently broad authority to purchase securities other than government bonds.

In his public speeches, Bernanke likes to cite 19th century financial pundit Walter Bagehot. In 1873 Bagehot, then editor of The Economist, clearly explained how to defeat a credit crisis. In his book Lombard Street he argued that a central bank should "lend in a panic on every kind of current security, or every sort on which money is ordinarily and usually lent." What the US government is planning, in effect, is to follow Bagehot's advice by entering the mortgage-backed security market to the tune of $700 Billion.

Americans and the world should hope that the bailout bill will pass soon, resuscitating the world's failed financial markets. The lesson to be learned from the crisis, however, is not that markets sometimes fail, but that markets only flourish through active cultivation by governments. Markets need governments. Governments create opportunities, set rules, enforce contracts, and yes, ultimately, intervene to restart failed markets.

Obama and McCain may not understand the theory of financial markets. What they should understand is that the American people, ordinary American people, are facing difficult personal finances. Nearly all of the increase in US national income over the past forty years has gone to the top 10% of the nation's earners. The root cause of the current crisis is the difficulty the other 90% of Americans are having paying their mortgages.

Coming out of the current crisis, the US government will own Freddie Mac, Sallie Mae, Ginnie Mae, and up to $700 Billion of privately-originated mortgage-backed securities, not to mention the nationwide system of Federal Home Loan Banks. This creates unprecedented opportunities for the next President to formulate social policies that improve the financial well-being of the vast majority of Americans. Hopefully, the next President will see and seize these opportunities.

For starters, the US government could liberalize the foreclosure terms on the mortgages it owns. Where a private mortgage-holder benefits from foreclosing early to minimize losses, the government as mortgage-holder will benefit from working with struggling families to keep them in their homes. Since the government has low funding costs and need not turn a profit on the mortgages it holds, it can also afford to reduce mortgage interest rates.

As the world's largest participant in financial markets, the US government is well-positioned to hedge long-term interest rate risk. It should thus offer to refinance borrowers' variable-rate
mortgages into equivalent fixed-rate loans. To reduce monthly payments, it could also offer to extend the terms of Americans' mortgages up to 50 years or more. Extending a $100,000, 6% fixed-rate mortgage from a 30-year term to a 60-year term reduces the monthly payments from $600 to $514.

More radically, the government could take a life-cycle approach to mortgage financing. Most people's nominal incomes rise throughout their working lives, due to both promotions and inflation. The government can afford to invest for the very long term, offering borrowers lower payments in their younger years offset by higher payments as they age, with payments declining again when they retire. The actuarial tools to do this are already available.

Ultimately, the government could spawn new private markets to support all of these initiatives. Having spent $700 Billion to acquire the failed market in mortgage-backed securities, it would be the height of folly for the US government to restart this market in its current form. Instead, the next President should play a leadership role in restructuring US mortgage markets to better serve the American people for generations to come.

Salvatore Babones is a Lecturer in Sociology and Social Policy at The University of Sydney.