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Subprime and the World Economy

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Foreign credit has been entering the US via Treasury bills, bonds and other credit instruments at $3 billion per trading day (2007). This inflow enabled the Federal Reserve to keep interest rates low, at 1 percent in 2003-04. Low interest rates fuel the American economy in two major ways. Cheap credit enables firms' leveraged buyouts, and mergers and acquisitions, in turn, prop up the stocks of the firms buying and bought and the middling banks. The Dow Jones rose above 13,000 in

2006. Secondly, low interest rates made mortgages cheap and larger mortgages fuelled a housing bubble. Rising real estate values, mortgage refinancing, and easy credit boosted consumer spending. American consumer spending, in turn, kept the world economy spinning and Asian exports and Asian vendor financing going. This charmed circle has kept the world economy in thrall.

The subprime mortgage sector was the latest extension of the easy credit bubble, the latest extension of funneling credit through the consumer grid, on terms that might be viable if the housing market continued its rise, but since it is the last and lowest segment of the money pyramid this was unlikely from the start.

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Subprime mortgages grew massively during this period. Adjustable rate mortgages (ARM) represented 40 percent of mortgages during 2004-05 (at $390 billion). Most of these were due to reset beginning in 2007 (involving $1 trillion). The subprime default rate was already 10 percent in 2006. The subprime market in the US is 20 percent of mortgages (in the UK the subprime market is 8 percent). The loans were sold to banks who securitized them as bonds ($800 billion in 2007) and derivatives and resold them in structured loans and collateralized debt obligations, etc. (incurring a loss of 40 percent in 2007). In late 2006 the housing market began to slow and 2007 brought "payback time." The collapse of subprime mortgage lending prompted a wider credit crunch.

At the root of the subprime problem was easy credit: lenders and their brokers were often rewarded for generating new mortgages on the basis of volume, without being directly exposed to the consequences of borrowers defaulting. During several years of strong capital markets and strong investor appetite for high-yielding securities, lenders became accustomed to easily selling the risky home loans to Wall Street banks. The banks in turn packaged them into securities and sold them to investors around the globe.[1]

Brokers who earned higher commissions on subprime mortgages offered them also to borrowers who qualify for normal fixed rate mortgages. Automated underwriting software, a technique that was first developed in the 1970s to process car loans and credit card applications, was used to generate as much as 40 percent of subprime loans. A leader in the subprime mortgage market, New Century Financial, on the brink of bankruptcy in 2007, “promised mortgage brokers on its website that with its FastQual automated underwriting system, ‘We’ll give you loan answers in just 12 seconds!’”[2]

Speculative home buying by “flippers” – who borrow money or leverage their own homes with double mortgages to buy properties, make some improvements, and then expect to sell them quickly – joined the pyramid scheme, again on the premise of ongoing expansion. False advertising and nonfunctioning credit rating agencies compounded the situation. The collapse of the subprime sector is a symptom of a wider problem: “The real issue has been the excess liquidity created by the central banks through a decade of ever-more ambitious crisis management. The risks created by those ‘solutions’ were not identified, let alone measured, by their econometric models.”[3]

Facilitating the real estate bubble was securitization or mortgages bundled in credit packages and derivatives sold to other banks. The vanishing boundary between banking and non-bank forms of finance facilitated sprawling derivatives, hedge funds and quantitative investment, supported by insurance companies and pension funds. Hedge funds became larger players than banks though their risks were partly underwritten by banks through arcane methods of splicing debt.

A cycle is ending. The world economy is decoupling from American consumer spending and is slowly shifting gear to demand in China, India and Asia.

The current crisis resembles the savings and loan crisis of the early nineties, Japan’s real estate bubble bursting, and the Asian crisis of 1997/98. Long term finance provided on short term conditions is vulnerable to short term market fluctuations, as in Thailand’s “hot money” crisis. In this financial crush, however, “Emerging market debt is the new safe haven.”[4] For a change, emerging markets have been unaffected because, having learnt from the Asian crisis, they built cash buffers. Sovereign wealth funds in Singapore, Qatar, Abu Dhabi and other places now emerge as new sources of stable liquidity.

The United States accounts for at least 20 percent of world consumption.[5] The chilling of the American housing market since the end of 2006 has withdrawn $800 billion from consumer spending. American retail sales at chains such as Wal-Mart and Home Depot were down in 2007. A cycle is ending. The world economy is decoupling from American consumer spending and is slowly shifting gear to demand in China, India and Asia. This means a rerouting of financial flows with Shanghai and Hong Kong coming to the fore as financial centers. High petrol prices create surplus liquidity in oil exporting countries with the United Arab Emirates as a financial hub. The Borse Dubai and Qatar together bought a 48% share of the London Stock Exchange in September 2007. Financial centers from London to the Netherlands vie to attract Islamic banking. For some time, the headlines have been changing: "Overseas investors lose taste for U.S. securities." "Gulf liquidity offers glimmer of hope for subprime relief."[6] The decoupling of the world economy from American consumers holds momentous ramifications.

Notes

[1] B. Masters and S. Scholtes, Payback time, Financial Times, August 9, 2007: 5.
[2] L. Browning, The subprime loan machine, New York Times, March 23, 2007: C1-4.
[3] J. Dizard, Fed and Wall Street farther apart on the credit crunch, Financial Times, August 21, 2007: 8.
[4] Financial Times, August 29, 2007.
[5] Robert Wade, Explaining US financial instability and its global implications, *Open Democracy*, October 6, 2007.
[6] J. Bater, Wall Street Journal, September 19, 2007: C8. G. Tett, Financial Times, November 23, 2007: 28.

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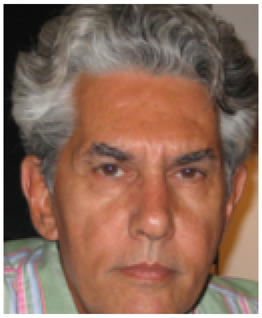

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