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Assigning blame for the bailout

By J Dwight, *Populist Economics*
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Without question, the center of the current financial problem is the subprime mortgage crisis. The implementation of "social equality" - or socialism in lending in this case - has created more damage than it is worth.

For Maine, the subprime crisis has meant postponing of bond issues and interest costs 20-25 percent greater than just one month ago. This will crimp current and future budgets, meaning less infrastructure spending at a higher cost.

To create equality in the financial system, the government lowered lending standards for everyone and made it easy to "game" the system.

The problem began in the 1990s with loosening mortgage standards under the Community Reinvestment Act passed by President Carter, which worsened during the Clinton administration. It was then expanded under Franklin Raines, former Fannie Mae chairman and chief executive officer.

The solution to problems from widely applying lower mortgage standards was to insure or "government guarantee" the mortgages by Fannie Mae (the Federal National Mortgage Association).

Fannie Mae's political connections, hefty lobbying, political contributions and foundation grants to community organizations helped exempt it from regulation by the Securities and Exchange Commission, or the Sarbane-Oxley Act, or by other actions or inaction by Congress.

(These connections are relevant. As recently as July, Raines was contacted by Obama's presidential campaign, probably for advice on policy. Jim Johnson, head of Obama's vice presidential search committee, was Fannie Mae CEO from 1991 to 1998. Fannie Mae also contributed $126,349 to Obama in the last three years.)

Then, under the new labeling of "AAA, government guaranteed," subprime mortgages became attractive to investors and sold by Wall Street firms.

Raines, as Fannie Mae chief, chided government for not going far enough, according to the New York Times on Sept. 30, 1999. "Fannie Mae has expanded home ownership for millions of families in the 1990s by reducing down payment requirements," he said. "Yet

there remain too many borrowers whose credit is just a notch below what our underwriting has required who have been relegated to paying significantly higher mortgage rates in the so-called subprime market."

Before President Bush took office in January 2001, the government further lowered lending standards and pressured banks to lend more to subprime borrowers. Banks and mortgage companies then applied these lowered standards to still more subprime borrowers and others.

The looser standards were also applied to those who weren't considered subprime borrowers, but who now could get much more credit, much more easily. This hugely expanded mortgage lending and dragged previously high-rated borrowers into subprime status.

Wall Street then took the already common practice of slicing mortgages into pieces (or tranches) and selling them to thousands of investors as "government guaranteed."

Housing boomed from 2002 to 2006 with the flow of money; speculation then followed.

Because of lax lending standards and low interest rates, housing prices bubbled.

Raines, after garnering some $92 million in salary, bonuses and stock options off the backs of subprime borrowers, was forced to resign amidst an accounting scandal in 2004. A $2 million director's insurance settlement was paid in 2006. But the infection was already in place.

Gas prices shot up and interest rates started to rise, crippling the cash flows of subprime borrowers and others. Mortgage foreclosure rates began to rise. Holders of government-guaranteed mortgage investments (including the Chinese and the Saudis) went to Fannie Mae to collect.

By Sept. 9, Fannie Mae and Freddie Mac's problems had become so bad, they were taken over by the U.S. government, effectively destroying the American market for mortgages. This action spread the crisis of confidence into the rest of the bond and money markets, leading to the cascade of takeovers and failures of the last month: Lehman Brothers, AIG, Merrill Lynch, Washington Mutual, Wachovia - just in the United States.

Extraordinary actions are now being taken to repair the damage done over the last 20 years. Several steps are being taken, and still need to be taken, to restore markets and confidence. It may take years or months to fix; no one can accurately predict.

Some blame Wall Street greed. Some blame government mis-regulation. Some blame high oil prices. Some blame Main Street's lack of financial sophistication.

But blaming the Bush Administration and Republicans alone is wrong. It began much earlier, under President Clinton, was exacerbated by low interest rates after September

2001 and lax lending standards under Raines and Fannie Mae, which was then kicked over the edge by rising oil prices.

Some 250,000 unemployed people have Raines, Fannie Mae and the philosophy of "social equality" to blame for their troubles. Hopefully, everyone will place the blame where it deserves to be.

J. Dwight is a SEC registered investment advisor and an advisory board member of the Maine Heritage Policy Center. He lives in Wilton. E-mail jdwight@gwi.net.