

## **Financial Stability and Instability Presented by the Example of Sub Prime Crisis**

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*Abstract: The millennium created a great number of favourable conditions for the American economy. There was economic prosperity, the participants were optimistic, which was further enhanced by the optimism of the fiscal and monetary authorities. These factors resulted in a very quick rise in the demand for real estate, a boom in the real estate price and in addition, the prosperity of the mortgage market. The low global level of interest made application for different types of mortgages possible for many people. This practice of granting credit lasted till 2007 when the real estate market bubble blown so huge in the previous years and was born and kept alive by the careless interest placement practice of credit institutions burst. The objective of our paper is to present the unstable state of financial instability through the example of the crisis of the American mortgage market by highlighting the main reasons and arguments that generated and kept up the crisis. During the making of the study we relied on the most up-to-date sources to make a true picture of the present state of the crisis.*

*Keyword: crisis, Minsky theory, global effects, Hungarian effects*

## 1 Precedents and the Present Situation

The strength and stability of the American economy exist only in the past. The real estate boom that peaked last year and the real estate crisis that came alive as a side effect have spread worldwide so there is no single economy that could not be more or less affected in this process.

Subprime credits became attractive in the second half of the 90's and it was not until 2004 when they reached a record height. In the meantime, real estate prices also soared that helped speculative investment in real estate to be prosperous in the hope of gaining bigger profit. Alan Greenspan, president of FED favoured both the public and the banks with the base rate set around 1-2% but as we can see, only in short term. Minimal level of interest rate resulted in unlimited credit extensions. The American banks, the most innovative and developed representatives of the financial intermediary system came along with countless financial constructions when noticing the situation, which only increased demand for credits inducing huge bank earnings. The competition between creditors in the USA resulted in the considerable loosening of credit conditions by taking a greater and greater credit risk for the extra profits that could be realised. Among the debtors the so-called „subprime<sup>1</sup>” debtors appeared in greater numbers whose creditworthiness is below the standard (those with low income, unemployed, pensioners (Fischer-Kócsán, 2008).

Subprime credits have considerably greater interest earnings with which risk is in line. The real innovation in profitability and risk reduction is a new phenomenon, making mortgage securities, that was the cheapest step towards enhancing liquidity from the part of the banks. Careless credit extension was even made worse by credit assessors as it should have been their task to examine the credit risk of securities issued this way.

The real decrease began in 2006 when the real estate market started to go down and due to the rise of the interest rate, credit debts became greater so bad debt appeared in masses causing significant losses to investors (Pénzcentum, 2008b).

The process reached its peak at the beginning of 2007 and in spring there were fears and doubts about the riskiness of American mortgage market (MNB, 2008). The stability of subprime and other mortgage bonds was shaken and it was confirmed by the leading credit assessing institutions. By autumn the first, most striking signs of the crisis became visible: market uncertainty and rumours about bank losses flooded the market. Inter-bank market totally dried out not only in the USA but also in the Eurozone.

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<sup>1</sup> The group of risky clients who used to have payment difficulties, who do not possess the required collateral and due to their low income, the debt/income proportion is rather high.

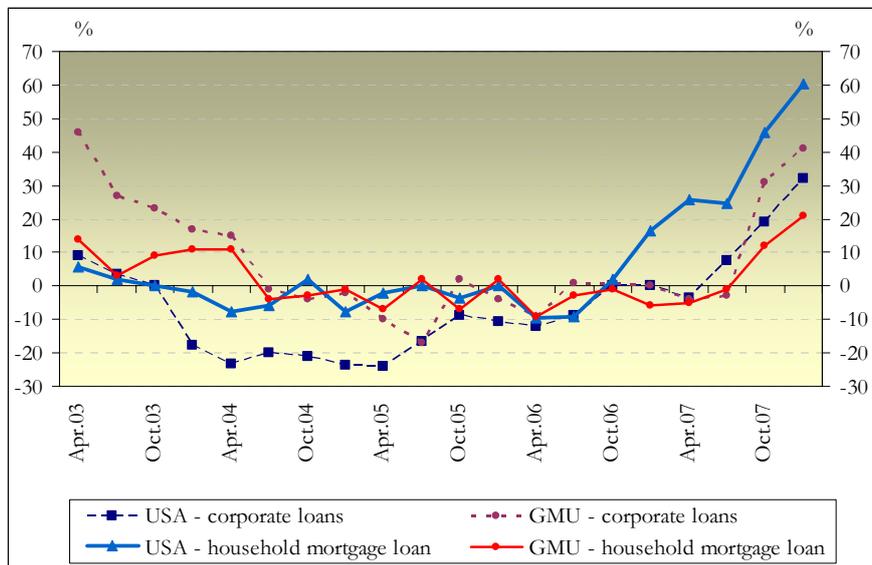


Figure 1  
Changing credit terms between 2003-2007<sup>2</sup>  
(Source: MNB)

As most banks do not know how some single institution is affected by the crisis-hit American market, we can state that global lack of trust was created among the players of the financial system. The lack of trust led to the fact that banks were not willing to extend any secured or unsecured credits to one another so practically their extra liquidity was piled up on their own accounts. According to a study of the Hungarian National Bank (MNB) published in February 2008 (Fischer-Kóczán, 2008) „liquidity did not disappear from the system only its redistribution became impossible”. Since the beginning of the crisis banks were less and less able to finance their transfers from external resources. Moreover, a significant part of American households went into debt. These two factors led to the abandonment of aggressive crediting practices of the banks whose direct outcome was the reduction of bank profits. In the first couple of months of the present year banks were compelled to write off significant losses<sup>3</sup> and it was truly reflected in the rate of their stocks<sup>4</sup>.

Global lack of trust in the whole banking system still holds true nowadays although signs for the end of the crisis are also visible. The greatest losers of the

<sup>2</sup> Positive values mean making the terms stricter, negative values indicate making the terms looser.

<sup>3</sup> Several ten billion write-offs per institution.

<sup>4</sup> Rate decline was a lot greater than justified in many cases as the market priced a greater loss than actual.

crisis and the drying out of inter-bank money market are credit banks who do not possess public savings so the only source of financing their activities derives from the inter-bank money market.

Credit market crisis last nearly one year but we still cannot draw a balance how many credit institutions, companies and households how and to what extent are affected. Fear still controls market participants but there is a slight ray of hope for the future. Markets, stock exchanges and rates are still “ready to jump” and extra sensitively react to any kind of change.

However, the market needs years to get over the shocks. If we only consider the outcomes of the dotcom crisis, we can see how surprisingly long time (7 years) were necessary for the sector to regenerate. According to the opinion of some experts the banking system “needs not less, either” as the trust in riskier money market tools is totally lost and their extra liquidity is invested rather in safer investments of lower return (Portfólió, 2008a). The behaviour described above is also presented by Figure 2 that shows the greatest write-offs of global financial players in connection with the crisis. It can be seen that the crisis also affected the biggest institutions not only the more sensitive credit banks failed as a result of the crisis.

Furthermore, it is also striking that among the listed financial players only a few are European institutions but the losses were enormous here, as well.

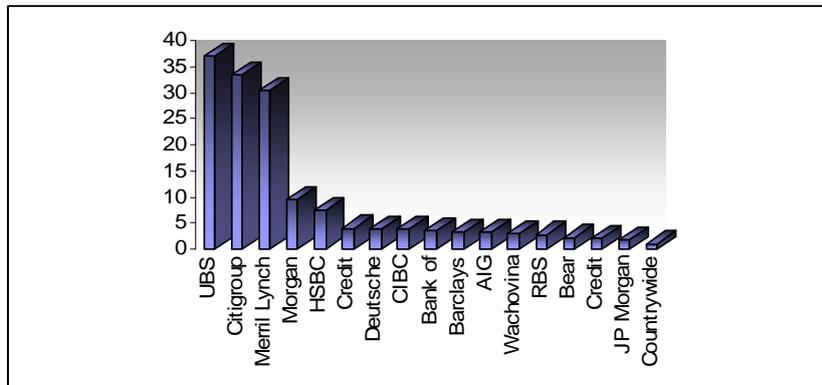


Figure 2

The greatest write-offs of international financial players (bn USD)

(Source: Portfólió.hu, 2008a)

## 2 Mortgage Market Crisis and the Minsky Theory

The financial system if not controlled can develop bubbles by destroying itself. This correlation was formulated by Hyman Minsky, American economist years ago. According to the Minsky theory all crises has seven well discernible stages and declares that crises have a lot in common in many aspects.

The stages of crises:

1 Displacement:

All crises begin with a trouble so there is something uncommon happening in the market (economic-political change, decrease in the rate of interest). This change can affect any sector of the economy.

2 Prices start to increase:

As a result of the change prices are about to rise in the affected sector. At the beginning the economic players can hardly feel price rise but if this effect is there to last, the players' attention is caught.

3 Easy credit:

High prices themselves are not enough to create a bubble so it needs a kind of „fuel”: easy credit. If the participants of the financial sector did not heat the situation with their easy credit, the affected sector would return to the ordinary state. Easy credit attracts players from outside who join this affected segment of the economy in the hope of making more profit.

4 Overtrading:

As a result of easy credit markets start to grow dramatically that is reflected in greater trading and scarcity in some cases. Prices start to rise that induces huge profit making on the supply side. Consequently, the sector attracts more external participants and prices will become uncontrolled. The rising pace of price increase attracts more and more careless and greedy participants to the market. As fire needs more wood to burn better, bubbles also need more outsiders.

5 Euphoria:

The bubble created this way cannot grow further. Experts can see the coming crisis and warn the others but the participants do not want to listen. Prices will soar further and speculation starts. Speculators know that prices cannot go up forever but they deny it to attract more outsiders. Speculators will remain in the market till the situation seems to be stable but they exit before the bubble bursts and the „less knowledgeable” players will be stuck inside.

6 Insider profit taking:

Certain players gain huge profit in the making of the bubble but others will fail. „Insiders” will come out in silence with their pocket filled, which signals the beginning of the end.

7 Revulsion:

Revulsion can be evoked by several factors: the profit line in the sector declines dramatically, unexpected bad news and euphoria will immediately turn into revulsion. The sector is „in flames” and everybody escapes. Revulsion comes, prices decrease, profit rates go down and it is the end for easy credit. Losses pile up, everybody escapes but there is no way out.

Minsky with his theory formulated the paradox of bubble theory (Shostak, 2007): everybody knows that the combination of easy credit, over-demand and euphoria will sooner or later become lethal. However, America falls in the trap from time to time so starting from the supply bubbles to the real estate bubbles we could meet a lot of types of bubbles so far. As it can be seen, the stages listed above can be traced from point to point even in connection with the present-day sub prime crisis. A question can be raised: if there is a useful theory about the creation and operation of crises, then why do not the economic and market leaders listen? In our opinion analysing the answer would be too difficult but could be summarised in four words: the greediness of market participants.

### **3 The Effect of the Crisis on European and Hungarian Participants**

The crisis rearranged the economy of the United States significantly. Households went into debt in such an excessive way than never before so through the cutting of their consumption expenses they significantly hinder economy. Through the tight relation of the EU and the USA the effects are transferred to the European economy so Hungary is not an exception, either.

Financial markets are related on a global level, they cannot exist in isolation, they are in everyday financial contact or they are subsidiaries or parent companies of one another. Our country can be regarded lucky from the aspect that the parent companies, headquarters of our banks are not or only slightly affected in the crisis. Global lack of liquidity directly or indirectly has an impact on our country, as well.

As we know, Hungary acts as a net liabilities importer on global financial markets. In a country like Hungary, that significantly depend on international capital import making it more difficult by the unfavourable prospect of growth, the high level of indebtedness and rather bad or worsening macroeconomic indicators from a

regional aspect, the aftermaths of the crisis can definitely be felt that has an outstanding impact on the assessment of the national government securities. For many national banks, even everyday operation was made more difficult that causes financing problems for a net liabilities importer. The amount of the available external sources has been limited and the costs of the present ones are rising, which makes the competition for clients with savings tighter (Pénzcentrum, 2008a).

The stability report of the MNB draws attention to the topicality and importance of the topic (MNB, 2008), too. The specialists of the central bank approach the domestic effects from two sides: internal and external risks.

Among the external reasons they mention the impact of global slowdown on decreasing export as well as the decreasing pace of global economic growth. For Hungary, it means decreasing revenues from the export that has a negative effect on the otherwise declining GDP figures. Moreover, the risk premium of the national assets can increase that weakens the forint, can increase the basic interest rate and can make import more expensive by decreasing output and increasing inflation risks. Besides, even the involvement of external assets is made more difficult for the corporate sector so their investments decrease and, as a result, they also hold output down, which can even worsen our not so attractive prospects of growth.

The report lists the negative impact on the originally so little growth among the internal risks that can be due to three factors of key importance:

- a) unfavourable labour market processes, lack of incentives and the rather high tax burden,
- b) low corporate investment,
- c) growth rate curbing real convergence process.

The economic slowdown has an unfavourable impact on the vital macroeconomic issues, both consumption and investment, which refers to the more pessimistic expectations and the decreasing incomes incurring the decreasing demand for credit both in the corporate and household sectors (Portfólió, 2008b).

If most of the outlines internal and external factors are realised, a really catastrophic picture can be made in connection with one of the most important macroeconomic factor, i.e. growth. Nevertheless, it is good news among the bad ones that companies as profit-oriented organisations are able to adapt to the altered economic situation quickly. Their demand for labour is restricted to maintain their profit level and their investment activity is also decreased due to the rising costs of materials. Unfortunately, the above-detailed behaviour of the companies will have a negative effect on households. It is true that real wages showed a slight increase in the past years but unemployment also increased- making the indebtedness of households even greater. This process is further enhanced by the aggressive marketing policy of the banks and the poor financial knowledge of households.

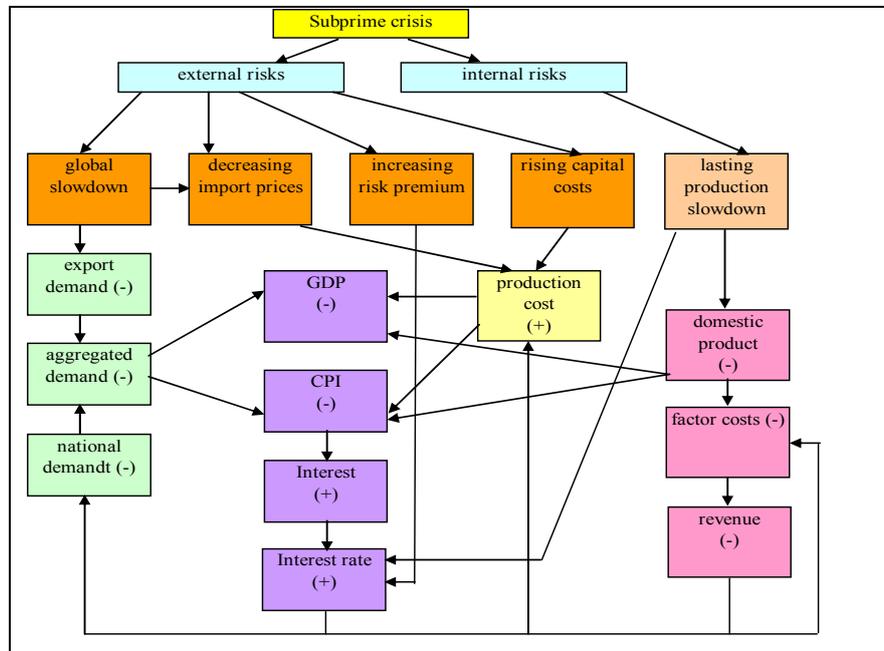


Figure 3

The possible effects of the sub prime crisis in Hungary

(Source: MNB, 2008)

### Conclusions

To sum it up, we can state that the Hungarian economy will have to face difficult macroeconomic circumstances both in national and global levels in the forthcoming years. The factors below will affect macroeconomic situation (Portfólió, 2008c):

- improving budgetary balance (if the projected steps and paces can be kept in the future),
- decreasing need for external financing due to the careful banking sector, the planned restriction of state expenses and the decrease in investment activity,
- low and slowing down economic growth,
- rising prices of consumer goods and those of raw materials,
- rather significant inflationary push.

However, we hope that the reasons listed above will not be considerable and the awaited economic miracle will be realised functioning as a protecting shield against the possible aftermaths of the crisis.

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