

# The Impact of the Subprime Mortgage Crisis on the Us and World Economy

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**Keywords:** Subprime crisis, Formation process, Cause of formation, A major influence, Revelation

**Abstract:** America's 2008 monetary crisis is additionally known as the subprime crisis. In the years from 2000 to 2006, housing fees in the United States increased rapidly. Because of high housing prices, many families are struggling to manage to pay for high housing costs, and many people with low incomes or negative credit score histories are unable to get domestic loans. In the monetary environment of these years, the interest price in the market was once usually very low in contrast with the speedy growth of the housing price, so it was once also a way to amplify the earnings of the loan companies, so the loan groups issued a giant quantity of subprime loans.

## 1. Introduction

At that time, a individual with a very low profits to get via walking into a mortgage employer in the morning did no longer want to grant a lot of guarantees, and in the afternoon ought to get a a hundred percent mortgage to purchase a house. By late 2006, many of the low-interest costs on subprime loans had come due, and subprime borrowers faced higher mortgage payments. In this way, the first borrowers have been foreclosed on because they ought to no longer pay their loans. The subsequent aspect the lender wishes to do is put the foreclosed property on the market and promote it to cowl the loss. Because of this, a giant quantity of homes want to be offered on the market, and a giant grant and inadequate demand lead to the decline of house prices. For example, if you borrowed \$1 million from the bank five years ago to buy a house, and you still have five years to pay back the loan, the remaining outstanding amount of the loan is \$900,000. Five years ago, your house was worth \$1 million, but now it's down to \$500,000, and it's not going up. If you're rational you're going to walk away from the loan in this situation. Because it's only worth \$500,000, you don't have to pay off the remaining \$900,000 for something worth \$500,000. As house prices plummet, many borrowers will walk away from their loans, leading to a surge in bad debts at the lenders. A lot of people who had been getting new mortgages all at once realized that my house wasn't really worth anything now, so they defaulted on the loan, and there used to be a second wave of defaults. As a result, their homes have been liquidated as collateral and put on the market for sale, further driving down house prices. Such a vicious cycle led to a extremely good disaster in the charge of subprime loans. There are several main reasons for the subprime mortgage crisis, one is the subprime mortgage securities left hidden dangers. Subprime mortgage securities are financial derivatives that obtain funds by packaging and selling subprime mortgages. Due to its high leverage and low quality of subprime mortgages, subprime mortgages contain extremely high risks. The second is the direct cause of falling housing prices. When the Fed raised activity prices in 2006, it induced domestic house fees to fall, which in turn triggered massive swings in the secondary bond market. Third, credit score default swaps in addition amplify the risk. The subprime mortgage crisis was once brought about with the aid of the bursting of the real estate bubble in the United States. A large range of middle and low-income people have been unable to repay their debts, and many families offered their homes at a low price, leading to a sharp decline in housing consumption and the fall in real estate prices, which further exacerbated the bursting of the real property bubble. In the United States, sales of new homes and construction had fallen by half from their peak at the end of 2007, and real estate investment was at its lowest level in nearly 27 years. It is widely estimated that the housing market is only halfway through this downturn, and the negative effects will continue to spread.

The output value of the US real estate industry accounts for 5% of GDP, contributes up to 75% of employment, and plays a decisive role in the growth of private consumption, which is the key to the US economic growth. The double blow of the bursting of the real estate bubble and the subprime loan crisis has considerably reduced the “wealth effect of housing prices” of the American people, directly weakening American patron confidence and client spending. We will improve the regulatory system. Banks should operate safely and liquidly before they become profitable. Improve the securities market. The market value of listed real estate companies accounts for a large proportion of the securities market. The fluctuation of its stock price greatly affects the stability of the whole stock market. The rapid rise in house prices will indirectly widen the gap between the share prices of acquired property companies in the secondary and primary markets. This greatly increases the risk for investors in the secondary market. We will strengthen the resilience of banks. The essence of banks is chance management. To reduce the have an effect on of the crisis on banks, banks need to have the capability to face up to risks.

## **2. The Impact of the Subprime Mortgage Crisis**

In October 2007, the subprime mortgage crisis that originated in the United States unfold to the international economic market and then introduced the global economic system into a downward trajectory, turning into one of the most serious monetary crises in the history of American finance and even in the international finance. Its inner mechanism is the lack of transparency of monetary products, statistics asymmetry, and financial risks are progressively transferred and amplified to investors. These risks spread from housing to deposit markets, capital markets, from the monetary region to the economic sector, and via funding channels and capital channels from the United States unfold to the international scope. The crisis can also drag the US financial system and even the global economic system into the abyss of recession, which also motives the profound reflection of financial innovation, disaster transmission, and chance prevention in quite a number countries.

The dot-com bubble burst in 2001, plunging the US economy into recession. The Bush administration's design to improve monetary growth, stimulate real estate and encourage American families to purchase homes. But at that time, the demand for houses through the wealthy category in the United States used to be saturated. As a result, the authorities turned its attention to those with low or medium-income or uncertain income or no income, and these human beings with low credit rankings became the darlings of the real estate market consumption, which led to the large issuance of subprime loans. After 2001, the Federal Reserve cut hobby prices 13 consecutive times. The federal funds charge dropped from 6.5% in early 2001 to 1% in June 2003, and the interest fee on 30-year fixed-rate mortgage contracts dropped from 8.52% in May 2000 to 5.45% in March 2004. Legislation in the United States requires monetary institutions to make loans to the poor. Loose lending costs have spurred demand for home purchases with the aid of low-income groups. In the United States, the majority of financial institutions that make subprime loans are mortgage companies. To cost more fees, they blindly developed the customer market, overlooked or even deliberately concealed the customer's borrowing risk. Subprime mortgages are loans made to humans who have defaulted in the past, often without jobs, normal income, or assets. This group of humans normally do no longer have correct repayment ability, but they can nevertheless get loans easily, and some banks even provide loans to them on their initiative. Many subprime lenders provided zero-down loans, allowing borrowers to buy residences besides capital and in reality declare their income except offering any proof of their ability to repay. In 2007, the complete fee of monetary products linked to subprime loans reached \$8 trillion, five times the dimension of mortgages. Under the Fed's policy of low-interest rates, the fees of homes used as collateral have been rising. Even if there is a default, the bank can auction off the residence as collateral. Since house fees have been rising, banks are no longer involved about losing cash if borrowers default, so they are setting lower and lower threshold requirements for debtors and expanding their loans like crazy. The percentage of residential investment in the whole investment reached 32% at the peak, and the annual boom fee of new housing construction exceeded 6%. The Federal Reserve raised the federal dollars rate 17 consecutive times in two years from June 2004 to June 2006. Home costs in

the 10 largest U.S. cities rose to an all-time high of 226.29 in June 2006, 2.9 times the level in December 1996, in accordance to a 10-city index of home prices. The upward thrust in benchmark activity prices progressively pricked the bubble in the US housing market. Since 2006, the S&P Case-Shiller index, which displays modifications in house costs in essential US cities, has fallen significantly. For mortgage providers, falling residence costs have reduced the value of collateral, making it impossible to sell the collateral to recoup the important and interest on the loans. For subprime borrowers, falling home expenses have left them unable to take out new mortgages on home-equity loans and unable to repay the fundamental and hobby even if they promote their homes, so they have to default. In February 2007, HSBC added \$1.8 billion to provisions for terrible loans at its U.S. subsidiary's subprime business. In April 2007, New Century Financial Corporation, the second-largest subprime lender in the United States, filed for bankruptcy protection, and extra than 30 subprime mortgage corporations went out of business. Next came institutional buyers such as hedge funds and investment banks that bought subprime RMBS and CDOs. Lehman Brothers, Merrill Lynch, RBS and other massive European banks were nationalized one after another. The purpose why the US subprime mortgage disaster escalated into the international economic crisis used to be that the US housing loan belongings were derived into other monetary products by using funding banks and resold to world investors. This economic innovation intently linked the US real estate market and the world economic market in no way before.

The American subprime personal loan crisis and the bursting of the actual estate bubble are mutually causal and at the same time reinforcing, forming a vicious circle. By the cease of 2007, sales and building of new homes had fallen by way of half from their peak, and real estate funding was at its lowest stage in nearly 27 years. It is widely estimated that the housing market is only halfway through this downturn, and the negative effects will continue to spread. The output value of the US real estate industry accounts for 5% of GDP, contributes up to 75% of employment, and plays a decisive role in the growth of private consumption, which is the key to the US economic growth. The double blow of the bursting of the real estate bubble and the subprime personal loan crisis has significantly reduced the “wealth effect of housing prices” of the American people, without delay weakening American patron confidence and customer spending. Consumer confidence index has been on a downward slide since the second half of 2007, falling to 87.9 in January 2008, down 21.4 percent from July 2007. Retail sales fell 1.2 percent in September, the biggest drop in three years. US personal consumption expenditure has slowed markedly since the fourth quarter of 2007. Industrial production stagnant or negative since July 2008, rising 0 percent, -1 percent, and -2.8 percent month-on-month from July to September respectively.

In the European interbank market borrowing rates with maturities of more than a few days rose in the wake of the subprime crisis. This is partly because of fears that borrowers may fall delinquent because of subprime exposure. On the other hand, considering their future demand for liquidity is difficult to be solved from the market, they need to maintain more liquidity. As a result, the spread between money market rates and short-term government bonds has widened sharply and the market is facing a severe illiquidity problem. In the interbank market, for example, the spread between three-month lending rates and short-term government bonds was less than 20 basis points before the crisis. The subprime crisis interrupted the technique of the European Central Bank's tightening monetary policy. It was once broadly expected that the ECB would continue to increase interest prices in 2007 to tighten its formerly unfastened monetary policy to head off inflation in the medium to long term. However, after the outbreak of the subprime mortgage crisis, the liquidity scarcity appeared in the money market, and the ECB's interest rate hike was once certain to aggravate the shortage, and the economic trend of the EU was once greater unsure due to the subprime mortgage shock. To stabilize the economic situation, the European Central Bank had to choose to maintain the contemporary activity rate unchanged. But the ECB's selection has some negative implications for its efforts to curb inflation. After the subprime mortgage crisis, the financial belongings held by way of some banks and financial institutions shrank significantly, which hurt their balance sheets and confined their ability and willingness to lend money,

consequently causing a credit crunch. On the other hand, after the subprime loan crisis, the bank's use of asset securitization to disperse and transfer credit risks is reduced, which will lead to the upward thrust of deposit pastime rates and the implementation of greater stringent lending conditions, which will also cause deposit contraction. Household debt in the euro vicinity has risen rapidly in latest years, from 45 percent of GDP in 1999 to 59 percentage today. Its share of disposable income has risen from 70% to 90%. The debt is mainly used to finance real estate investments. The credit crunch will have an effect on the direction of the housing market and, in turn, household customer self assurance and housing investment growth. Since housing funding is the fundamental driver of economic boom in many EU member states, its slowdown will also contribute to the slowdown. The upward thrust in hobby rates brought about with the aid of the credit crunch will expand the burden of households' hobby payments and decrease their consumption capacity, which will additionally harm financial growth.

A fictitious economy should serve the wishes of the real economy. The important motive of the subprime crisis is that the fictitious financial system has end up excessively bubbly in the absence of supervision. Unprudent housing mortgage loans, asset securitization, asset management, and other fields emerge in without end financial innovation tools, promote the excessive self-cycle and enlargement of the virtual economy, create false prosperity, and eventually accumulate huge risks. After the economic crisis, the United States and other developed nations have realized that they cannot only rely on financial innovation and deposit consumption to pressure their economy. They have begun to pay attention to the development of domestic industries, particularly advanced manufacturing industries, and have taken “reindustrialization” and the return of the manufacturing enterprise as strategic guidelines to adjust their economic model and rebuild their competitive advantages. These totally show that the virtual financial system is a “double-edged sword”. Based on the wants of the development of the actual economy, the average virtual economic system can play a unique role in financing, facts transmission, market pricing, and other aspects. On the contrary, if the virtual economy “idles” away from the actual economy, it will shape asset bubbles, motive misallocation of resources, motive chaos in the relative price relationship of the economic system, and accelerate the hollowing out of the real industry. We want to center of attention on prudent and balanced macro policies. Although the subprime mortgage crisis happened in the financial field, the imbalance of macro insurance policies together with fiscal policy, monetary policy, and housing policy used to be the predominant purpose of the crisis. Since 2000, the U.S. government's finances deficit has ballooned due to the bursting of the dot-com bubble, government tax cuts, and wars in Iraq and Afghanistan. The combination of large fiscal deficits and international exchange imbalances gives the US an incentive to monetize its debt. In 2000, the Federal Reserve began to put into effect a low-interest rate monetary coverage to stimulate the economy, and the money supply remained loose for a long time. At the same time, the “Home Ownership” housing coverage led to the continuous relaxation of housing mortgage standards, and financial institutions issued a giant number of subprime mortgages. Low hobby rates, expectations of rising housing prices, and ever-loosening lending standards caused speculators and low-income people to borrow a lot to purchase real estate, driving the continued growth of the real property bubble, which was once further exacerbated by way of the proliferation of structured economic products. The bursting of the bubble led to a fall in house prices, at once triggering the subprime crisis. This thoroughly demonstrates that crises in the financial zone are regularly the product of macroeconomic policy misalignment. In the method of promoting economic development, we ought to always adhere to prudent macroeconomic policies and make sure that monetary and fiscal policies are balanced, coordinated, and sustainable. Regulatory departments have to avoid oversight gaps. In concept beneath the influence of financial liberalization, the United States to the emerging of more than a few sorts of monetary innovation of the lack of corresponding regulatory measures, otc complex economic derivatives market regulatory gaps, the investment banking, and corporate governance construction housing credit score institutions and credit score rating companies regulation additionally serious lag, shaped the obvious “regulatory failure”. Financial supervision failed to preserve up with the pace of monetary innovation without delay and failed to entirely investigate

and resolve the risks existing in economic innovation, which was an important cause for the outbreak of the subprime crisis. Financial innovation and monetary supervision are the solidarity of contradictions. Continuous monetary innovation, while promoting financial development and improving economic operation efficiency, constantly impacts the existing financial order and financial supervision system. The recognition of new financial products and services has broken the ancient monetary order and pattern, increasing many unstable factors and requiring new rules to regulate and restrain them. Therefore, the regulatory authorities ought to constantly pay attention to the development of the financial market, so that the financial supervision closely catches up with the tempo of market innovation, to avoid the regulatory vacuum and the absence of supervision.

### 3. Conclusion

A fundamental cause of this disaster is the acceleration of neoliberal economic policies in the US over the past three decades. The outbreak of the subprime loan crisis in the United States started when the Federal Reserve tightened monetary policy. The rising interest price increased the cost of funding and reduced the expected income. This led to the revaluation of subprime loans and derivatives, the decline in the value of volatile assets, and the eventual tightening of liquidity and volatility in economic asset markets. As a result, the demand for actual property investment decreased. Under the action of inflexible supply, the real property price began to decline, and then the overpayment price of subprime mortgages began to rise, and the risks of subprime actual estate mortgages appeared. The real estate loan has the traits of speedy growth and large scale, so it is very essential to strengthen the supervision on the real property credit risk. The US's neglect of risks in the upward stage of economic growth will definitely lead to risks and even the outbreak of the disaster in the downward stage of economic growth. Therefore, it is necessary to re-attach brilliant significance to the risks of financial derivatives. In the subprime crisis of the United States, commercial banks' risk urge for food increased in the boom stage of the economic growth cycle, which brought about the enchancement of their profitability. However, their neglect of risks and rapid expansion also laid hidden risks for them. Therefore, in the rapid development to maintain a steady pace is a rational desire to nip in the bud.

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