Research paper on the united states subprime crisis and its impact to the world

Parts of the World, Europe

A Study

The US Subprime crisis and its impact

Introduction

The United States subprime mortgage crisis was a chain of events in the country that led to a financial crisis that was one of the biggest in the world since the era of great depression of the 1928 -1933. It began in the late 2000's and the effects of it are still being felt in 2012. The subprime mortgage crisis originated due to a number of factors. Those included a boom and the bust in the housing market, the house-owners speculation, improper and high risk mortgage loans and lending/borrowing practices adopted by many banks and agencies and mortgage fraud.

The subprime crisis in the United States was one of the events or occurrences in the global scenario and the slowing down of world economies. An argument exists which proposes that it was the United States of America, its policies and mortgage practice that was responsible for the global economic slowdown. Peng (2010) cited He Weiwen as saying that it was US that was responsible for " triggering the global financial crisis and should take the most responsibility for addressing world imbalances". Kellog (2010) cited that it was America's war economy that is to be blamed for the Global Economic crisis rather than the Chinese. Both the opinions cited above were in responses to the claims that the Chinese were in part responsible for the global economic slowdown. Krowley (2012) claimed it was foolish on the part of European Commission President Jose Manuel Barroso to blame U. S for Europe's debt crisis. Thus it is clear that the world opinion is divided when it comes to the reasons for the global economic slowdown.

The essay shall present a historic perspective and key events that led to the global economic slowdown. We shall look into the factors that led to the crisis to originate and if indeed it spilled over to the rest of the world from the US, the consequences of the events and the responses that originated across the world.

The Subprime Crisis and Housing Market

The subprime mortgage crisis was closely linked with the real estate and housing prices in the United States. After the terrorist attacks on US and the bursting of the dot-com bubble, there was a marked rise in the housing prices in the country and it was done so with a view to soften the effects of the crisis and counter deflation. The Federal Reserve lowered the Federal Funds Rate from 6. 5% in May 2000 to 1. 0% in June 2003 (Board of Governors of the Federal Reserve System, 2010). Thus the central banks in United States could give out loans at very low interest rates. This motivated the people to invest in houses as real estate was deemed as a ‘ safe’ investment since the dot com bubble burst. The low interest rate were a further incentive for the people to refinance their house loans with longer payment periods to reduce the monthly payments.

Quite a large percentage of the new mortgages were subprime. Subprime mortgages are given out to those individuals with low credit ratings. The risks involved in such loans are considerably higher and sees a more frequent mortgage delinquency and foreclosures. Following the initiatives of central banks to lower the interest rates, the lending procedures also underwent drastic relaxations. First the lenders started handing out loans to

high risk borrowers and also the undocumented immigrants (Pasha, 2005). Thus the subprime mortgages began to rise in numbers and it grew from 5% in 1994 to 20% in 2006. The qualifications guidelines for mortgages were also changed. First the stated income, verified assets (SIVA) system was introduced where no income proofs were needed. The qualification guidelines kept getting loose and the NINA (No Income No Assets) was introduced in which no proof or statement of income or assets were needed for approval of loans. This led to a lot of subprime loans being handed out and the housing market to rise as well.

Following this spree of lenient lending procedures, foreclosures grew in numbers and the real estate markets began to crash. There was a surplus of new houses available in the market and median price of a home fell by 10. 4 percent in December 2007, when compared to December 2006 (Associated Press, 2008). This was followed by an increase in the rate of interest by the Federal Reserve, in an effort to curb the decline. From 2004-2006, the interest rates were increased as many as 17 times from 1% to 5. 25% (Board of Governors of the Federal Reserve System, 2010). This resulted in further foreclosures and loan defaults for people on floating interest. Thus the subprime crisis engulfed the whole of America and slowed the growth tremendously.

The Effect of Subprime Crisis on other Countries

There is evidence that the global economic slowdown began from the US subprime crisis. With the increase in foreclosures and delinquencies and the decline in the housing prices, the banks were unable to recover the loan

amount from the borrowers. This put considerable pressure on the many banks and Bear Sterns merged with JP Morgan in March 2008 and Lehmann Brothers collapsed in mid 2008 to mark as important milestones in the building up of the crisis.

The crisis did emerge in the developing countries, primarily US and later spilled over to developing nations through capital reversals, rising borrowing costs, collapsing world trade and commodity prices, and subsiding remittance flows (United Nations, 2009). The unemployment figures also grew in the period and the Developed and developing economies were severely hit.

Role of Investment Banks

The role of investment banks in worsening the situation also needs to be studied closely. It was due to many of the activities and practices of the investment banks that the number of subprime loans that the lenders could create. The secondary mortgage market was used by the investment banks where the lenders could sell off their debt in the secondary market and collect the fee. This created even more capital for the lenders to hand out as subprime mortgages. The Investment banks repackaged these debts and securitize these mortgages into bonds and sold it to investors. This creation of assets that pooled mortgages together into a security is known as collateralized debt obligation (Petroff, 2007). These Collateralized Debt Obligations were sold around the world and the buyers also ended up in huge losses, irrespective of the country they belonged to.

Even more scrupulous was the role of rating agencies and they were largely

blamed by banks and investment agencies around the world who bought such CDO’s as to misleading them into buying them (Tomilson and Evans, 2007). Also little regulation existed in the marketplace for the buying and selling of the CDO’s which were mostly sold privately (Tomilson and Evans, 2007). Since the first CDO that was created in 1987 by Michael Milken (Das, 2005), the CDO’s were little known till the 1990’s. The CDO’s were always characterized as high risk investments that could yield positive returns if worldwide economic situation is stable. The CITI group faced $1. 6 billion in losses through financing commitments to about a dozen collateralized debt obligations in 207. (Henry and Goldstein, 2007).

Hedge Funds

Hedge Funds also contributed to the aggravating of the crisis. Hedge funds are a type of investment that can undertake a wide range of trading and investment activities than the conventional funds. The hedge fund strategy that resembles “ credit arbitrage” involves purchasing of the subprime bonds on a credit and then hedging these positions with credit default swaps (Petroff, 2007). This increased the demand of CDO’s as the fund can buy even more CDO’s and bonds that was possible with existing capital and pushed the subprime rates further lower and thus adding to the problem. There is significant amount of leveraging involved in these hedge funds and losses in such funds are amplified. Thus it is quite possible for the funds to run out of money midway and shut down operations, thus resulting in losses of all those involved.

World Opinion on the Global Economic Crisis

Many economists blame the US lending and credit policy as the root cause of the problem. Reddy (2012) is of the opinion that the global financial disturbances were brought about by the crisis in the sub-prime mortgage in the U. S. in 2007 and spread to Europe. The collapsing of Lehman Brothers in 2008 also added to panic and threat of depression (Reddy, 2012).

Das et. al (2012) felt that it was the CDO's that brought the crisis to the world and even affected the Indian economy and agriculture sector though three distinct channels, viz., financial sector, exports and exchange rates. The impact of the global slowdown in India was decreased GDP growth rate, high inflation, FDI inflows and international trade.

Immergluck (2009) saw the problem as the result of the underlying economic system. He argues that the private sector should not be viewed as the appropriate means of providing housing and it should be the duty of the public or government sector.

However, a few opinions also suggest that the US was not to be blamed alone for Global economic slowdown. The crisis emerged from practices and regulation (or lack of it) in the developed economies. The European Sovereign debt crisis is not a result of the United States subprime crisis. It originated out of the globalization of finance, lenient lending policies in Europe and most importantly the practice of bailing out troubled banking industries and private bondholders (Lewis, 2011).

Thus the discussion does show that the origin of the worldwide crisis was indeed United States. However, the spreading of the crisis around the globe cannot be rested solely on the Americans. The other developed countries

and similar policies in the respective regions had equally to contribute towards the recession on 2008-2011. The Investment banks in a bid to transfer the debt were the chief organizations responsible for the word wide crisis. However, considering the world is far interconnected, socially, culturally and economically with each other through the phenomena of globalization than ever before, any major crisis in one region is invariably going to affect another. Thus as a concluding statement, one can say that it indeed looks as US is to be blamed, but it can be done so only partially as the crisis although originated in the country, but the spread and the effects in other countries was not their making.

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