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STATEMENT OF THE PROBLEM

OBJECTIVES

HYPOTHESIS (ES)

RESEARCH METHODOLOGY

RESULTS & DISCUSSION

FINDINGS

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SPILL-OVER EFFECTS OF MORTGAGE CREDIT CRISIS IN USA ON EUROPE

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DIRECTOR
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LUCKNOW

ABSTRACT

The banking industry in USA and Europe is, upto a great extent, connected to a global slowdown and to the world economy. Globalization and innovation, which used to be regarded as important factors for having contributing the global GDP increase, recently have showed us their downsides. Hazardous behavior of the US financial experts caused series of negative effects that soon after spread out all over the world thus made everyone feel the repercussions of their greedy undertaking. The economic instability and slowdown in developed countries, especially in US and Europe, may affect the economic stability and banking industry at global level to a great extent. The economic slowdown and declining banking industry in US and Europe in the last decade, left a bench-mark influence all over the world. The main point of this paper is the US subprime mortgage crisis and its impact on Europe. In the present paper, the roots of crisis are shortly represented as to help the reader understand why the effects of crisis have become worldwide.

KEYWORDS
mortgage credit crisis, global slowdown.

INTRODUCTION

Not even the most pessimistic economists could have expected that the European economy would be so badly affected by the negative impact of the mortgage credit crisis in the USA. The basis for their positive predictions experts found in the assumption that both the market and the investors were somewhat "conservative" by nature thus the new financial products wouldn`t be as attractive to the European financial markets as expected.

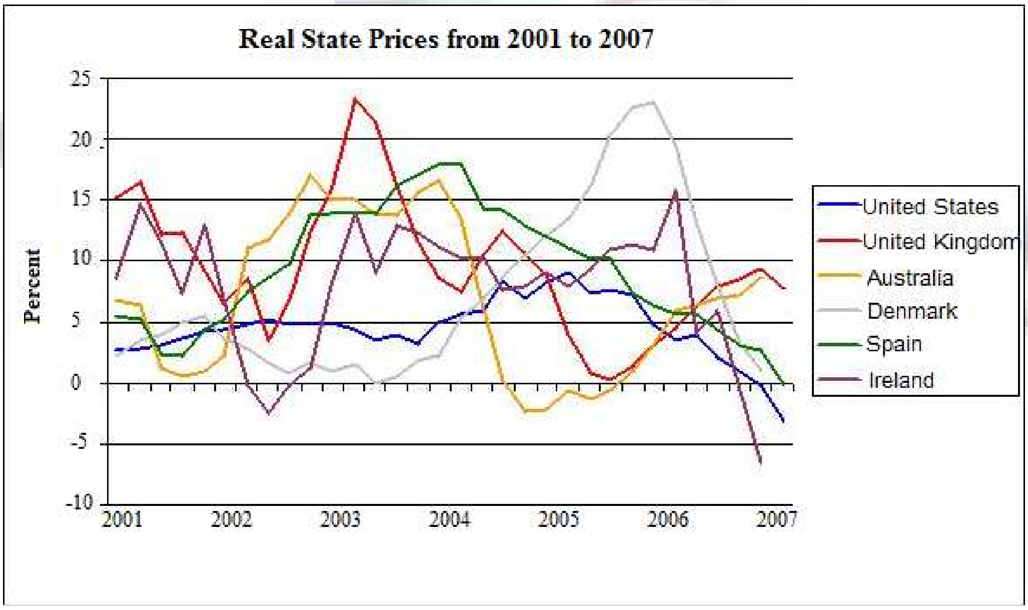
Mainly because of the business of the US companies themselves, but also because of the activities of the European financial institutions involving securities, the crisis almost immediately engulfed the two continents. Losses that were registered in almost all the companies in the financial industry accumulated, causing serious problems in their business. The loss in the world's financial sector was increasing continuously and reached its peak-1 trillion, in June 2009. Taking out loans was brought to a minimum and the severity of the whole situation seriously shook people's confidence in banks and other financial institutions. To such an inappropriate environment investors reacted by withdrawing funds from the financial markets and that complicated the situation even more. The increase in unemployment and poverty in the whole world contributed to the decline in the aggregate demand what, further more, dictated by the consistent economic trends, resulted in the drop of the GDP in almost all the countries (USA 2.3%, UK 5.2%, Germany 3.5%, etc. ...)[1].

The whole situation seemed bad, with great possibility to deteriorate even more. The necessity for the state intervention was obvious. Action plans, adopted by governments (TARP in the USA, FMStG in Germany, and others…), implied injecting large amounts of liquid assets thus enabling banks to continue with their operations. Contrary to the laws of the neoliberal theories, active state intervention to regulate the market and its mechanisms became a reality.

ROOTS OF THE CRISIS

After almost nine years of a continuous growth in share prices in the US financial markets, primarily due to the innovations in the field of the information technology, the value of shares started to decrease significantly, thus initiated slowing down of the economy. The burst of the "dot com" bubble and the terrorist attacks on 11th September contributed to the increase of uncertainty among investors, who responded to this situation accordingly by withdrawing considerable funds from the market. Such economic climate indicated that the situation could worsen even more if the major players' confidence in the financial market was lost. Bush's administration, together with the director of the Federal Reserves Alan Greenspan, advocated significant reduction in Central Bank interest rates that might have served as an invitation to the companies and the population to increase their investments and consumption. Starting from 2001. The reference interest rate kept being reduced by 0.5 percent every month, so that in January 2003. It reached its historic level of 1%. Offering significant amounts of money was accompanied by more liberal requirements, hence conditions for realizing loans. Namely, in desire to have the accessible money productively placed in the market, banks lowered their criteria, particularly with granting mortgage loans which put the credit history aside for the time being. This force of circumstances, especially under the influence of the high demand for real estates, initiated speedy increase in the prices of houses. The following graph represents quarterly increase in the prices of real estates for the period 1999-2005, as well as the decline that followed soon after, which will be thoroughly explained later on in this paper.

FIGURE 1: REAL ESTATE PRICES IN DIFFERENT COUNTRIES FROM 2001 TO 2007



A remarkable problem from the very beginning was the fact that the subprime loans had the biggest share in the total issued credit mass. If this indicator was to be talked about in abstractions, then we had neglected the fact that these debtors were less desirable as such, there go the likelihood of them paying off their loans was very small. To such unfavorable attributes their debtors had displayed, the banks responded by offering them inconvenient conditions for granting loans. Namely, there was a hybrid interest rate which was fixed in a first few years and then, after that period, the banks were free to set the amounts the way they desired.

In order to accept such negative conditions, both sides needed very strong reasons. From the point of view of the debtor, that was the only possibility for fulfilling "The American Dream" because of the bad credit history or their current credit ability. On the other hand, the banks, having been encouraged by the increase in the prices of houses, did not question the possibility of expanding the number of delinquent debtors, and they considered that any presumptively bad scenario could be resolved by selling the houses that had been impounded, what would help them make a profit again.

In addition, banks were increasingly relying on the business with securities. By this action, banks transferred junk assets to a separate legal entity (SPV Special Purpose Vehicle) and thereby improved credit potential, with reducing risk to a minimum. This phenomenon led to the expansion of securities which had a base in subprime loans (MBS Mortgage-backed securities).Relatively new financial products were not only attractive to the financial markets in the USA, but the considerable volume of trade was also registered in stock exchanges throughout the world , especially in Western Europe, China and Japan [1].

The reflection on the economy was extremely positive and contributed to the increase in activity and to the significant growth in GDP during this period. And everything was moving in a positive direction until the banks, after the expiry of the fixed interest rates for hybrid loans, decided to change the interest rates and made numerous of debtors unable to pay off their debts practically over night. The rate of the delinquent debtors and the number of the houses impounded grew rapidly. Only in 2007. Nearly 2 million houses were impounded and most of the banks offered them in the market, thereby initiating the decrease in the prices of real estates. The negative impulse, initiated by the collapse of the mortgage market, spread at high speed and crept into every pore of the financial system.

The bankruptcies of banks, insurance firms and other companies which trade with the securities issued by the subprime loans, became an everyday life. Financial giants such as "Bear Stears", "Lehman Brothers", and similar companies collapsed under the blow of the first wave of the crisis, what resulted in numerous harmful consequences others could have felt, as well.

This was a clear signal to the US government to start dealing more seriously with the issue of illiquidity and the other difficulties financial companies were faced with. Uncertainty, the biggest enemy of any investment, again played a significant role in deepening the crisis and contributed to the more evasive depreciation of the value of shares in stock exchange markets around the world. Regardless of the fact that the crisis had actually started as a result of the hazardous behavior of the financial institutions in the US, the losses, having been initiated by the collapse of these very institutions, affected the world economy [2].

CRISIS OF MORTGAGE LOANS IN THE UK

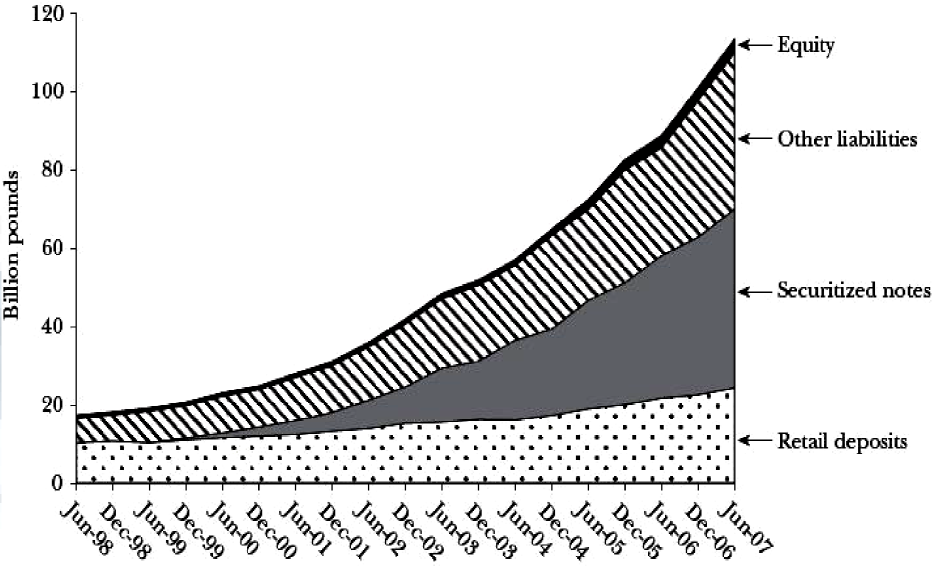
The United States and Great Britain had the same structure and handled business in the financial sector in the same way for years. With the strong political support, and the motivation coming from the Central Bank of England the business with securities was getting ever more important, so that the number and the types of securities assets grew rapidly.

The most attractive activities related to the securities in "prime" and "subprime" mortgage loans were performed by many banks. What was typical of the US and Great Britain, but significantly different from the rest of the world, was the fact that in these two countries a large number of mortgage loans was approved by the brokers. In this way, active analysis of the number of debtors, as well as the concern about the prospects for debt repayments, was put aside and the quantity of the loans granted became a priority. The financial derivatives market in the UK was the largest one in the world and the whole financial industry produced 7% of GDP.

The decline in interest rates and the weakening of credit standards lately have resulted in the growing tendency of the population and the companies to borrow. The number of credit arrangements and the real estate prices kept rising (the price index of real estates in the UK has risen from 100 in year 2000. to 240 in year 2007).

However, the decrease in prices that occurred soon after that, as a result of the negative impulses coming from the US, contributed to the deterioration of the situation. The largest banks in the UK market, in a row, reported the liquidity problems and asked for help from the state. In its assets, these banks, like the US ones, reported numerous worthless securities issued on the basis of subprime mortgages. "Northern Rock", "HBOS", "Bradford and Bingley" were just some of the examples, depicting the problematic situations.

FIGURE 2: CAPITAL STRUCTURE OF NORTHERN ROCK BANK

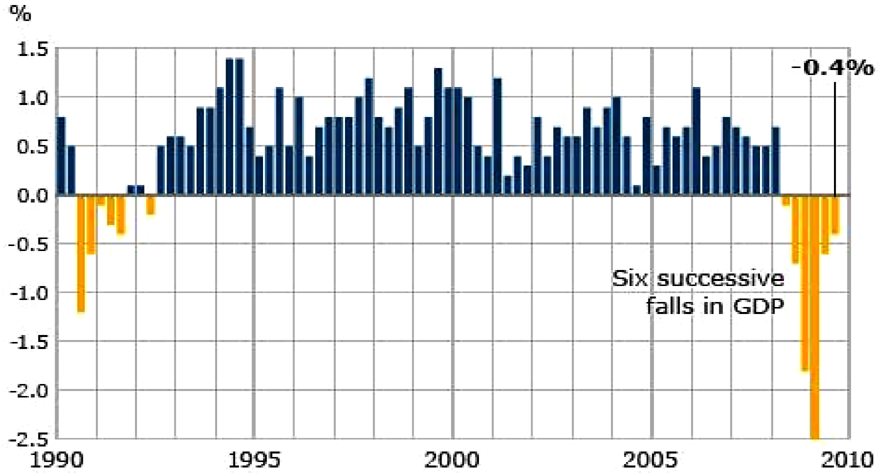


The "Northern Rock" Bank was the eleventh largest bank in the UK with a total capital of 113.5 billion pounds. It was extremely active in the mortgage loans market, what was obvious from the fact that in the mid-2007. The value of the approved mortgage loans was around 10.7 billion pounds or approximately 19% of the total value of loans granted in the UK that year. The following graph shows that from 2000. The shares of these securities have constantly grown. The first level represents the savings deposits, which are relatively stable source of funding, with the standard participation. The second level represents securities resulting from the securities business with loans, whose share, as previously mentioned, has increased dramatically since2000. The third and the fourth level represent other liabilities and assets whose participation was standard.

Such a fragile structure and active participation in international financial markets caused for the first effects of the crisis to be seen and experienced on 17th September 2007., when the bank sought the assistance of the Central Bank as to be able to continue with further operations. The analysis showed that the bank was solvent and that attaining guarantees by the state would be the best solution so as to regain the trust of its clients. However, it did not show any results and on 21 February 2008. The Northern Rock Bank was nationalized.

Financial institutions, such as “HBOS” and “Loyds” had 36 that is 23 billion pounds respectively in these toxic loans. Such a structure threatened to create problems in the operations of these institutions. The first problems that “HBOS” reported on February 2008 were related to the loss based on the securities business worth 227 million pounds. Unfortunately, the loss did not stop at that figure, but increased instead, and in July that same year it reached the level of 1.09 billion pounds. After that, it was clear that the nationalization was the only solution, what eventually happened in October 2008, when the “Loyds TSB” took over the control package.

FIGURE 3: GDP FLOW IN UNITED KINGDOM



Repercussions, that the whole economy felt, were also very serious. Gross domestic product has been decreasing repeatedly for six quarters since the beginning of 2008. It is important to note that such a decline has not been remembered since 1955.

Besides manufacturing, these significant effects have reflected badly on unemployment too, which is currently at the level of 7.9% that being the highest level in the last eleven years. What is even worse is the fact that the continual growth in unemployment is expected in the upcoming period. In regards to the structure, the worst situation is in the financial and the construction sectors that have been recording a permanent market growth since 2008. In addition to that, the unskilled, young employees have paid the highest price of the global economic crisis.

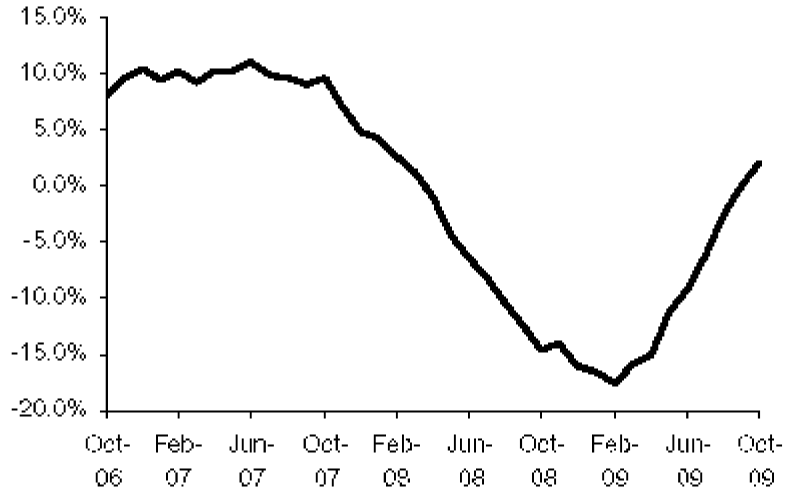
It was clear to everyone that the situation was alarming. The necessity for some serious reaction at all levels was not questionable. In order to avoid blocking the operations in the financial sector, which was caused by liquidity problems in banks, permanent injections of money by the Central Bank of England were required. This would help banks to continue issuing credits and customers would be more confident in banks. In addition to motivate savings, the value of guarantees on savings deposits increased from 35,000 to 50,000 pounds.

Government plan and the plan of the committee for the economic crisis were to create an atmosphere for increased investment and consumption. By expansive monetary policy of lowering the Central Bank interest rates and expansive fiscal policy of lowering tax rates they created the climate for increased investment of business sector. The process of lowering interest rates in 2009 landed at an extremely low level of 0.5%.

The desired effects of any significant increase in investments weren’t achieved at first, as evidenced by the fall in GDP. However, the reason for hope was the fact that in the last quarter it was only 0.4%. In addition, much more important reason for optimism was the increasing prices of real estates.

Economists believe that after each crisis, during which the depreciation of real estate prices occurs, this market experiences the slowest recovery since the speculators, as well as the population, tend to think that prices will fall even more and they wait for a moment when prices would come to a minimum. In this waiting period prices experience the “free-fall”. The situation in the UK fully disproved this theory and in early 2009, a steady growth was recorded.

FIGURE 4: REAL ESTATE PRICES IN UK



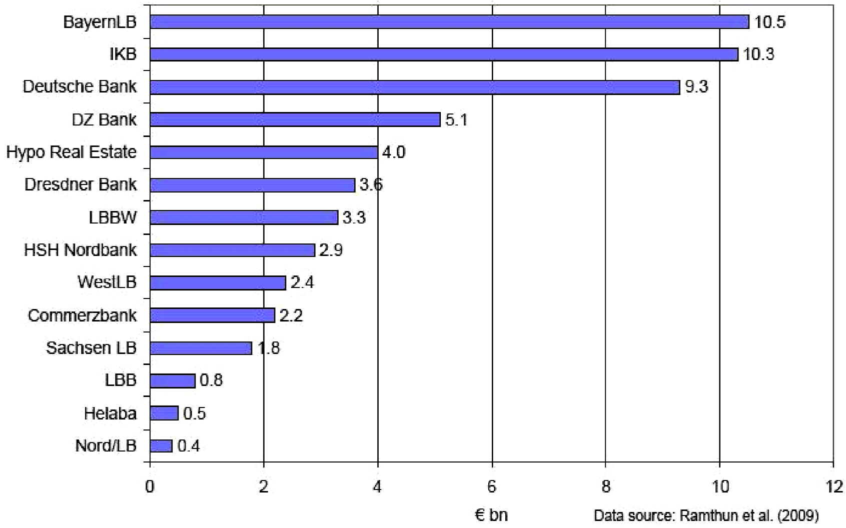
IMPACT OF THE CRISIS ON GERMANY

In the preceding years, the development of the financial sector in Germany did not follow the progress of the financial systems of the countries from the region. The mortgage market in Germany, which has been existing for about 200 years now, is significantly different from the Anglo-Saxon type of the mortgage market. In addition to that, since the 1990s German banks have been issuing bonds (Pfandbriefe) based on mortgages, but in contrast to the methodology of the USA and the UK, mortgages have not been transferred onto the legal entity, but the banks kept them instead. Those bonds are sold with the low interest rate, because of their high liquidity and safety, since their correctness is being constantly monitored by the bank.

Besides, for a bond issue, it is necessary to get a state's consent, which can only be received if all the legal rules are being followed and if it is allowed for the state to monitor the bonds all the time. Regardless of what has been previously mentioned, the financial sector does not play a significant role in the domestic

product of Germany, meaning that direct contribution of financial industry to the GDP of the country is not significantly big. Compared with other countries from the region and the world, it is clearly seen that its minor contribution to the added value of GDP is only 5%. The following graph confirms that empirically.
From what has been previously mentioned, it could be wrongly concluded that any positive and especially negative change in this sector would not have any negative effects on the real economy itself. On the contrary, since the beginning of the financial crisis, the financial sector has suffered the loss of about 38 billion Euros, which is, by some predictions, only 10% of the overall loss.
The real estate market stayed pretty much stabile, with the growth of only 5,9% in the period from 2003 to 2006, as opposed to the markets in other countries from the region, where the prices grew rapidly (Ireland 153%, Greece 148% and Spain 132%). That was one of the main reasons that enabled German economy to save itself from the first wave of the crisis caused by the rapid downfall of the real estate prices. However, the second wave, which was created as a consequence of the bankruptcy of big investment banks and the loss of the value of bonds, which were issued based on the mortgages, could not left Germany immune to the global crisis.

FIGURE 5: LOSSES OF BANKS IN GERMANY IN 2009



First serious problems were reported already in August 2008 by Sachsen LB and Deutsche Industriebank AG. Sachsen LB reported losses, which were the consequence of the trade with securities issued on the base of subprime mortgages, and they asked for the loan to keep its current liquidity. Later on, all the other banks, in a row, reported huge losses and the decrease in value of equity, amongst them first having been Bayern LB, then IKB, Deutsche Bank, and others. Next graph shows the list of German banks that reported the biggest losses in 2008.
It is also important to reflect on the distribution of the loss among three basic columns of banking that exist in the German financial sector. The first and the third level are commercial and cooperative banks that have significantly lowered losses in comparison to their market shares, which is the reflection of their managers' interests, who wanted to make lower, but more certain income. The second level is savings banks, which have had disproportionally huge losses when compared to their market shares. The reason for this is their active participation in the international financial market, as well as the extremely hazardous behavior of their management, which is up for discussions for a much longer period of time. The fourth level is specialized banks, which are the only ones to make lower loss in comparison to their market share.
The damage that entire economy has suffered directly as a consequence of the loss in the financial sector (about 0.4% of its total value or 1% of GDP) is minor when compared to the indirect effects of this crisis. The first step every bank takes the moment it becomes aware of its loss and possible liquidity problems is to tighten the conditions for lending and to increase the interest rate.
Such behavior results in the increase in savings (in period from 2007 to 2008 saving was increased for 14.6%), but also in the decrease in investments taken by firms, as well as those taken by the population. Moreover, what occurs is the decrease in inter-banking loans, which additionally complicates the situation and the liquidity problems. All together it makes the number of the allowed loans fall drastically, which has been the case with Germany, and that is proved by the following graph, which analyses the number of approved loans to small and medium firms. However, policy makers are aware of the possible consequences of the fall of total savings and therefore they have undertaken a serious of actions to help banks in order to enable them to do their business normally.
The action plan for the stabilization of the financial market was made incredibly fast and on October 18th it was made public and applied immediately. The basic idea of that plan was to balance the money market and banks' business. Modeled according to the American TARP, a huge amount of money was planned to be used for that purpose, about 400 billions of Euros. The first 400 billions were planned to serve as a guarantee for the assets of the banks, while the rest was to be used for the recapitalization of banks and for purchasing valueless assets. The nationalization of the banks was also one of the possible solutions for the liquidity problems, in what way the state would pump liquid assets into the banking system and rehabilitate it for normal business, and in return it would get a share in the ownership. First nationalization was done with Commerzbank, when the package of 25% of equity was overtaken.

CONCLUSION
The hazardous behavior of certain individuals in the US financial market caused that very sector to collapse completely, there go pull the entire economy into a recession. The bankruptcies of investment banks and other financial organizations, involved in businesses with new financial products, became an everyday life, while the value of the assets was depreciated over night. Under the influence of these negative effects, bad sequences spilt over thus were felt in the entire world. Banks in the UK and Germany kept reporting huge losses and asking for help from the central monetary institutions.
The existing economy sector was also badly affected. The stock indices reflected every vibration and displayed the current state of the economy. In November 2008, the industrial index Daw Jones fell down to the lowest level ever recorded in history, i.e. 7552. The decrease in the economic activity initiated a huge growth of unemployment, in the USA 10.2%, in Euro zone 9,7%, in the UK 7,8% and in the other countries of the world, respectively.
Since the issue in question is the worldwide economy crisis and not just a minor economic downturn, it has only attached even greater importance to the very moment at which further mutual steps for overcoming the newly arisen situation are taken and decided upon. On the other hand, the awareness of the policy makers that there is a big similarity between the crisis that has been happening these days and the one from 1929 has made them ever more confident that the only possible solution to the existing problem is active intervention of the government. Regardless of the great resistance of the tax payers, who are supposed to carry out the whole burden of the stabilization programs, TARP, FMStG and other similar programs have been accepted without any corrections whatsoever.
First, but fairly small positive effects of the programs mentioned above, were felt already by the mid of 2009. Banks that had received the funding from the TARP were able to make profit and repay the loan, and the stock indices in the USA and the EU recorded an increase. However, the entire economic picture is far from being ideal and it is unreal to expect any significant improvement any time soon.

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