

Deregulation caused the crisis

It was the deregulation of the mortgage market – the interest only loans – which caused the crisis. There is a need for regulation.

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Danish house prices increased by 20% when financial institutions were allowed to implement interest only loans in 2003. Is the crisis we are experiencing today a mix of deregulation and greed? And is it something we should learn from. Photo: Soren Schnoor

Facts

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The global crisis, we are experiencing today, has long been predictable.

Already in March 2006 I concluded in my Masters Thesis, that the burst of the first internationally synchronized house price bubble would lead to a credit crisis, financial crisis and potentially end in a global recession. My conclusions were at the time in line with several leading international economists, which took the alarms from the housing market seriously.

Economists like Robert Shiller, Nouriel Roubini and our own Jakob Brochner Madsen warned that a crisis was on the horizon. They had all identified the initiation of a housing price bubble, which was about to enlarge. Further on, they were all agreeing that the consequences of a busted bubble would be enormous.

With respect to parameters such as income, rent, building costs and inflation it was clear that house prices had experienced unsustainable increases. The long run views only pointed in one direction – a crisis.

3 factors

The foundation for the crisis was made in the US in 2002 due to a massive credit expansion. The aggressive monetary expansion from central banks as a response to the burst of the IT-bubble in 2000 and the uncertainty of the consequences by 9/11 created a boom.

After 8 years of high economic growth we were on the way into a natural adjustment of the economy, but instead of letting the economy adjust it self, the economic growth was swept away by an economic stimuli without comparison.

Central banks lowered the interest rate aggressively, and from political side mortgage markets were deregulated. Together these two factors are the primary factors, why we today are experiencing a historic large downturn.

The illusion bursted

In the US the initiation of the crisis started through the deregulation in 1999, which made subprime loans possible – and from 2002 popular due the low interest rate. The construction of a loan type with an initial appealing interest rate, which after a few years would be adjusted upwards – combined with the fact that the loan was based on the short term interest rate, which was kept extremely low by the central bank – was doomed to fail.

In 2006, when the short term interest rate in the US had increased many suddenly experienced double digit interest rates. Many Americans could not handle their monthly payments. The interest rate is however, not only important for the monthly payments on loans, but is also a key factor for the pricing of real estate.

The illusion of ever increasing house prices bursted, and the consequences is, that even today 20-25 pct. of American house owners are technically insolvent.

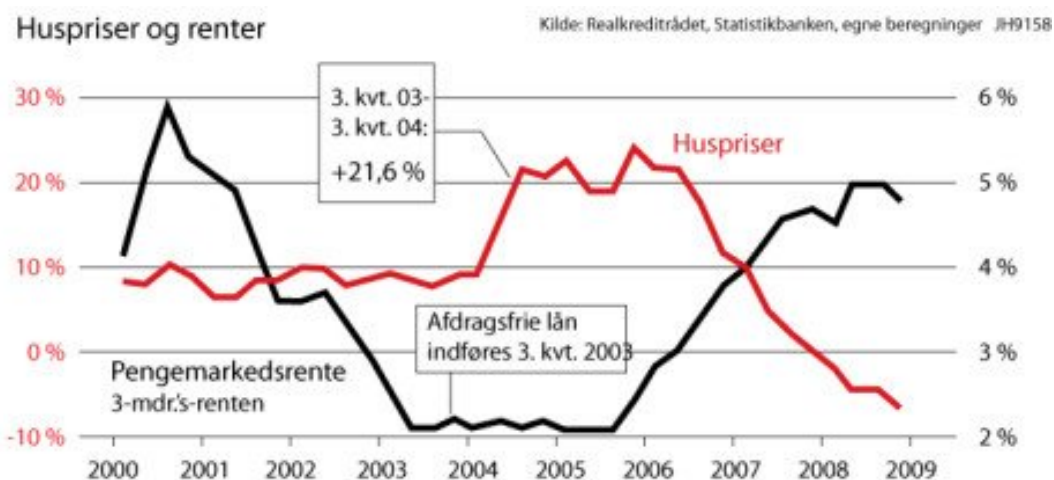
Interest only loans

We have not implemented such aggressive loan types in Denmark. But Denmark has not just been sitting on the sideline in the international race of deregulation, which lead to numerous financial innovations. In a short number of years we have for instance learned words like interest only loans, flex loans and reverse loans.

It is especially the interest only loans that should remain in focus. This loan type is like sub prime loans based on the short term interest rate and thereby very depending on the monetary policy made by central banks.

Further on the interest only loans indirectly assumed that house prices could not decrease. Without paying down the loan will a house buyer in case of decreasing house prices become technically insolvent sooner and increase the risk of foreclosure substantially. The interest only loans were – in spite of warnings from several sides (amongst others the consumer council) – implemented at the end of 2003.

I the period from 2003-2005 it became possible to finance a house by almost the half of the payment for a traditional long term fixed loans. The risk profile was completely different.



Prices under pressure

Real estate is the single most important asset for many individuals, and it is also the asset in which it is easiest to gear investments, because loan givers have (had) security in a relatively stable priced asset. With access to the existing real estate wealth a massive credit expansion was initiated when the interest only loans were released.

The entire credit growth in 2004-2006 came from 'non fixed loans'. During the boom it was the most aggressive loan type, the interest only loans, which set the price for real estate.

The marginal house buyer could with an interest only loan push the price higher in order to secure the dream house. An intense competition for market shares in the financial sector assisted, since the limits, for how much it was possible to loan at the basis of an annual income, moved.

Predictable crisis

The credit growth was a central factor. Not only in the US. Also in Denmark. And as a cause of a *laissez faire*-attitude towards credit expansion the bubble increased in size.

Soon after the implementation of interest only loans house prices increased by 20%, as seen by the graph. Adaptive expectation created a hype and speculation about increasing house prices and was therefore a creation of the deregulation.

Credit cycles are a well known phenomenon, which especially appears in connection to larger deregulations. In 2007 the 'The Minsky Moment' appeared, as the point in time when the bubble economy could not be sustained. The crisis was predictable – and Denmark participated in the creation of the largest international credit and asset bubble ever.

Learn from experience

In order to prevent a similar crisis it is necessary to acknowledge the reasons for the crisis. If we do not realise what caused the problem, we risk doing more damage than good.

Especially with respect to incentives structures where return should mirror risk. Implementations that strive against this core principle will increase the moral risk amongst market participants and be directly destabilizing for the economy.