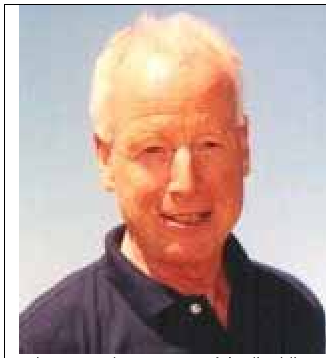
[Comment] Could a Financial Crisis engulf Europe?

21.09.2007 - 09:22 CET | By George Irvin

EUOBSERVER / COMMENT - If you're worried about the close connection between negative household savings in the United States and world economic instability, you need look no further than the 'sub-prime lending' crisis of 2007, an instructive lesson in how quickly a set of apparently unrelated factors can combine to produce the threat of financial meltdown.



"The contagious nature of the liquidity crisis is a further sign that unfettered free markets do not guarantee economic stability and prosperity" (Photo: George Irvin)

Earlier this month small savers in the UK queued up 1930s-style outside the branches of Northern Rock, one of Britain's many building societies which (much like a US 'thrift') specialises in mortgage lending. Until quite recently, Northern Rock was one of Britain's most dynamic mortgage lenders, achieving a high average annual growth rate and holding little bad debt.

But in the course of a few weeks, depositors withdrew nearly £20bn, and the company's share price plummeted by 80% making it ripe for takeover.

In 2006 the company's chairman, Adam Applegarth, had paid himself a modest £1.4mn; as one journalist noted, unlike Jimmy Stewart in 'It's a Wonderful Life', he did not appear at the door of the bank offering to repay customers from his own money.

Ironically, the run on this particular bank appears to have been precipitated by factors which have little to do with the institution's financial integrity, but rather have been caused by the credit crunch in the US market. Indeed, what is most worrying about this episode is that contagion has crossed the Atlantic and could easily spread to other financial institutions in Europe.

The US Fed and the European Central Bank have already poured billions into keeping financial markets solvent, the former $70bn and the latter €150bn in July and August; moreover, only a few days ago the US Federal Funds rate was cut by ½ a percentage point. The Bank of England followed with a £10bn injection of credit, in recognising - perhaps a trifle late - that the damage needed to be contained quickly, given the central role of the City of London in the world's money market. How did all this come about?

How it happened

A generation ago when the world of finance was still relatively simple, mortgage banks took in savers' deposits and used these to make long-term loans, making their profit from the spread between the interest rates paid to lenders and borrowers. Loan outflows are a bank's assets and deposit inflows are a liability; hence the traditional golden rule of banking - lend short and borrow long - is meant to keep the inflow of maturing loan repayments well ahead of the outflow of liabilities to depositors.

A banker's worst nightmare is the bank's creditors - traditionally, thousands of small savers - will all turn up at once demanding their money back, thus precipitating the bank's collapse. Ostensibly, mortgage banks defy gravity because their loans are all long term; hence, the supreme importance of lending only to those who can repay and whose collateral is quite literally 'safe as houses'.

Several things have happened over the last generation to change the picture. First, the rapid development of financial markets, and particularly that for short-term funds (the international 'money market'), has made access to credit nearly instantaneous and made financial and other institutions more reliant on such credit.

Equally, central banks today are more conscious of their obligation to act as lender of the last resort if a bank cannot meet its cash obligations its own funds or from the money market. Also, flexible mortgages mean that if interest rates rise, a mortgage bank can pass the rise along to borrowers.

Perhaps most important, banks need no longer carry risky mortgages which, if unpaid, would be classed as a 'non-performing asset'. Instead, mortgages can be bundled up ('securitised' in the jargon), segmented by their degree of risk, and sold in the market just like any other commodity. In short, banks can unload risk onto whoever buys these 'asset backed securities' (ABSs); buyers might be any institution looking to diversify its asset portfolio, including other banks.

In the United States, one of the factors fuelling the housing bubble was the eagerness of banks to lend for house purchase and remortgage existing property, reflecting the ease with which banks could pass on mortgage risk to the secondary market. Initially, banks granted mortgages to high- and middle-income clients; such mortgages, when bundled into bond-like assets, were given a 'prime' rating by valuers such as Moody's Corporation and thus considered virtually risk-free.

As the momentum behind the housing boom grew and interest rates remained low, banks extended their services to low-income clients eager to join the consumption spree - often using bait and switch tactics to lure them in, then charging them above-prime rates. Since such clients were vulnerable to any rise in interest rates, the resulting mortgage pools were deemed to be sub-prime. But when sub-prime mortgages were bundled together with prime mortgages, the resulting mortgage pools could still be bought and sold in the world money market like any other financial product.

Starting in June 2004, the Federal Reserve repeatedly pushed up the federal funds rate from a low of 1% to 5.25% by late 2006, in effect nearly doubling the burden of mortgage repayments on the finances of an average family. Predictably, one result was a dramatic rise in the default rate on mortgages granted to sub-prime borrowers. Banks and other institutions holding fully or partially sub-prime ABSs now found it difficult to sell these in secondary markets and, as the assets lost value, so too did the asset sheet of their holders who, in turn, tightened credit.

Europe narrowly avoided trouble

Because the world money market is today so large and electronic trading is ubiquitous, a wide variety of institutions rely on the money market for short-term credit needs. By mid-2007, what had started as a rise in the default rate on mortgages amongst US borrowers now turned into a world-wide credit crunch. The worlds' leading central banks may have talked tough about the moral hazard of bailing out overexposed institutions, but faced with the prospect of recession they flooded the market with liquidity.

At the time of writing, the contagion seems to have been contained and the pain will be borne chiefly by low-income American families for whom the prospect of buying a home has become even more remote. Europe has narrowly avoided serious trouble. But the consumer spree of the past two decades, first facilitated by financial deregulation and driven by the booming stock market and then by the housing market, may be drawing to a close.

The danger is that the world financial system is already dangerously fragile; as the US dollar falls, a further speculative crisis could send the world economy into a tailspin. More generally, the contagious nature of the liquidity crisis is a further sign that unfettered free markets do not guarantee economic stability and prosperity, nor do they give rise to an income distribution that underwrites social stability and individual well-being.

George Irvin's new book, 'The Road to Inequality', will appear in the spring of 2008.