INTERNATIONAL
# Herald Tribune
THE GLOBAL EDITION OF THE NEW YORK TIMES

MONDAY, JULY 21, 2008

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# U.S. bonds facing global test of faith

## America's ability to finance future debt at stake in the mortgage rescue plan

**By Heather Timmons and Julia Werdigier**

**NEW DELHI:** For more than a decade, Fannie Mae and Freddie Mac, the housing giants that make the American mortgage market run, have attracted overseas investors with a simple pitch: The securities they issue are just as good as the U.S. government's — and they usually pay better.

The marketing plan worked: About one-fifth of securities issued by Fannie, Freddie and a handful of much smaller quasi-government agencies, some $1.5 trillion worth, were held by foreign investors at the end of March. One-tenth of all American mortgages are, in effect, in the hands of institutions and governments outside the United States.

Now that the two companies are at risk, these foreign holders are watching closely to determine the future of hundreds of billions of dollars of investments. How Fannie and Freddie's rescue is handled will ultimately test the world's faith in U.S. markets and could influence the level of interest rates and weigh on the strength of the dollar for years to come, analysts say.

"No less than the international perception of the credit quality of the U.S. government is at stake," said Richard Hofmann, an analyst with Credit Sights, an independent research house with offices in London and New York.

Also at stake is the ability of Americans to access credit in the future. If foreign companies and governments abandon these investments, home, auto and credit card loans will be much more difficult to come by.

That helps explain why Treasury Secretary Henry Paulson Jr., who is responsible for preserving the full faith and credit of the U.S. government, is pressing American lawmakers so hard to provide him with the authority to inject unspecified billions in cash into either company.

The "blank check" nature of his request raises hackles among some in Congress, but Paulson is counting on the fear of much worse to come if nothing is done to rescue Fannie and Freddie to win the battle on Capitol Hill.

During an appearance on the CBS television program "Face the Nation" on Sunday, Paulson said that he was "very optimistic that we're going to get what we need from Congress."

The total exposure of foreign creditors to Fannie- and Freddie-issued bonds makes the scope and depth of the subprime mortgage crisis look like child's play.

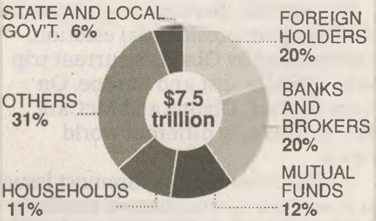
Asian institutions and investors hold some $800 billion in securities issued by Fannie and Freddie. The bulk of this is held in China and Japan, with $376 billion and $228 billion, respectively, according to the most recent country-specific Treasury figures, which date to June 2007. Bank of China, a major state-controlled Chinese bank, has $20 billion in exposure, estimates CLSA Group, or about 2.6 percent of its total assets.

In Europe, roughly $39 billion in Fannie and Freddie debt is held in Luxembourg and $33 billion in Belgium,

**CREDIT, Continued on Page 14**

### Who's holding U.S. debt?

There is more than $7.5 trillion in debt from government- sponsored enterprises like Fannie Mae and Freddie Mac. Here is a breakdown of who held it at the end of March.




Foreign holders of U.S. agency long-term debt.

| | In billions |
|---|---|
| China (mainland) | 376 billion |
| Japan | 228 |
| Russia | 75 |
| South Korea | 63 |
| Taiwaqn | 54.8 |
| Cayman Is. | 52 |
| Luxembourg | 39 |
| Belgium | 33 |
| Australia | 32 |
| Mexico | 31 |
| Britain | 27 |
| Ireland | 25 |
| Netherlands | 23 |
| Hong Kong | 19 |
| Switzerland | 16.8 |
| Germany | 14 |
| Malaysia | 13 |
| France | 10 |
| Brazil | 7.4 |
| Denmark | 5.7 |
| Singapore | 5.2 |

**Business with REUTERS**

### U.S. now finds itself to be too big to fail

Since World War II, the United States has virtually dictated the conditions under which many other nations can get access to capital. Letting weak companies fail has been high on the list. But now, America finds itself in a rescue mode of its own. *Page 14*

### Main Street is asked to rescue Wall Street

Here's a disconnect: Troubled homeowners are expected to shoulder the consequences of signing loan documents they didn't understand, but executives who financed these loans get to be rescued by the taxpayer.

*Gretchen Morgenson, Page 13*

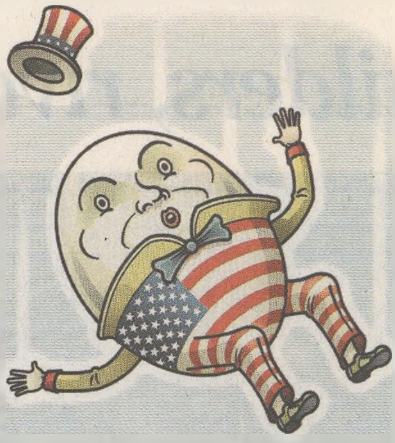
### Government is trying to save America Inc.

The U.S. government's pledge to rescue two mortgage finance companies is about more than bolstering the floundering U.S. housing market. It is also aimed at shoring up the U.S. economy and, along with it, the global image of America Inc. *Page 15*

# U.S. finds itself too big to fail

## Adopting tactics once scorned

**By Peter S. Goodman**



Peter and Maria Hoey

**News Analysis**

In the narrative that has governed American commercial life for the past quarter-century, saving companies from their own mistakes was not supposed to be part of the U.S. government's job description. Economic policy makers in the United States took swaggering pride in the cutthroat but lucrative form of capitalism that was supposedly indigenous to their frontier nation.

Through this uniquely American lens, saving businesses from collapse was the sort of thing that happened on other shores, where sentimental commitments to social welfare trumped sharp-edged competition. Weak-kneed European and Asian leaders were too frightened to endure the animal instincts of a real market, the story went. So they intervened time and again, using government largess to lift inefficient firms to safety, sparing jobs and limiting pain but keeping their economies from reaching full potential.

There have been recent interventions in America, of course — the taxpayer-backed bailout of Chrysler in 1979, and the savings and loan rescue of 1989. But the first happened under Jimmy Carter, a year before Americans embraced Ronald Reagan and his passion for unfettered markets. And the second was under George H. W. Bush, who did not share that passion.

So it made for a strange spectacle as the current administration of George W. Bush, which does cast itself in the Reagan mold, hastily prepared a bailout package to offer the government-chartered mortgage financing companies, Fannie Mae and Freddie Mac.

The reasoning behind this rescue effort — like the reasoning behind the government-induced takeover of Bear Stearns by JPMorgan Chase this year — sounded no different from that offered in defense of many a bailout in Japan and Europe: The mortgage giants were too big to be allowed to fail.

Big indeed. Together, Fannie and Freddie own or guarantee nearly half of the $12 trillion worth of home mortgages in the United States. If the companies collapse, so may the whole system of finance for American housing, threatening a most unfortunate string of events: First, an already plummeting real estate market might crater. Then the banks that have sunk capital into American homes would slip deeper into trouble. And the virus might spread globally.

The central banks of China and Japan are on the hook for hundreds of billions of dollars worth of Fannie's and Freddie's bonds — debts they took on assuming that the two companies enjoyed the backing of the U.S. government, said Brad Setser, an economist at the Council on Foreign Relations.

Commercial banks from South Korea to Sweden hold investments linked to U.S. mortgages. Their losses would mount if American homeowners suddenly could not borrow. The global financial system could find itself short of capital and paralyzed by fear, hobbling economic growth in many lands.

Nobody with a meaningful office in Washington was in the mood for any of that, so the rescue nets were readied. The Treasury secretary, Henry Paulson Jr., announced that the government was willing to use taxpayer money to buy shares in Fannie and Freddie. The chairman of the Federal Reserve, Ben Bernanke, said the central bank would lend them money.

The details were up in the air as the week ended, but some sort of bailout offer was on the table — one that could ultimately cost hundreds of billions of dollars. Whatever the dent to national bravado, or to the free-enterprise ideology, the phrase "too big to fail" suddenly carried an American accent.

"Some institutions really are too big to fail, and that's the way it is," said Douglas Elmendorf, a former Treasury and Fed economist who is now at the Brookings Institution in Washington. "There are no good options."

Still, there are ironies. Since World War II, the United States has been the center of global finance, and it has used that position to virtually dictate the conditions under which many other nations — particularly developing countries — can get access to capital. Letting weak companies fail has been high on the list.

Paulson, who announced the bailout, made his name as chief executive of Goldman Sachs, the Wall Street investment banking giant, where he pried open new markets to foreign investment. As Treasury secretary, he has served as chief proselytizer for U.S.-style capitalism, counseling the tough love of laissez-faire. In particular, he has leaned on China to let the value of its currency float freely and has criticized its banks for shoveling money to companies favored by the Communist Party in order to limit joblessness and social instability.

All through Japan's lost decade of the 1990s and afterward, American officials chided Tokyo for its unwillingness to let the forces of creative destruction take down the bloated banks in the country and the zombie companies they nurtured. The best way out of stagnation, Americans counseled, was to let weak companies die, freeing up capital for a new crop of leaner entrants.

But as Japan's leaders engaged in bailouts and bookkeeping fictions to keep banks and companies breathing, they offered those words of justification now heard here: The companies were too big to fail.

Today, among strict adherents of laissez-faire economics, the offer to bail out Fannie and Freddie is already being criticized as a trip down the Japanese path of putting off immediate pain while loading up the costs further along.

For one thing, this argument goes, taxpayers — who now confront plunging house prices, a drop on Wall Street and soaring costs for food and fuel — will ultimately pay the costs.

To finance a bailout, the government can either pull more money from citizens directly or it can print more money — an inflationary step.

One fundamental reality continues to offer assurances that foreigners will still buy U.S. debt: In the global economy of the moment, the United States itself is too big to fail.

The logic for that assurance goes like this: The U.S. consumer has for decades served as the engine of world commerce, using borrowed cash to snap up the accouterments of modern living — clothes and computers and cars now manufactured, in whole or in part, in factories from Asia to Latin America. Eliminate the American wherewithal to shop, and the pain would ripple out to multiple shores.

Globalization, in other words, allowed China and Japan to amass the fortunes they have been lending to the United States. But globalization also emboldened U.S. capitalists to take huge risks they might have otherwise avoided — like borrowing to erect forests of unsold homes from California to Florida, delivering the speculative disaster of the day.

Bailouts amount to mortgaging the future to stave off the wolf howling at the door. The likelihood of a painful reckoning is diminished, while the costs of a reckoning — should one come — are increased.

The costs are getting big.