Subsidize bad behavior?

by Lawrence_Kudlow

President Obama's massive mortgage-bailout plan is nothing more than a thinly disguised entitlement program that redistributes income from the responsible 92 percent of home-owning mortgage-holders who pay their bills on time to the irresponsible defaulters who bought more than they could ever afford. This is Obama's spread-the-wealth program in action.

Team Obama is rewarding bad behavior. It is enlarging moral hazard. It is expanding its welfarist approach to economic policy. And with a huge expansion of government-owned zombie lenders Fannie Mae and Freddie Mac, Team Obama is taking a giant step toward nationalizing the mortgage market.

Reporting from the Chicago commodity pits, my CNBC colleague Rick Santelli unleashed a torrent of criticism over this scheme. Santelli said: "Government is promoting bad behavior. ... Do we really want to subsidize the losers' mortgages? This is America! How many of you people want to pay for your neighbor's mortgage? President Obama, are you listening? How about we all stop paying our mortgages! It's a moral hazard."

All this took place on the air to the cheers of traders. Santelli called for a new tea party in support of capitalism. He's right.

Obama's so-called mortgage-rescue plan amounts to $275 billion in new debt that will have little if any lasting impact on deeply corrected housing prices or the mortgage-default problem that stemmed from the insistence of government to throw home loans at lower-income people. A modest reduction in mortgage rates will have little impact on home prices, as Harvard professor Ed Glaser has shown. And by the way, re-default rates on modified mortgages have been running 50 percent to 60 percent. This is not going to change. So why should we throw more good money after bad?

Meanwhile, Wall Street is awakening to the disappointment that the securitized mortgages behind the toxic assets that have done so much damage to banks and the credit system are not being treated in the Obama program. The oversight is incredible. There are no safe-harbor provisions to protect mortgage servicers against lawsuits if agreements are broken. The ownership of these securitized mortgage pools is wide and far, spanning the globe. Breaking contracts is exceedingly difficult, especially without any legislated legal protection.

Of course, banks that have whole loans can choose to modify them if they want. And in some cases it's much better to modify than foreclose. But 70 percent of this bank-owned paper is performing. It's the securitizations that have clogged up the world credit system.

Then there's the bankruptcy-judge cram-down, which would allow the courts to renegotiate interest rates and loan principal. This would abrogate private contracts and throw out the rule of law. Do we think future investors will put up mortgage capital if they fear judges will overturn the terms of contracts? Home-loan supplies will fall and mortgage rates will rise.

Then there's Fannie and Freddie, the big winners here. Only their products are eligible for mortgage relief. Jumbo mortgages are not. Neither are private-label mortgages created by various non-bank lenders. Fan and Fred already run 48 percent of the mortgage market. Obama's proposal would greatly enlarge that and move the mortgage system toward government nationalization.

What's even more incredible is Team Obama's stubborn refusal to have any faith in the free market. In some of the hardest hit areas of the country, markets are already solving the housing problem. Writing on his Carpe Diem blog, University of Michigan professor Mark Perry notes that while California home prices dropped 41 percent in 2008, home sales in the state jumped 85 percent. It now looks like 2008 sales for single-family houses will exceed levels reached in 2007.

What's more, the unsold-inventory index for existing single-family detached homes in December 2008 was 5.6 months, compared with 13.4 months for the year-ago period. And the median number of days it took to sell a single-family home dropped to 46.1 in December 2008, compared with 66.7 in December 2007. So inventories are dropping, the number of days to sell a home is falling, and sales are rising in the wake of lower prices.

If the government really wants to help, instead of bailing out irresponsible mortgage-holders, it should support new and younger families who want to buy starter homes and begin to climb the ladder of prosperity.

All this is free-market economics 101. And I say, let free-markets work. Let's remember that most folks â€” even those with underwater mortgages, where the loan value is more than the home value â€” do not walk away from their obligations. They don't want to wreck their credit â€” and their homes are their castles. That's the American way.

But if we penalize the good guys and subsidize the bad ones, we are undermining the moral and economic fabric of this country.

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