Subprime Woes: Are We Out of the Woods Yet?

In the last week, many encouraging signs have been on the economic radar: The Bush administration has stated that a consensus has been reached about the impending $145 billion economic stimulus package, the Federal Reserve has cut their most important interest rate by the largest margin in a quarter century, and bond insurers are to receive government help in order to guarantee that banks will be able to avoid further damaging losses. But are these steps enough to curb a recession in the global economy, or even the US? It would appear that investors are optimistic. The 22nd and 23rd of January both saw rallies, first in emerging economy markets and later in the US, with the Dow finishing up a stunning %2.5 in a single day. Encouraging, yes. Guaranteed to succeed. hardly. Let's go over the effectiveness of each of these strategies individually, and then assess them together.

First, the Bush tax break: $300 per household, allowing up to $1,200 if you have four children. Due to Democratic pressuring, the rebates even go to poor people who can't pay taxes (re: sub-prime mortgage holders). And because Republicans need something for their constituency as well, the rebates are good for couples with income up to $150,000 a year (so that their spending will trickle down into the greater economy, thus providing enormous benefit to all related industries). This represents a meager sum when compared to the average mortgage payment, which on sub-prime loans tends to roughly double once the adjustable rate kicks in. Moreover, the deficit is sure to be off the charts next year as a result of what amounts to pulling money out of thin air.

Now for the Federal Reserve cut. While it took most everyone by surprise, it didn't keep the Dow from ending down %1 the day it was announced (Jan. 22nd). While the stock market made substantial gains over the next couple of days, volatility is the name of the game these days, and cutting the interest rate cut so suddenly on the heels of MLK Day's depressing Asian market performance looked to many like a panic move. The Fed have the unenviable task of attempting to appear composed when they may not always be, and minimizing the impression that they aren't responsive to falling consumer confidence. As no other central bank saw fit to act in concert with the Fed, (save Canada, whose meeting was scheduled and whose cut was a mere quarter-point) many analysts speculate that their motives are driven by short-term need for stability in financial markets, and less by the still-ominous sub-prime threat.

Finally, the bond insurance bailout. If it weren't for this action, few would doubt that the US is headed for imminent recession of a particularly painful variety. But if the mechanics of the financial system, much of which depends on companies being able to confidently lend money (insured with solid capital) to one another, is allowed to grind to a halt? The sub-prime crisis would pale in comparison to the amount of profits that would instantly be lost, which some speculate would be in the hundreds of billions. This is clearly unacceptable, but an inherent danger still exists: Without the course correction on housing prices (and the debt which was transferred to major banks, and then to their, we may be doomed to something similar to the Japanese housing bubble of the 1990's wherein bank managers actively colluded with policy makers to obscure their collateralized debts in a similar fashion to the structured investment vehicles of today's credit crunch.

Taken together, these factors would probably lessen a recession if it were impending. But unless people are able to get more credit, exacerbating existing problems, the downturn the US is now experiencing will likely be long and harsh. The kinks have to be worked out, and the unfortunate aspect of this reality is that those who have the least must pay the most.

About the Author

Escapeso is an Austin realty company. Their site is filled with information about Austin real estate along with a free search of the Austin MLS.