The Core of a New Type of Crisis: Subprime crisis

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The quality of mortgage loans had been deteriorating since 2001, when interest rates were consistently below 3 per cent for several years. Housing prices dropped substantially since their high in 2006. This article examines the current credit crisis against the background of recent financial meltdowns in wealthy and emerging markets. We argue that securitisation involves various tensions between market participants and is based on several different criteria that gauge liquidity and creditworthiness. Most often, liquidity and credit enhancement are part of the deal. The problems in the subprime market led directly to the Fed Rescue, in which it guaranteed $30 billion, although Fed's authority over investment banks is murky. The United States had been experiencing subprime crisis, and that affect EU 's policies on interest rates and exchange rates. The situation also influence Romanian creditors to study more closely a borrower's capability to pay the loan. The possible implications of the U.S. subprime crisis on EU's public equities, hot money, domestic credit, and exports are discussed in the following article.

Key words: *subprime crisis, subprime loans, Federal Reserves, The European Central Bank*
JEL classification: *E40, E 41, E 44, E 51, E 52, G 01*

1. Introduction

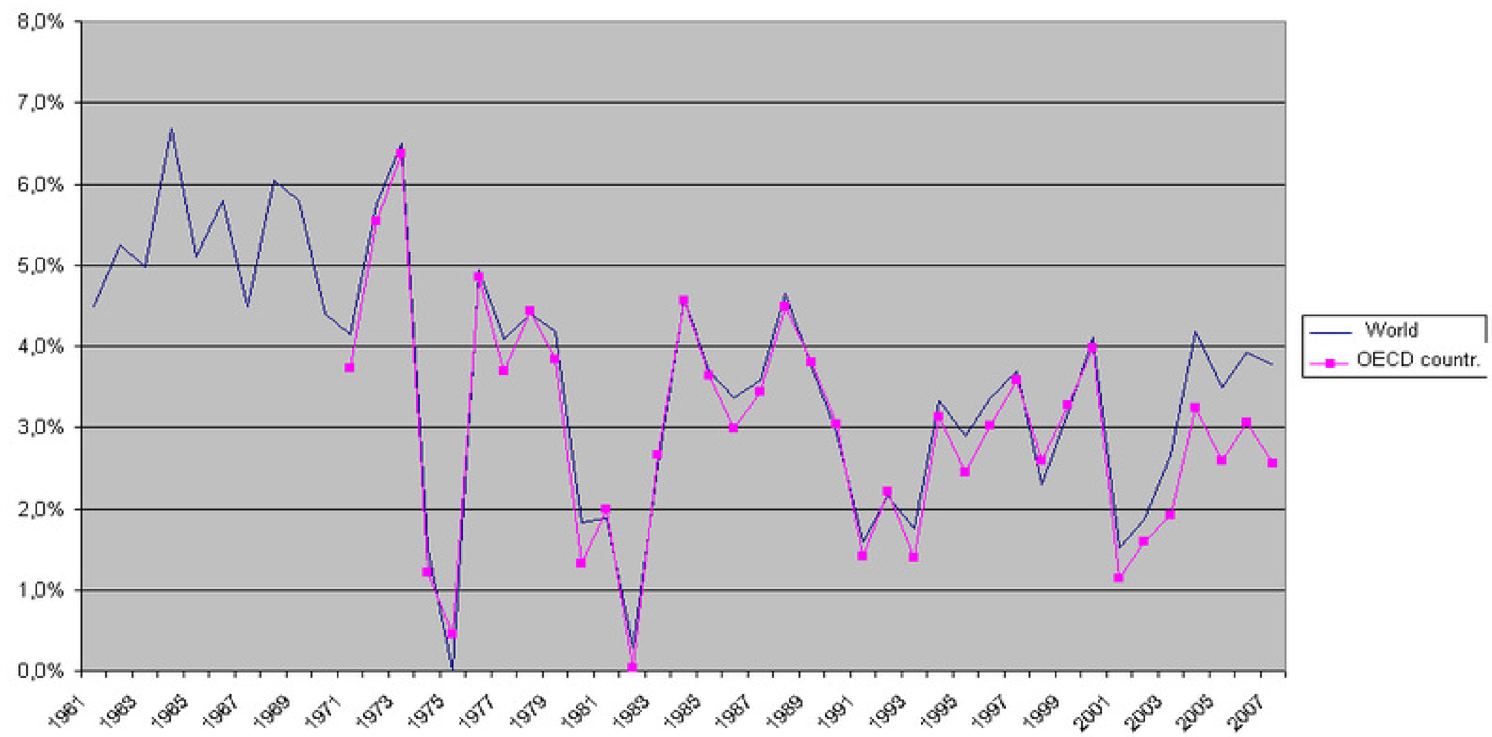
The World economy is facing the most serious economic and financial crisis since the Great Depression, 80 years ago, and governments make massive efforts to support the markets, as the major economies of the world entered into recession. The attacks of the 11th September have emphasized the decline of the U.S. economy, the profits made by companies in some industries were drastically going down. However, in early 2001 the economy was showing a remarkable condition. In the first moments after the terrorist attacks, when clouds of black powder were wrapping the New York city, who would have thought that a period of prosperity would follow?

Who would have thought that house prices would reach record levels in the end and that the highest percentage ever of American families will be able to buy houses? Who would have thought that interest rates would reach very low levels and that the share market will increase by approximately one third, despite the increase of the budget deficit? Nobody considered it to be the cause of a new disaster: the crisis on the mortgage market that could affect up to two million Americans (Whallen, 2008).

At present, this scenario begins to change and looks more like the one in September 2001. But now we have different causes, they root in the decisions taken by the U.S. authorities and the Central Bank in an attempt to limit the effects of terrorist attacks. The most important decision, the drastic reduction of interest rates, combined with the emergence of complex financial instruments on the mortgage market, led tot hat what may be called "a new 11th September" for the U.S. economy: *the falling of the mortgage market at high-risk,* a process that has affected the U.S. economy and even the global economy (Crouhy, Thunderbull, 2008).

The American crisis began to spread from the real estate market to the import of goods, affecting the sales of foreign companies, an example being the Japanese car manufacturer Toyota Motor. Moreover, the rise of credit costs, which followed the crash of the risky mortgage market, has affected the financial markets all around the world (Apostoiu, 2008).

World gross domestic product year on year growth rate, 1960s onwards, according to IMF and OECD



Source: OCDE Report, 2008

2. Literature Review

Understanding the nature of contagion in financial markets is of fundamental importance and there is an extensive literature addressing its causes and effects. Important recent papers on contagion include Allen and Gale (2000), Kodres and Pritsker (2002), Kiyotaki and Moore (2002), Kaminsky, Reinhart, and Vegh (2003), Allen and Gale (2004), Brunnermeier and Pedersen (2005, 2007), and many others. From a research perspective, the current crisis in the subprime asset backed market provides a near-ideal "laboratory" for studying the role that contagion may play in financial markets when an asset class becomes severely distressed.

The contagion literature identifies at least three possible mechanisms by which shocks in one market may spill over into other markets. First, Kiyotaki and Moore (2002), Demyank and Hermert (2008), and others describe mechanisms in which negative shocks in one market represent the arrival of economic news that directly effects the collateral values or cash flows associated with securities in other markets. Second, Allen and Gale, (2000), Brunnermeier and Pedersen (2007), and others show how investors who suffer losses in one market may find their ability to obtain funding impaired, potentially leading to a downward spiral in overall market liquidity and other asset prices via a "flight to quality." In this mechanism, contagion occurs through a liquidity shock across all markets. Third, Apostoiu (2008), Georgescu (2008), Badin (2008), and others imply that a severe negative shock in one market may be associated with an increase in the risk premium in other markets. In this mechanism, contagion occurs as negative returns in the distressed market affect subsequent returns in other markets via a time-varying risk premium.

3. The Core of the Subprime Crisis

Problematic loans were part of the so-called "subprime" products through which the banks agreed to give loans in exchange for minimum guarantees. The U.S. banks had offered massive loans in such circumstances and with time, people were no longer able to repay loans (Colibăşanu, 2008). The lack of cash flow that began to be the major problem of some banks degenerated into a cash flow crisis when more and more banks began to refuse granting loans to other banks, fearing that they will not recover their money.

In 2005, in the U.S., if a customer could not qualify for a loan or had difficulties in obtaining a loan by normal means from a bank, the "subprime" credits would solve all these problems. In a few words, these types of loans were granted to persons who had a history of low reimbursement or to those who didn't have enough money for such a loan. The bank would cash in more money, and bankers would live with the illusion that house prices would increase for ever and ever and even if they will not recover the debt, they will sell house and then get back the amount borrowed. But this time, bankers' intuition had not worked out, and the greed of some had led the whole world into the biggest postwar financial crisis (Apostoiu, 2008).

The main cause leading to this kind of problem is the lack of supervision of the banking system (Demyank, Hermert, 2008). It is important to note that since the market is created by millions of individuals acting within, it can be dominated only by the uncertainty caused by human relations, translated through the phenomenon of informational asymmetry. Thus, market deviations are the result of the interaction between two entirely opposite elements: the wrong perception of humans and the existing reality. [14] For example, during the real estate boom in the United States there is this reality: low interest rates and the possibility of easily contracting a loan. On the other hand, consumers have a wrong perception. They imagine that real estate prices will continue to grow without being affected by low interest rates.

And the deviation of the mortgage market, implicitly the real estate market, had occurred at the moment when the wrong perception of the people fueled an explosion that could not have been sustained any longer in the end. The belief that the market corrects itself is completely wrong, when the previous major crises, which have almost destabilized the financial system, could have been resolved only by the vigorous intervention of the authorities, and not by market corrections (Allen, Gale 2004).

During the recent years, people on Wall Street have proved themselves to be extremely creative in terms of the means for transforming loans into bonds that can be sold to investors chasing high levels of profitability. And the climax of these means had been the subprime loans - i.e. financial assets created by the "packaging" of the loans given to people with questionable quality and that were involving a high level of risk (Brunnermeier, Pedersen, 2007).

Now however, with the crisis in the U.S. financial system, investors do not want to assume any more risk and are not willing to pay the market price for the financial instruments guaranteed by mortgages, fearing that the borrowers would be unable to repay their loans. Banks and brokerage companies and have already significantly reduced their assets represented by financial instruments based on subprime loans, as a result of the record levels of bad payers (Allen, Gale 2000). Moreover, there is no sign that the real estate market decline would come to an end, which increases the uncertainties on the final amount of bad loans even further. Under these circumstances, the most important activity of a company on Wall Street can only be taking care of their own survival (Demyank, Hermert, 2008).

4. The Subprime Crisis: USA vs. EU

The cash flow crisis had spread from America to Europe and gradually to all major financial markets, and immediately after that hitting the real economy worldwide. The difficulties of the financial markets are directly linked to the ignorance of the risk that the new instruments for real estate in the United States bear. Some mortgage credit institutions have managed to protect the most dubious loans, transferring the risk to the commercial banks and hedge-funds in America and the Old Continent by issuing bonds with collateral loan (Kodres**,** Pritsker, 2002). A central bank may act to prevent cash flow crises on a short term, but in any case it should not adopt a lax monetary policy when the future evolution of the inflation is not justified. Emerging economies may slightly be affected by a financial crisis, because they depend on commercial trade with more advanced countries. Signs indicate that the storm triggered in the United States is not yet extinguished (Kaminsky, Reinhart, 2003).

The subprime crisis is based on the securitization – the „packaging" and selling of risk, based on ratings. Two factors underlie the process of securitization - external ratings and internal ratings (Georgescu, 2008). Both have become the subject of important debates, marking a likely collapse of the whole current concept regarding securitization.

Most mortgage loans are granted in the United States by specialized banks. Besides Freddy Mac and Fannie Mae, which have draconian credit conditions (their deposits are guaranteed by the state), there are numerous institutions that have some more relaxed regulations. These specialized banks have had their balance sheet cleaned of the most risky loans, transferring them through operations to some so-called Structural Investment Companies (SIC), created sometimes exactly by those banks. SIC financed credit portfolios acquisitions by issuing bonds with collateral credit, and sometimes through debt securities for short terms ("commercial paper") (Colibăşanu, 2008). Some had a very low rating. Investment companies and banks worldwide, including Europe, have bought these bonds, not out of generosity, but out of greed, as these bonds brought a return that appeared extremely high, before the crisis. Consequently, they have to bear losses now.

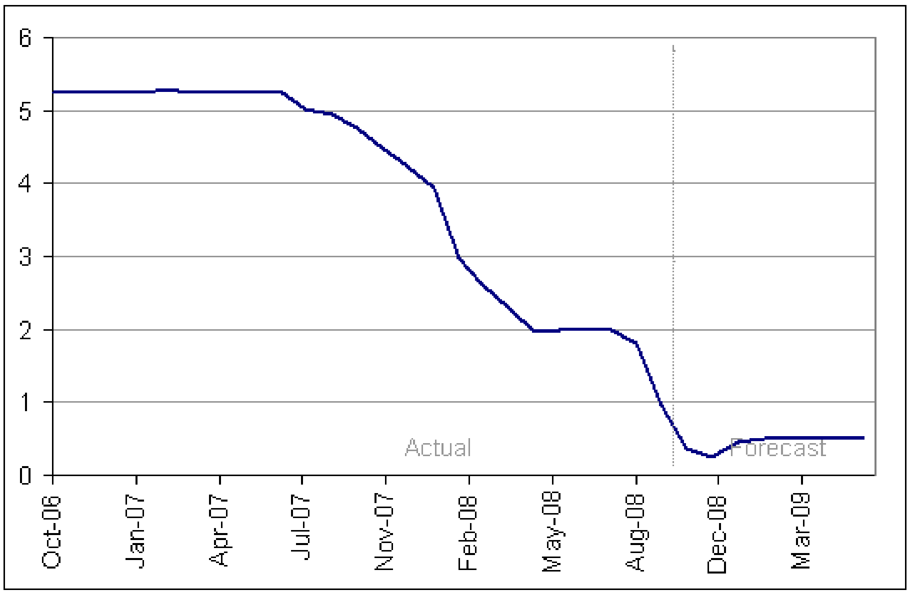
The measures taken before the subprime crisis by the Federal Reserves - USA (FED) on the one hand, and the European Central Bank (ECB), on the other hand, were never very different, talking about fighting against a financial crisis. Since the beginning of the financial crisis in the summer of 2007 and until the spring of 2008, the ECB has not changed the reference rate, thus it didn't change it even when the financial crisis was about to take place on a global scale.

ECB is a young bank, and so far it has not been faced with the emergence of a brutal and significant gap between the main interest rate - the so-called "minimum bid rate" (the lowest marginal interest for banks to borrow money from the ECB) - and the "overnight" interest, where banks lend cash to each other. It's natural that the ECB does not want to take any risk (Demyank, Hermert, 2008). Therefore, it issued a large amount of cash flow on the market, which it is able to withdraw just as easily. In America, the interest for which banks borrow money from Fed ("discount window rate”) is not the main monetary instrument. But the fact that the Fed lowered the interest rate and urged major banks to call on this facility is similar to the ECB strategy (Whallen, 2008).

EDF, however, announced in the beginning that it will not decrease the reference interest rate to prevent the expansion of the crisis, since this could lead to the amplification of the increased inflation risk. In contradiction to the ECB, since the beginning of the financial crisis of August 2007, EDF has reduced the reference rate by 7 times, from 5.25% to 2% in an attempt to avoid a possible recession in the United States (Crouhy, Thunderbull, 2008).

In order to avoid the economic recession in the U.S., the FED (Federal Reserves) had dropped the reference interest in January of 2008 by 0.75%, lowering it to the level of 3.5 percentage points. The reduction by 0.75% is the largest decrease operated by EDF since 1990.

Chart 2: EDF – the evolution of the interest rate (2007 - 2008)



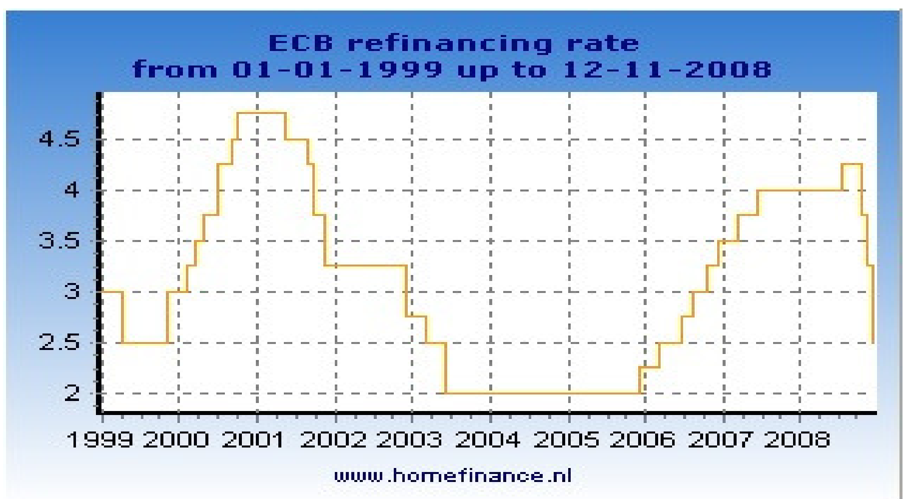
Source: Financial Forecast Center, "FED Funds Interest Rate Forecast", 2008, http://www.forecasts.org/ffund.htm

Meanwhile, EDF officials are aware of the fact that the policy of reducing the reference interest rate does not have the capacity to immediately solve the problems in the lending segment. In fact, this policy could lead to a worsening of things, as the reduction of rates for mortgage loans could discourage investors to buy instruments based on those loans. Thus, avoiding entering as soon as possible on the real estate market, the investors contribute significantly to the continuing of the market decline and the increasingly visible problems of the financial institutions.

The ECB, however, faces another problem, namely to maintain price stability. From this point of view, the ECB considers an increase of the interest rate in order to keep prices under control. However, the European Central Bank, even if it has not modified the interest rate as a monetary policy, has not remained completely indifferent to the financial crisis. So, it took the decision to grant funding to the European banks at a lower interest, as that they have become increasingly reluctant to grant interchange credit.

By this measure, the ECB has ensured that banks, individuals and companies will continue to access credits, thereby encouraging consumption. The ECB has ensured that the banking sector in Europe would benefit from sufficient cash flow, without the infusion of capital to affect the economy as a whole, which could lead to an increase of the inflation.

Chart 3: ECB increase of the interest rate



Source: HomeFinance, http://www.homefinance.nl/english/international-interest-rates/ecb-refinancing-interest-rate.asp

During 2007 - 2008, almost 50 global financial institutions, including the major investment banks in the United States and Europe, have lost 140 billion EUR as a result of the powerful exposure on the subprime loans market. The losses of the companies in the United States were approximately 55% of the total. Among those who lost the most, i.e. 60% of the total, are the following four banks: Merrill Lynch, Citigroup, UBS and IKB (Scott, 2008).

The losses on the financial market have reached 18 billion dollars, after Merrill Lynch and Washington Mutual have reported great losses (Financial Times, standard.ro). The investment bank Merrill Lynch has reported losses of 8.5 billion U.S. dollars in the third quarter of 2007, due to the decreasing value of mortgages at high risk (subprime) and collateral obligations, while Washington Mutual (WaMu), the largest American company for savings and loans had recorded a profit lower by 75%, during the same period, (970 million U.S. dollars), due to a significant increase of the losses generated by the segment of credit provisions. Similar negative results have also reported Citigroup, UBS and Deutsche Bank (Whallen, 2008).

In September 2008, The Bank of America consolidates its status as the largest retail bank in the United States, saving Merrill Lynch from bankruptcy by the agreement to purchase the largest brokerage firm in the world, for approximately 50 billion U.S. dollars. While Merrill has a net loss of nearly 19 billion dollars, related to mortgage loans, The Bank of America will win the 16,690 brokerage firm consultants that manage 1600 billions U.S. dollars for their individual clients (Apostoiu, 2008).

The collapse of the financial titles guaranteed by mortgages at high risk (subprime) in the U.S. had caused great losses for credit institutions all over the world. Several large European banks like the UBS, Credit Suisse and Deutsche Bank have launched warnings on their financial results for the third quarter of 2007, after the mortgage crisis in the U.S. forced them to reduce their assets by several billion dollars.

Also as a consequence of the subprime crisis, the investment bank Bear Stearns, one of the oldest financial institutions on Wall Street collapsed, after being taken over by rival JP Morgan supported by EDF, with only two U.S. dollars per share. At this time, most of those on

Wall Street believe that the assistance granted by the EDF investment bank to Bear Stearns is just the beginning of an operation that could culminate with saving the entire real estate market by the government in Washington.

In 2009, EDF will extend the period for the program financially aiding the banks on Wall Street that are in deadlock, taking a series of further measures to combat the effects of the credit crisis (International Herald Tribune, December. 2008). Across the Atlantic, the European Central Bank and the Swiss National Bank have announced that they will put billions of Euros at the disposal of non-American banks that need cash flow. [15]

5. The subprime crisis effect: assessing the dollar rate against the EURO

A year and a half after the beginning of the subprime crisis that has scarred and still shakes down strong real estate, mortgage and financial U.S. markets, and that then expanded to the level of the global capital system, the Euro reached mid-July of 2008 a historical maximum of $ 1.6038, "the green banknote " gaining back thus lost ground. In August the U.S. dollar managed to recover to about 10 euro cents and by year-end, analysts estimate that the parity between the two currencies could fall down to $ 1.40. In 2009 we could be witnessing a similar trend of the U.S. currency to recover lost ground to the other major currency (Georgescu, 2008).

Chart 4 – The Evolution of the Euro – U.S. Dollar Rate, 2005 -2008

Source:www.dailyfx.com

The positive development of the dollar is due to the fears regarding the beginning of the British, Japanese and euro-zone economies recession, while the measures taken by the U.S. Federal Reserve, which has dropped its interest of monetary policy from 5.25% to 2 % in September 2008 (the European Central Bank is maintaining it at 4.25%) began to show their effects (Demyank, Hermert, 2008).

Economic analysts consider that a level of parity of $ 1.47 is the most appropriate rate for the U.S. economy to reduce the huge U.S. budget deficit, helping exporters and limiting imports. But the Federal Reserve, taking into account the inflationary effects of oil price increase and the fact that the U.S. is the biggest oil consumer in the world, has increased the interest since the first months of 2009, justifying the fact that a stronger U.S. dollar could maintain the barrel price at a normal level.

Another positive factor for the dollar appreciation is the improving of the trade balance in the United States. The U.S. exports rose by an annual rate of 19% in the third quarter of 2007, well above the growth rate of the imports, of 4.4%. Also, the U.S. continues to attract foreign investment, which represents capital flows with positive effect on the dollar, the movement of investment sovereign funds providing the financial U.S. companies with tens of billions dollars.

6. The effects of the subprime crisis in Romania

The international financial crisis, which has caused very serious problems to some of the strongest financial institutions in the world, turns over Romania too, by limiting the flow of capital and by reducing investors' appetite for risk. The influence of the financial crisis in progress on Romania and of the slowing U.S and global economic growth will depend on the extent to which these events reduce capital flows to the country, focusing on the stability and health of the global banking and Romanian systems. It is expected that the credit conditions should be harsh, and their costs should increase. For Romania this is relevant, given the external imbalances and the financing needs of our country that are increasingly needed (Scott, 2008).

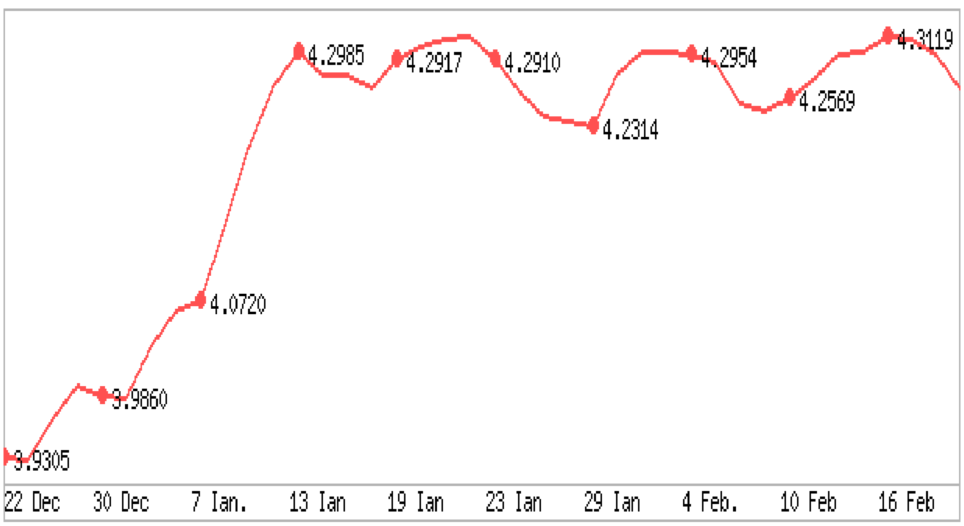
Romania, just like other European markets still in development, is on the edge regarding the current economical crisis, is shown in the Stratfor forecast. According to the report regarding the IV quarter of 2008, published by the quoted source, Romania is among the countries most prone to economical collapse. Also, the European financial system could be more severely affected than the U.S. system, due to the individual economic position adopted by the European Union member states, these acting separately and not as a unitary body. However, Romania's situation is better than Hungary's, but our country will still have problems because of the lack of cash flow on the European market.

Romania's situation is therefore similar to or better than Hungary's, scarred by the credit crisis that revealed the weak economic foundation and a banking system dominated by foreign banks using Swiss Francs and Euros in order to finance loans for customers and businesses. Regarding the economic bases, Romania is faced with a budget deficit of 2.5 percent of GDP and a great trade deficit (14 percent of GDP). Although the governmental debt are not very high - only 19 per cent of GDP - the question that arises is how will Romania finance the budget deficit during the crisis of cash flow, especially now that the credit rating of the country was reduced, making it the issuance of bonds almost impossible. Romania's problem is stressed out also by the fact that almost all productive sectors of the economy - particularly machinery construction and the industrial production of cement - is in the hands of foreign companies, which are already reducing production because of the crisis spread in the region (Badin, 2008).

The Romanian economy felt the shocks coming from the American continent, even if they were of low intensity. Not having an active very developed secondary market, Romania has not taken many of the external imbalances of the financial markets. However, in the medium term, the Romanian economy may face problems because of the general internationally created climate. The stock market indicators were the first ones that have suffered in spite of the results of six very good months, reported by the listed companies.

Also, by comparing the Leu to the Euro, the Leu has lost ground. It is also possible that these reductions should only be slight adjustments to the increases of the last 6 months, due to a decrease emphasized by the caution on the Romanian market. But there is also feared that this prudence will be present on the market for many months now: the Leu will still lose value and the Romanian assets, currently overvalued, will be adjusted.

Chart 5 The Evolution Leu – Euro, Dec. 2008 – Feb. 2009



Source: http://www.cursbnr.ro/grafic-valute , BNR, 2009

Banks will pay more attention to granting loans; the Romanian subsidiaries of the multinational companies will obtain loans from parent firms in the harshest conditions and will be subject to higher pressures in terms of profitability and cash flow; many speculators will retire. All this will have a significant impact both on the exchange rate and on the cash flow on the Romanian market.

The reference interest rates of the EU states and the U.S. are quite high and are likely to increase, so the interest rate of 7% offered by the National Bank of Romania will not attract foreign capital as in previous periods. NBR has the interest to keep inflation under control and a depreciation of the Leu would certainly not be of help. Money reserves are significant for the NBR to support the Leu - Euro rate in that corridor. However, an adjustment of course Leu - Euro will positively affect the exporters and the trade and current account deficit will decrease.

The international crisis has raised the costs for external funding for local banks, which should increase their interest rates on deposits in order to attract money from the domestic market. This could have a positive effect by stimulating savings, which would help to decrease the deficit. Even if the banking system will tend to attract resources from the market, this could only be on a short term basis. Meanwhile, if the lack of cash flow in the banking system would lead banks to borrow money from NBR, the measures of monetary policy may become more effective through the mechanism of the monetary policy interest. The investment system is required to remain at high level, especially because the forecasts on Romania remain optimistic. Given the existence of minimum reserve requirements imposed by the NBR and that the market for products derived from Romania is not related to the banking system, one can not speak of a cash flow crisis of the system even if some banks are faced with a tightening of external financing

7. Conclusions

The subprime crisis is now perceived at sectoral level in the United States. However, the financial and capital markets have suffered the effects and it is assumed that this instability of the global financial system is one of its consequences. The food crisis is also considered by some experts that has derived from the subprime crisis, due to diversion of funds for investment to assets-primary goods. The evolution of the subprime crisis shows that there is still a "winning" strategy for settlement and reducing its effects, as that there is no estimation that this crisis could end by the chain effect termination.

Although the authorities state that the situation will start to improve in the second part of this year, analysts say that its effects will continue to disrupt activity on financial markets and beyond. It seems that the situation is more serious than the authorities would recognize it to be and measures taken so far, such as reducing the monetary policy interest rate or reducing the taxes in order to stimulate consumer spending were "necessary but not sufficient". Until now, nearly 50 global financial institutions, including the major investment banks in the United States and Europe, have lost 232 billion dollars as a result of the powerful exposure on the subprime loans market. At the same time, however, the money released on the market by the central banks are insufficient to cover such amounts, which may be yet another proof that the authorities have not assumed their responsibility for controlling "the financial market bubble" before it would reach this far. In order to return to normal, a tightening of the financial market supervision and a restriction of credit for speculative investment is probably needed. But it still remains to be seen how this will affect the development of the global financial system, already characterized by solid interdependencies. Regarding the possible repercussions of the international developments on Romania, economists are of the opinion that there is a low probability that Romania would be confronted with a liquidity crisis caused by a crisis of mortgage at high risk (subprime).

Any effects would only be felt marginally and that should not raise any problems to the central bank nor to the banking system. The current development of the crisis known as " subprime" crisis, underlines the inexistence of a „winning" strategy for settlement and reducing its effects, as there is no estimate on when this crisis could be ended, its evolution along parallel sectors are still surprising for the economic analysts.

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