When Will US Subprime Mortgage Crisis End?

Zhou Shijian,
Senior Research Fellow, Center for US- China Relations, Tsinghua University

There are three levels concerning borrowers' credit in the US real estate mortgage market: Prime Mortgage Market, Mortgage Market and Subprime Mortgage Market. Based on borrowers' credit index, 700 to 820 points is categorized to excellent, 600 to 700 good, 500 to 600 moderate and 300 to 500 poor. The last two categories comprise subprime mortgage, which is provided to borrowers having other debts and without high credit index and repayment prove. Compared to favorable mortgage provided to high-credited borrowers, the interests of subprime mortgage are higher. That's why financial institutes provide mortgage to borrowers of lower credit rating. They always chase for maximum profits. In order to attract low incomers, financial institutes lower the threshold to subprime mortgage. People can borrow money with no down payment and only pay interests for the first three years. The policy stimulates rapid expansion of subprime mortgage market.

In 2003, the total value of subprime mortgage was only 300 billion US dollars. The number reached 2,000 billion in 2006. Forty percent of new house buyers relied on subprime mortgage in 2006.

The interests of the first two years remains low, but as time goes by, the interests of subprime mortgage increase accompanying benchmark rate rising. In 2003, the repayment interest was 3 percent. And it raised above 12 percent three years later. For buyers with low incomes, they resort to subprime mortgage for they expecting housing prices to rise despite heavy economic burden resulted from high interests – the interests of subprime mortgage are usually 30 percent higher than those of mortgage. While financial institutes don't keep the high-risk subprime mortgage in hand. They turn those mortgages to stocks and securities and sell them to other institutes and public investors. Those Wall Street securities traders even create various complicated financial derivatives, including house mortgage in Collateralized Debt Obligations and sell to risk-prone investors after being labeled with high rates. Subprime mortgage and its derivatives transfer from hand to hand in merely several months. Nobody knows who will be the last possessor and how many he will possess. The snowball of such financial derivatives become bigger and bigger.

Two elements may be blamed for subprime mortgage crisis: low interests and surging housing prices. Alan Greenspan cut deposit interest for 13 times since January 30, 2001. The rate decreased to 1.0 at the end of June 2003 from 6.5 at the first place. From 2002 to 2004, low interest boosted real estate market for three consecutive years. According to statistics, the increase rate of housing prices was 5 percent higher than that of GDP in the same period and the housing prices rose by about 80 percent. To avoid inflation and overheating economy, Greenspan started increasing interest on June 30, 2004. After the 17th increase, the rate reached 5.25 on June 29, 2006. At the same time, the mortgage interests, especially subprime mortgage rate surged from 3 percent to more than 12 percent. When the housing prices move upwards, people can raise a mortgage on their houses, but when the trend is down, low

incomers are faced with mortgage defaults. Their houses will be confiscated and auctioned if they fail to make their monthly payment in three months. That results in bad debts of lenders, bankruptcy of banks and finally leads to crisis of financial market. Since the end of 2006, with decreasing housing prices house owners found their losses increasing. So did the bad debts. The average housing price fell by 17.8 percent in July 2008. In some states, such as California, Florida and Las Vegas it fell by more than 30 percent. The plummet of real estate trade and puncture of housing bubble reflected inevitable crisis.

Several years ago, subprime mortgage and its derivatives were praised as "innovation to financial derivatives". It's known to all that financial innovations are lifeline to the Wall Street. Warren Buffett said that subprime mortgage was a poisonous wine brewed by American financial industry itself. But American financial institutes also sell subprime mortgage to other parts of the world, such as Europe, Japan, China and India.

On March 12, 2007, New Century Financial Corporation, the second biggest mortgage institute in America filed a bankruptcy petition and lifted the curtain on the crisis. However, that didn't make the US government alert. On May 17, Federal Reserve chief Ben Shalom Bernanke told the Congress that the subprime mortgage crisis wouldn't have severe impact on other financial sectors or the whole system. The crisis had been under control. But as the crisis emerged, people realized that the subprime mortgage crisis was more than bad debts.

The crisis forced Federal Reserve to abandon the currency contract policy conducted in the last two years and cut base rate by 0.5 percent at the regular meeting on September 18. But the measure was half a year late. American economy declined enormously in the fourth quarter with an increase rate of merely 0.6 percent. On January 21 and 22, 2008, the New York stock market witnessed two "Black Days" with consecutive slumps. The American economy steersman had to cut interest rate by 1.25 percent (0.75+0.5) twice from January 22 to 29.

The congress also reacted quickly. On February 13, President Bush approved an emergent fund for drawback of 168,000 million US dollars and required the cheques to be mailed to tax payers before July 11. A family with four members will have a drawback of 1,800 US dollars. Federal Reserve also pour 160,000 million US dollars into big- and medium- sized banks and institutes with heavy losses. Another 200,000 million US dollars poured into the market on March 11. Federal Reserve also asked the Group of Ten to help local banks and save the market. By the end of April, Federal Reserve had offered 782,700 million US dollars of capital flow to the financial market. And the loss of 12 American financial institutes reached 153,600 million US dollars by the end of June 2008.

Citibank lost 42,900 million US dollars, Merrill Lynch 37,100 million, Bank of America 15,100 million, Morgan Stanley 14,100 million, JP Morgan 9,800 million, Washington Mutual (WaMu) 9,100 million, Lehman Brothers 8,200 million, Wachovia Corporation 7,000 million, Goldman Sachs 3,800 million, Wells Fargo 3,300 million, Bear Stearns 3,200 million, National City 3,100 million.

There are three to four hundred medium- and small- sized banks stuck in the crisis. By that time, subprime mortgage finally triggered financial crisis. According to International Monetary Fund (IMF), the total known loss of financial institutes around the world reached 395,800 million US dollars and the estimated loss 995,000 million US dollars.

The institutes with heavy losses outside the US include: UBS 38,200 million US dollars, HSBC 19,500 million, IKB 15,900 million, Royal Bank of Scotland 15,200 million, Credit Suisse 9,600 million, Crédit Agricole 8,300 million, Deutsche Bank 7,600 million, HBOS 7,000 million, Bayerische Landesbank 6,700 million, Fortis 6,600 million, Canadian Imperial Bank of Commerce 6,500 million, Barclays Bank 6,300 million, Societe Generale 6,200 million, Mizuho Financial Group 6,000 million, ING 6,000 million. Three state-owned banks in China bought subprime bonds of 8,800 million US dollars. (Bank of China 4,990 million, China Construction Bank 2,600 million and Industrial and Commercial Bank of China1,200 million.)

As a result, the economic growth rate slowed down in the fourth quarter of last year. Since last fall, Federal Reserve continuously adjusted its predict of 2008 American economic growth. The predicted growth rate was 1.8-2.5 last October, 1.3-2.0 last February and 0.3-1.2 last May. On April 9, IMF predicted that the growth rate was 0.5, the worst since 1991. And the global growth rate was merely one percent. The Bush administration has conducted three measures accordingly: large-scaled tax rebate, financial rescue plan and interest rate cut – seven consecutive cuts from September 18 last year to April 30, and the rate reduced to 2.0 from 5.25. However, the measures won't be effective until the second half of the year and the rebound is expected to appear in the fourth quarter.

"A recession is possible," said Ben Shalom Bernanke in his statement before the Joint Economic Committee on April 2. "It now appears likely that real gross domestic product (GDP) will not grow much, if at all, over the first half of 2008 and could even contract slightly…Clearly, the US economy is going through a very difficult period. "

But he maintained that "we expect economic activity to strengthen in the second half of the year, in part as the result of stimulative monetary and fiscal policies."

Bernake's judgment was based on the hypothesis that the subprime mortgage crisis is approaching the end. But the fact seems to move in the opposite direction. The crisis broke out in the spring of 2007 and spread to the whole economic sector in July, 2007. Since then, the American market has experienced four shock waves, which indicated that the financial crisis is getting worse.

Five financial institutes involved with subprime mortgage closed down during July and August 2007. Federal Reserve had to cut the rates from time to time. And the period from the end of 2007 to the beginning of 2008 witnessed financial giants such as Citibank, Merrill Lynch, Bank of America and Morgan Stanley trapped in huge losses. The great market

fluctuation forced Federal Reserve to cut the rates, again. In March 2008, Bear Stearns advised Federal Reserve that it would have to file for bankruptcy. Federal Reserve had to provide funding to Bear Stearns to avoid the sudden failure of one company leading to a chaotic market.

The latest shock was the plummet stock prices of Fannie Mae and Freddie Mac. From the late June to July 15, the stock price of Fannie Mae lost 64 percent and that of Freddie Mac 68 percent. The two companies together possess 5,200 billion US dollars of housing loans, accounting for 43 percent of the total loans of 12,080 billion US dollars. That made the crisis worse. Moreover, it made a big lash to overseas investors.

On July 11 and 23, the Congress approved the rescue plan of 300,000 million US dollars allocated to help borrowers and banks get through the difficult time. At least 400,000 thousand borrowers kept their houses. Bad debts and potential bankruptcies reduced considerably.

Another big deal on July 11 was that Federal Deposit Insurance Corporation took over Indy Mac. The regional bank and mortgage institute reopened on July 14 under the new name of Indy Mac Federal Bank. Indy Mac had declared bankruptcy after 11 consecutive business days of bank runs of 1.3 billion US dollars. Indy Mac was the second big financial institute falling down in the US history.

The newly released statistics show that American economy will face the threat of inflation before the recession ends. The inflation index in 2007 was 2.9 and the number in May and June this year both 4.2. Along with oil and food prices hike, economists predicted that the CPI of August would rise to five percent. Federal Reserve is trapped in a dilemma: Cutting rates will result in inflation and increasing rates will hinder economic growth.

Subprime mortgage and financial crisis impaired customers' confidence. According to a recent survey by Nielson, 63 percent of customers cut down expenses, 78 percent reduced shopping and 52 percent ate outside for fewer times. People tend to buy discounted goods with coupons.

Economists predicted the difficulty would last until next year. And people have to live a frugal life. When I was in America, I found few people in some shopping malls. You don't have to wait at the cashier counter. Most department stores offered quite favorable discounts as much as 50 to 75 percent.

Overseas shoppers can enjoy a tax refund of 11 percent, higher than local consumption taxes. There were few visitors to Capitol Hill and Lincoln Memorial during the hot season of July and August. Some Americans drive to work in one car so as to save gas expenses. Banks tightened credit and mortgage due to bad debts. As we all know, Americans rely on credit and loans. The credit card department of the biggest savings and loan bank in America WaMu lost 1,750 billion US dollars in the second quarter. The cardholders' debts reached averagely 8,400

US dollars, almost eight times the figure eight years ago. Credit card consumption plays a key role in American economy. Consuming expense is the biggest momentum of the economy, accounting 72 percent of the annual GDP growth. The consumer confidence index revealed by Michigan University showed the number in July 2007 was 90.4, that in January of 2008 78.4, February 70.8, March 69.5, April 62.6, May 59.8, June 56.7 – the lowest since 1980 (the number of May 1980 was 58.7). And the retail sales of March were the lowest in the last 13 years.

The unemployment rate of 2007 was 4.6 percent and the Federal Reserve predicted the rate would rise to 5.3. The rate in the first half of the year was 4.9 in January, 4.8 in February, 5.1 in March, 5.0 in April, 5.5 in May and June respectively. Rising unemployment rate will further impair consumption.

The crisis leads to American economy contraction, consumption decrease and reduces capital flow of importers. According to the US Customs, the import from China increased 19.32 percent in the first quarter of 2007. The growth rate declined to 13.21, 9.41 and 7.14 percent in the next three quarters. The number was poorly 1.82 in the first quarter of this year, but it rebounded to 4.4 from January to May.

On July 7, Bernanke said on the Federal Deposit Insurance Corporation Forum that the emergent financing for the Wall Street due in September would continue to 2009. He also promised to take more measures to maintain market stability. Paulson also said on July 20 that it would took months for American economy to resume rapid growth again.

When will the crisis end? Nicholas Lardy(?), a senior research fellow at the Peterson Institute for International Economics maintained that the optimistic prediction was the summer of 2009. The more common idea is the end of 2009 and pessimists think it lasts until 2010. There are three signs of the end: the rebound of housing prices and consumer confidence index, and the decline of unemployment rates.

Pieter Bottlier with the World Bank echoed his opinion.

Another issue is how to rebuild consumers' confidence. There are a lot of people waiting to purchase a house. They are watching the price trend and more accurately, the tendency of American economy. Maybe the result of presidential campaign will have positive impact on the economy.