



Released July 18, 2008

## **A child's guide to the sub-prime crisis and other troubles**

Professor Bill Mitchell  
Director, CofFEE

The billions of dollars recently shed on global bourses reflect fears that a major recession is looming. Investors are seeking safe havens for their funds.

The US, the world's largest economy, has been near recession for months as a result of the so-called sub-prime crisis. In turn, world growth estimates are being downgraded significantly.

In Australia, despite on-going growth the cost of living is rising and the risk of widespread mortgage defaults is increasing as commercial banks hike interest rates.

Meanwhile, world starvation is increasing as food prices escalate.

All the events are linked and expose the fragility of the wealth generating machine we call the world economy. The chain goes like this.

Market economies are myopic and are driven by greed which prioritises profits before humanity.

Recently, those strange named US financial institutions – Fannie Mae and Freddie Mac had to be rescued from insolvency. These mortgage juggernauts dominate the US home lending market. They profit by buying mortgages from banks and brokers and then on-selling them in guaranteed bundles to other investors. Their guarantee derives from the "credit line" they enjoy from the Federal Reserve Bank (the US equivalent of our RBA).

Over the last decade, these institutions and other mortgage brokers sought bigger profits and successfully pressured government to relax the 80/20 rule on mortgages. The 20 per cent deposit rule was intended to deter borrowers from taking loans they couldn't afford.

As lending rules slackened, billions were loaned to home buyers with no deposits and precarious work and past debt servicing histories.

While we should extend home ownership to the poor to provide intergenerational wealth building capacity within poor families the expansion of credit in the US was unsustainable. It would have been better to provide the poor with risk-free public home loans.

While profits initially soared, the financial markets didn't factor on the rapid growth in China and India driving up world energy demand and inflation rates.

To reduce inflation, central banks increased interest rates. The rising rates caused large-scale defaults among marginal home borrowers due to unsustainable debt servicing costs and loss of income due to rising unemployment.

The same financial institutions that had profited by pushing massive debt burdens onto the poor now had to write off billions in bad debts.

The financial markets reacted by shutting off credit which pushed up borrowing rates to the commercial banks. These banks aggressively borrow from domestic and foreign sources and then loan at higher rates to domestic customers. With the cost of funds rising, Australia's big banks have taken the unusual step of increasing mortgage rates beyond the RBA rate increases.

So does the sub-prime crisis matter? The real economy, where real goods and services are created and jobs generated, is somewhat separate from the financial turmoil.

However, the rising inflation and global credit crunch is now clearly impacting on world production and unemployment is rising around the world.

While Australia enjoys strong demand for our primary commodities as part of this energy binge in China, the higher petrol prices are reducing our living standards.

Until recently only wealthy nations could afford having high levels of car use. The rapid industrialisation of China and India has allowed them to generate enough wealth to compete with the wealthier nations for energy.

Oil prices are set by a small number of nations who enjoy a near monopoly (for example, Saudi Arabia). With demand from China and India so strong, these "swing producers" are able to increase output while pushing the prices ever higher.

The competition for oil has significant distributional impacts. The wealthy in China are, in effect, squeezing the poor in the US and Australia and elsewhere who are increasingly unable to afford to drive while maintaining other financial commitments.

But the problem is worse and goes to the basis of our humanity.

Driven by the higher oil prices, Western investors are pouring cash into biofuels to extract energy from wheat, soy, corn and other food products.

In a misplaced effort to be green (abetted by environmental lobbies) and to provide some energy security, governments have given huge subsidies to the biofuels industry.

The diversion of food into fuel has dramatically increased food prices and starvation is rising.

So the desire of wealthy to run their cars and profit is causing starvation elsewhere.

This period in our history is marking a fundamental shift in world economic power towards China and India and away from Europe and the US.

It is a mixed bag for Australia. As a primary commodity exporter we are enjoying good times. But consumers are suffering the rising fuel costs and the sceptre of world recession is threatening to stop us all.