

THE GLOBAL  
URBAN ECONOMIC  
DIALOGUE SERIES

# THE SUB PRIME CRISIS

THE CRISIS OF OVER-SPENDING  
AND OVER-SUPPLY



UN  HABITAT  
FOR A BETTER URBAN FUTURE

THE GLOBAL  
URBAN ECONOMIC  
DIALOGUE SERIES

# THE SUB PRIME CRISIS

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AND OVER-SUPPLY

United Nations Human Settlements Programme  
Nairobi 2011

UN  HABITAT

## **The Global Urban Economic Dialogue Series**

The Sub Prime Crisis: The Crisis of Over-Spending and Over-Supply

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## FOREWORD



extent, Latin America and the Caribbean.

We live in a new urban era with most of humanity now living in towns and cities. Global poverty is moving into cities, mostly in developing countries, in a process we call the *urbanisation of poverty*.

The world's slums are growing and growing as are the global urban populations. Indeed, this is one of the greatest challenges we face in the new millennium.

The persistent problems of poverty and slums are in large part due to weak urban economies. Urban economic development is fundamental to UN-HABITAT's mandate. Cities act as engines of national economic development. Strong urban economies are essential for poverty reduction and the provision of adequate housing, infrastructure, education, health, safety, and basic services.

The *Global Urban Economic Dialogue* series presented here is a platform for all sectors of the society to address urban economic development and particularly its contribution to addressing housing issues. This work carries many new ideas, solutions and innovative best practices from some of the world's leading urban thinkers and practitioners from international organisations, national governments, local authorities, the private sector, and civil society.

This series also gives us an interesting insight and deeper understanding of the wide range of urban economic development and human settlements development issues. It will serve UN member States well in their quest for better policies and strategies to address increasing global challenges in these areas

A handwritten signature in black ink, reading 'Joan Clos' in a cursive style.

**Joan Clos**

Under-Secretary-General, United Nations  
Executive Director, UN-HABITAT

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# INTRODUCTION

The sub prime crisis refers to the collapse of sub prime mortgage markets in USA due to the sharp rise in foreclosures beginning in 2006 and led to the failure, merger and government bailout of leading American financial institutions and enterprises such as Bear Stears, AIG, Fannie and Freddie, Merrill Lynch, Citi Group, Lehman Brothers and etc. The sub prime crisis triggered a financial crisis which rapidly spread to other countries around the world and became a global financial crisis in 2008. It affects every country and everyone through the global nature of the financial system.

In late 2008, the global financial crisis began to affect the real economy and triggered a global economic crisis. It resulted in the worst global economic recession since the Great Depression of 1920s and 1930s. The sub prime crisis is basically the crisis of the overspending of governments and individuals beyond their financial capacities. It is the crisis of over-consumption. It is the imbalance between consumption and production. It is the result of consumptionalism. This report examines the causes of the sub prime crisis and the impact of the sub prime crisis and that of the global financial crisis caused by the sub prime crisis.





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# THE CAUSES OF THE SUB PRIME CRISIS

## The Breakdown of the Global Financial System

In July 1944, a new international monetary system was agreed upon at the United Nations Monetary and Financial Conference held in Bretton Woods, New Hampshire, USA. The system was based on fixed exchange rates and a common standard. In the 19th and early 20th centuries, the role of monetary standard was played mainly by gold. The value of currencies was benchmarked against a fixed weight of precious metal. A country with a deficit in its balance of payments would make up the shortfall with sales of some of its gold reserves, with a concomitant reduction in its money supply.

The Bretton Woods system adopted a 'gold exchange' standard whereby one ounce of the metal was worth a fixed USD35.00, a rate the US government promised to maintain. Together with chronic US external deficits, this system established the hegemony of the US dollar in the global financial system, where it became the near-exclusive reserve currency. However, the US government found it increasingly difficult to meet its commitments.

In the post-war decades, the USA acted as the main engine of world economic growth, importing more goods and services than it exported. The resulting surfeit of dollars around the world was the near-exclusive source of international liquidity. The problem was that if dollar supply was perceived as excessive, confidence in the currency became weaker, and so did its gold peg. After a succession of currency crises in the late 1960s, the US government on 15 August 1971 unilaterally

lifted the fixed peg between the dollar and gold. The lifting of the gold exchange standard discipline triggered an era of uncontrolled printing of US dollars, leading to quick inflation and effective devaluation (the dollar had lost about 100 per cent of its value against gold by 1972).

## Excessive Public Spending and Excessive Growth of Government

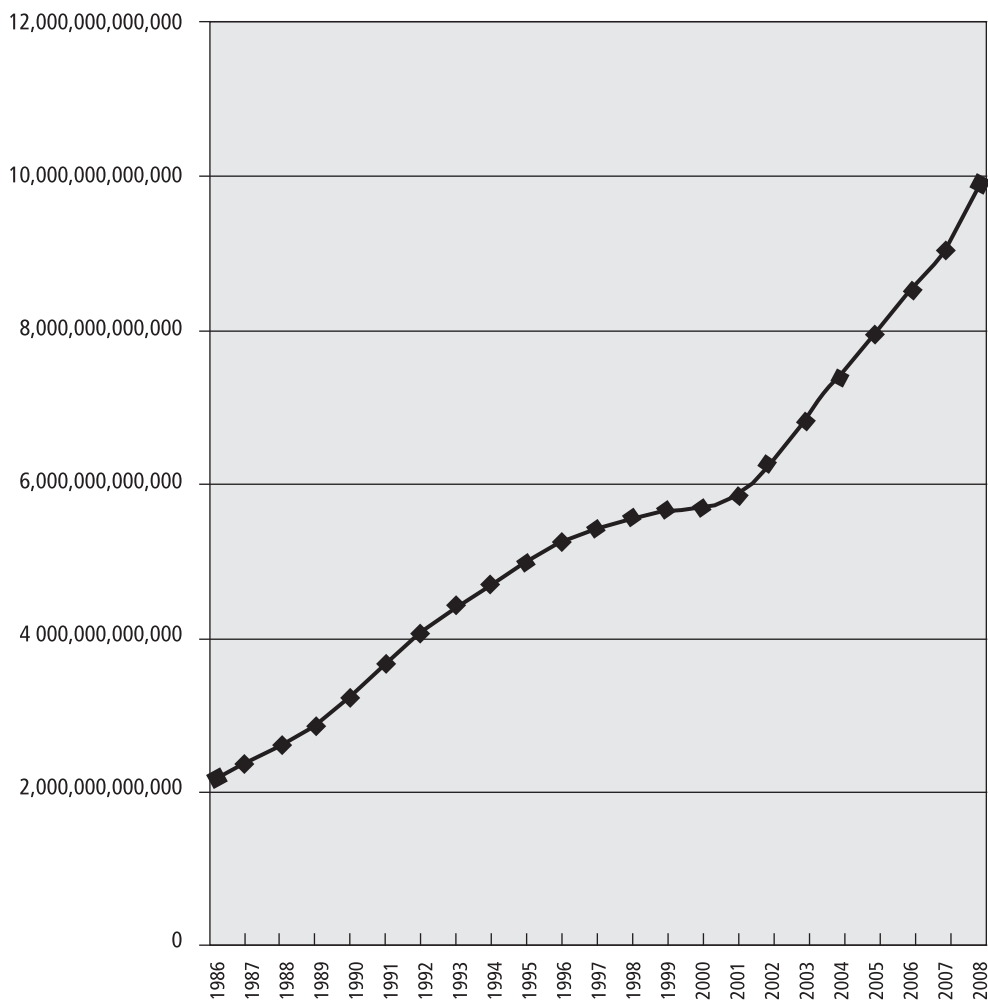
For many years, many countries have been advocating for market principles and small governments. But their practices or what they actually do are often different from what they preach. For example, public spending has soared. Government does not reduce public spending but rather increases it disproportionately. In the USA, it increased about five fold in the last two decades. The outstanding public debt in USA stood at around USD 10 trillion in 2008. The US government spends excessively. The US Government faced huge deficit (Figure 1 and 2). However, the US government tried to solve the problem by repeating the cause of the problem. That is to solve the deficit problems by borrowing more money and creating more deficits. This is why a former EU chairman criticises the approach of over-spending and recently warned that further public excessive spending is not a solution, rather a way to the hell. Recent debt crisis in Greece, Spain, Iceland, Portugal and Italy has more clearly demonstrated the problem of excessive public spending.

President Obama's budget blueprint would

raise a total spending to USD3.9 trillion in 2009, an increase of nearly 32 percent. This is the highest level since World War II. In the next five years, his plan would double the national debt. In 10 years, the debt would triple. Many would argue that the US government and the UK and EU had no option but to rapidly increase government spending and to bail out the banks whose reckless lending and use

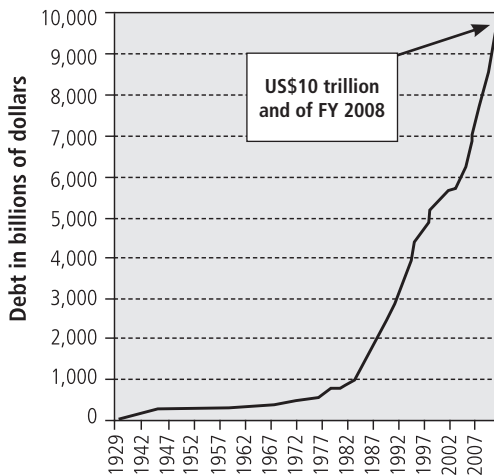
of dubious financial derivatives brought the problem in the first place. But it will ultimately lead to the overburden and depreciation of currencies, which affects the affordability of governments and shrinkage of people’s wealth due to currency depreciation and could lead to another wave of crisis sooner or later.

FIGURE 1: **Public Debt in USA** (in USD)



Source: Generated from [http://www.savingsbonds.gov/govt/reports/pd/histdebt/histdebt\\_histo1.htm](http://www.savingsbonds.gov/govt/reports/pd/histdebt/histdebt_histo1.htm)

**FIGURE 2: Rapid Increase of Federal Government Debt from a Long-Term Perspective.**



Source: <http://mwhodges.home.att.net/debt.htm>

Compared to 1929, the US federal government debt is 625 times larger. Starting late 1960s, an upward trend emerged, then accelerating in the early 1970s. In the meantime, the household incomes (adjusted for inflation) ceased rising for two and a half decades and real incomes fell for full-time employed male workers. This also makes household savings more difficult due to the decline in real income.

The government share of the economy accounts for 61 percent and is larger than the private sector in the USA. It equates to 6.7 months per year of a worker's income needed to cover government spending and regulations - 5.2 months to cover government spending and another 1.5 months to cover mandated regulatory compliance costs. The federal government spending was growing much faster than the nation's economy in USA. Not only the government is getting too big in terms of expenditure and staff but it is also more centralised rather than decentralised.

The government spending has 800 percent of increase in the federal share of the total economy in USA, which increased from 3 percent to 28 percent. Even though the federal government

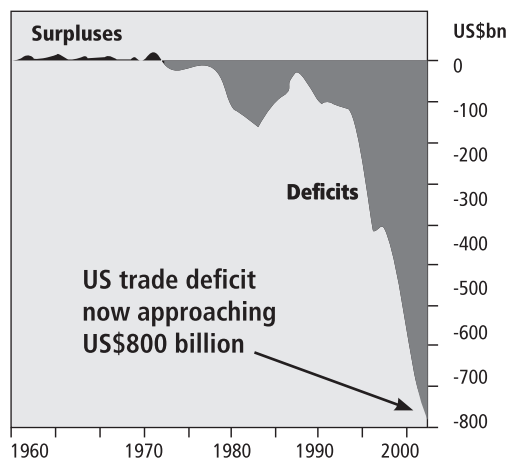
grows faster than state and local governments, the State and Local Governments still grow incredibly. The state and local government employees grow 12.7 million faster than the population at large in USA. The state and local government employees grow from 3.3 million in 1946 to 19.3 million employees today. That is more than 470 percent faster than the national population growth.

## Total US Federal Obligations Far Exceed the GDP of the Whole World

The real federal budget deficit was USD12.3 trillion, not the USD455 billion previously reported. Despite the huge deficit, the Obama administration continues to push through Congress its USD800 billion deficit-spending economic "stimulus" plan, the American public is largely unaware that the true deficit of the federal government already is measured in trillions of dollars, and in fact its USD 90 trillion in total obligations far exceeds the gross domestic product of the entire world.

Since 1990s, the trade deficit has continued to

**FIGURE 3 Huge Trade Deficit Shows the Imbalance of Production and Consumption in USA**



Source: <http://www.alkalizeforhealth.net/Ldebtclock.htm>

increase in USA. The country consumes more than it produces. The trade deficit reflects the imbalance of production and consumption in USA. It requires the government to seriously cut its spending, not the other way around.

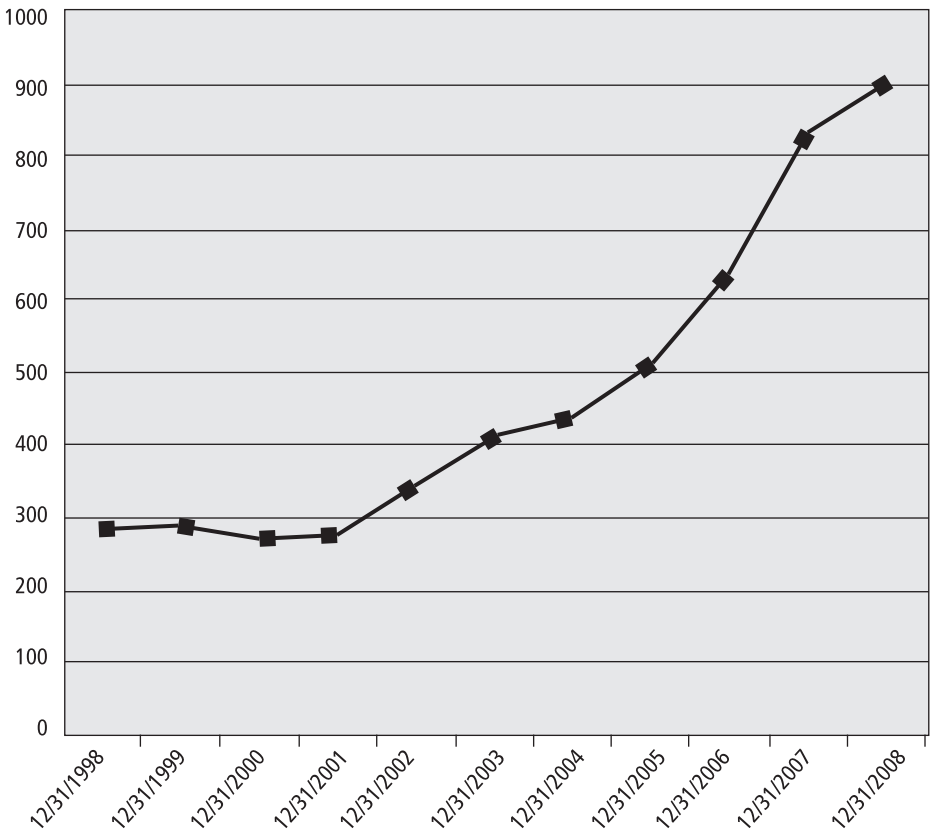
## Oversupply of US Dollars Distort Real Economy

In response to the rocketing expenditure and deficits, the United States maintained expansionary fiscal and monetary policies, whereby more and more money was supplied to the financial market and made US dollars “overflow” in financial institutions. The oversupply of dollars led to rapid increased commodity prices and inflation and reduced

the purchasing power parity of US Dollar. The magnitude of the currency problem can be reflected in the rocketing rise of gold price. The gold price increased from USD 288 per ounce in 1999 to more than USD 905 in 2008 (Figure 4), and further rocketed to more than USD 1,530 in early June 2011.

The oversupply of US dollars led to the depreciation of US Dollar. Many households needed to spend more money for the same amount of services and consumption in non-housing items. This resulted in less money available for them to pay housing mortgages and increased their likelihood of defaults in their residential mortgages.

FIGURE 4: Depreciation of US Dollar to Gold



Source: Finfacts Ireland 2008

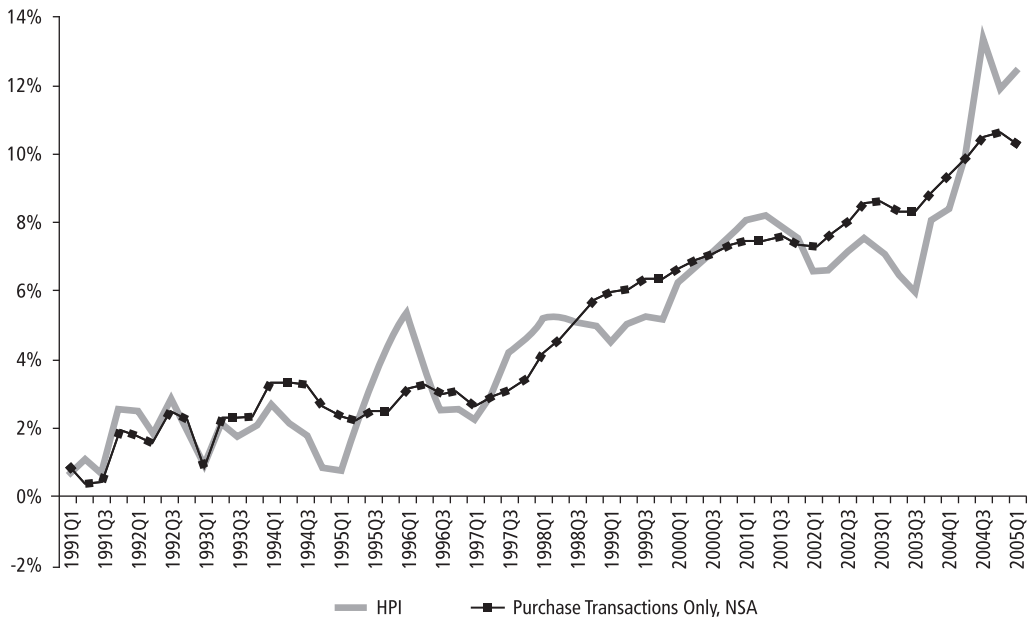
## Oversupply of US Dollars Making Financial Institutions Lowering Lending Criteria

Oversupply of US dollars largely increased the “liquidity” of US dollars. US financial institutions are full of US dollars. The financial institutions have increased pressure to lend out the oversupplied money. Financial institutions need to expand their client base to absorb the money. They lowered their lending criteria and innovated new products or instruments such as sub prime mortgage loans. They lent money to clients who are not qualified for loans on conventional criteria. Eventually it contributed to the sub prime mortgage crisis because people could not repay their loans. Freddie Mac, Fannie Mae and etc were remiss in underwriting mortgage loans, the major US banks and mortgage lenders such as Washington Mutual played a key role.

## Oversupply of US Dollars Contributing to the Soaring of Housing Prices

The housing sector is most sensitive to the oversupply of US dollars. Many US dollars flowed into the housing sector and left the housing price soaring. The price increase path has been getting faster and faster in USA during the last two decades (Figure 5). While American financial institutions provide loans based on the “value” of housing prices, the soaring prices make many households to borrow higher amounts of loans than their income level can afford. This becomes a time bomb for subprime mortgage lending crisis.

FIGURE 5: Housing Price Increase over the Previous Year



Source: Office of Federal Housing Enterprise Oversight, 2005

FIGURE 6: Inflation-Adjusted Housing Prices in USA

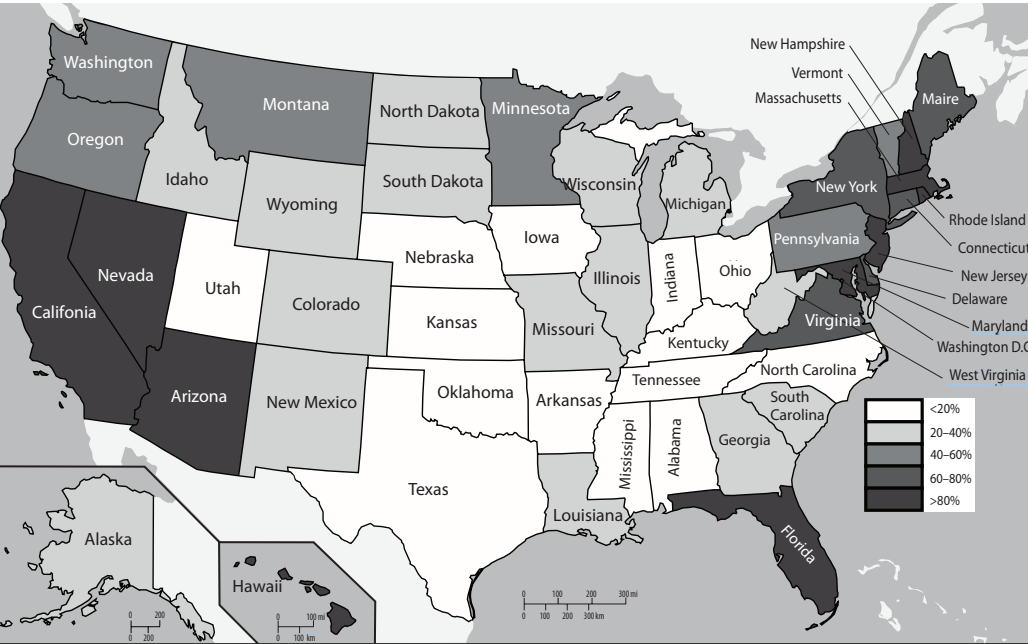


FIGURE 7: Housing Prices vs. Owner-Equivalent Rent in USA

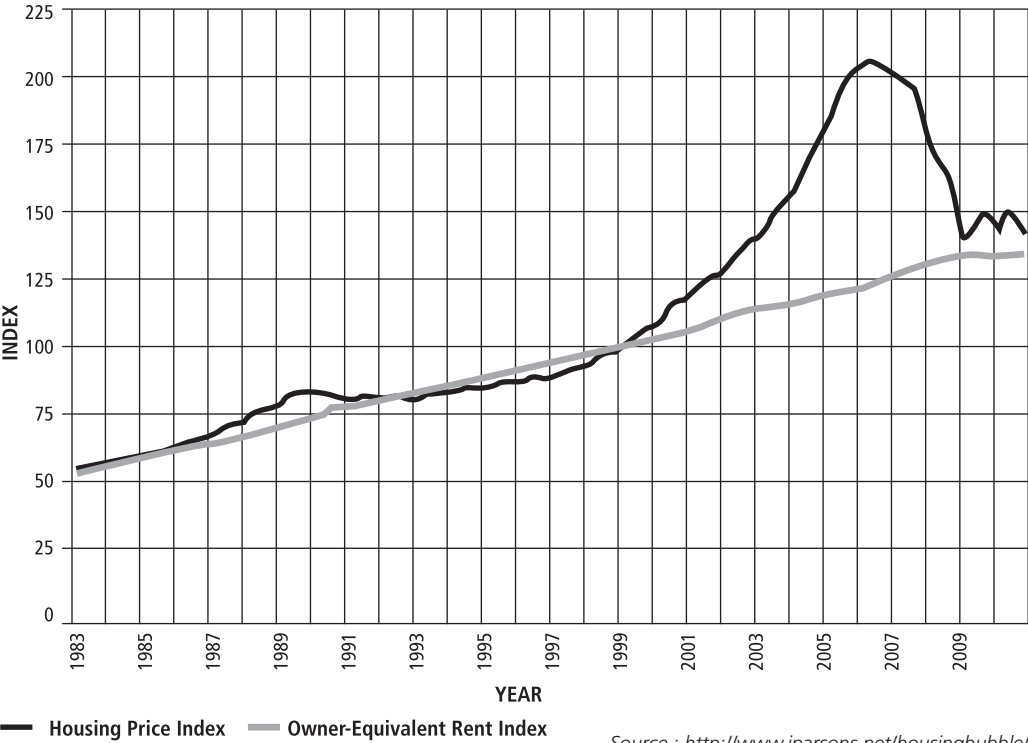


Figure 7 shows the change in nominal housing prices and in nominal rents since 1983. Housing prices are over-priced compared to the rent level. Housing prices are over-inflated due to the oversupply of US dollars.

Mr. Ben Bernanke warns that if the federal budget deficit is not under control, it will endanger the economy down the road. However, the federal government is still increasing deficits. During the recession, the Federal Reserve purchased some USD 1.7 trillion mortgage securities, corporate debt and government bonds. It increased spending drastically instead of cutting costs. The over-indebtedness of the government will lead to the inflation and devaluation of the dollar.

## Deregulation Opens Door for Sub Prime Lending

Another important factor to boost the sub prime lending is the deregulation of the financial markets. In 1980, the United States passed the Depository Institutions Deregulation and Monetary Control Act ("DIDMCA"). DIDMCA helped the Savings and Loan ("S&L") industry to offer checkable deposits. DIDMCA also allowed financial institutions to charge interest rates they chose to.

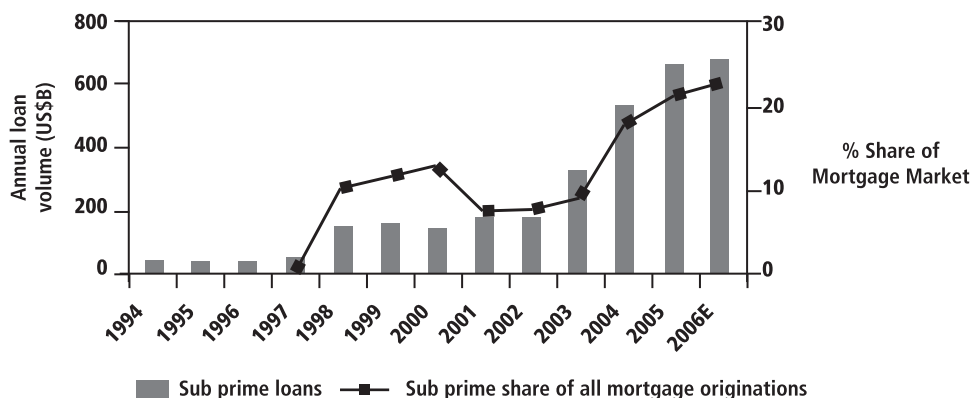
In 1982, deregulation continued with the passage of the Alternative Mortgage Transaction Parity which preempted state laws that restricted banks from making any mortgage except conventional fixed rate amortizing mortgages. The 1982 law allows the use of variable interest and balloon payments and also allows lenders to make loans with terms that may obscure the total cost of loans, which led to new mortgage instruments many borrowers failed to understand and could not afford.

These laws opened the door for the development of a sub prime market, but sub prime lending would not become a viable large-scale lending alternative until the passage of the Tax Reform Act of 1986 ("TRA"). The TRA removed the tax deduction of interest on consumer loans but encouraged the homeownership initiatives through increasing the home mortgage interest deduction as well as the addition of low income housing tax credit to boost homeownership for low income households.

In 1995, the US Federal Government implemented a major reform of the Community Reinvestment Act ("CRA") and issued its National Homeownership Strategy, both of which led financial institutions to further lower the mortgage lending standards. CRA encouraged the "use of innovative and flexible lending practices"; it increased riskier and unsustainable lending practices through lowering mortgage underwriting standards and shifting from ensuring the equitable lending procedures to ensuring equitable lending outcomes without due careful consideration of the borrowers' ability to repay the mortgage loans.

With the oversupply of money and deregulation, the sub prime mortgage market received rapid expansion. It grew from USD 35 billion in 1994 to USD 650 billion in May 2007 (Figure 8).



**FIGURE 8: Sub Prime Mortgage Market Growth and Share of Total Mortgage Market**

Source: *Inside Mortgage Lending Finance* as published by the center for Responsible Lending

## Reckless Lending of Financial Institutions

Reckless lending of financial institutions is a key contributing factor for the sub prime mortgage crisis. Financial institutions extended sub prime loans to individuals who do not qualify for prime credit, and are generally not eligible for credit from traditional sources. It represents mortgage lending that allows the unsuitable borrowers to get credit, as they are often unable to offer a down payment, they have a record of being unable to pay debts and they do not have a source of income. In the case of those who have income, their credit liability is disproportional to that income.

Financial institutions went down markets to reach lower income and minority borrowers as lenders promised loans with less paperwork, quick approval and no down payments. Financial institutions seduced the sub prime borrowers with easy-to-get loans and attractive short-term interest rates for the beginning years; but they subsequently had to reset to higher rates for the remaining majority of the loan period.

Lack of due diligence resulted in different types of subprime loans. Some loans required little

or no proof of a borrower's ability to meet repayments known as low documentation or no documentation loans while other loans needed no proof of income or credit history. Other types of mortgages included 'jumbos'- particularly large loans which were disproportionate to borrowers' incomes or house values. Mortgages were also sold by brokers and intermediaries without assessing the buyers' affordable capacity.

## The Role of Mortgage Brokers in Promoting Loans to Sub-prime Borrowers

The sub prime loans were often not responding to borrower demand; rather, they were created to maximize short-term profits of the suppliers, and they were aggressively push-marketed to consumers, who often couldn't afford. Brokers played a key role in this aggressive marketing and have contributed to the surge in delinquencies.

The main problem is that mortgage brokers do not represent the borrowers who pay them for advice. Instead, they are more driven by hidden fees and other incentives provided by

the lenders. Sub prime mortgages are sold to home buyers with lower credit scores. When the housing market boomed, mortgage brokers' influence grew as they became involved in arranging the majority of home loans.

One of the most controversial payments that mortgage brokers receive from lenders is called a Yield Spread Premium. If a broker can persuade a borrower to accept a mortgage with a higher interest rate than the par rate, the broker will get a fee from the lender equal to a percentage of the value of the mortgage (i.e. the Yield Spread Premium), which rewards the broker for arranging a loan that pays an above-market interest rate. The higher the interest rate, the higher the Yield Spread Premium is. But the Yield Spread Premium is often abused by mortgage brokers who want to collect as many fees as possible for arranging a loan and don't care that borrowers can end up paying a higher interest rate without even knowing it, and this practice contributed to the high rate of sub prime loan defaults.

## **The Role of Securitisation in Expanding Subprime Mortgages**

The subprime crisis is the first one that's magnified by securitization. The originators of the sub prime mortgages sell off sub prime mortgage through securitization. As long as the originators can sell these sub prime mortgages, they transfer the high risk of these mortgages to investors who buy the mortgages. Investors buy bundles of mortgages which are so complex that investors could not fully understand the real value. Investors relied on ratings agencies to value these mortgage assets. But the financial institutions pay the ratings agencies that give the highest rating.

Investors seem not to know what these mortgages are worth, who owns them, how much has been borrowed using these mortgages as collateral or how deeply their

value has declined. The disconnection between investors and its real physical assets created a loophole in its cycle of operations. Originators can write off sub prime mortgages through securitization and get back their capital quickly and then originate more sub prime mortgages. Securitization accelerates the growth of sub prime mortgages.

## **Over-emphasis of Homeownership and Lack of Oversight Driving Riskier Lending**

From the very beginning, the US federal government showed its preference of homeownership through the creation of Fannie Mae and Freddie Mac. The privatization of the agencies did not reduce its competitive advantages backed by the federal government. At their prime, they controlled over three quarters of the secondary market for prime mortgages in USA. However, Fannie Mae and Freddie Mac went much far and were often exempt from federal regulations guiding banks and lending. For example, they were allowed to operate with much lower capital requirement than their private sector competitors. They were only required to hold 2.5 percent capital against their on-balance sheet mortgage while banks are required to hold 4 percent capital against their mortgages. Lower down payments on mortgages and low capital requirements allowed Fannie Mae and Freddie Mac to achieve a huge leverage ratio of exceeding 70-to-1.

Fannie Mae and Freddie Mac were also exempt from key regulatory and market oversight. This exempt from oversight made Fannie and Freddie to conveniently engage in riskier practices. In 1990s, Fannie Mae and Freddie Mac injected USD 5 trillion to promote affordable housing. Fannie Mae introduced "qualifying flexibility" for low income borrowers and reduced the down payments to

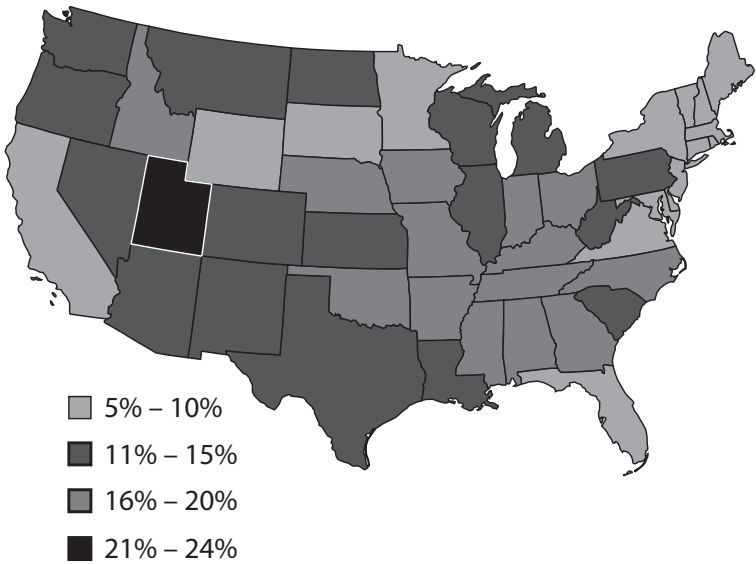
as little as 3 percent, and by 2001, it was even offering to buy zero-down payment mortgage loans. The riskier behaviors of Fannie Mae, Freddie Mac and financial institutions also encouraged the riskier behaviors of borrowers. Lower down payment reduced the equity stake in the homes borrowers purchased and made them less responsible for their homes when times got rough. Lower down payment also allured borrowers to increase their leverage and to purchase expensive houses they would be unable to afford and also to spend more generously on other goods using the money saved due to the low down payment of mortgages. For example, in 2000, the ratio of housing price to income in USA was 4 to 1. In 2005, the ratio increased to 8 to 1. As a result, the mortgage debt between 2000 and 2006 in USA increased by 80 percent.

## **Rapid Increase of Subprime Mortgages Leading to Credit Crunch**

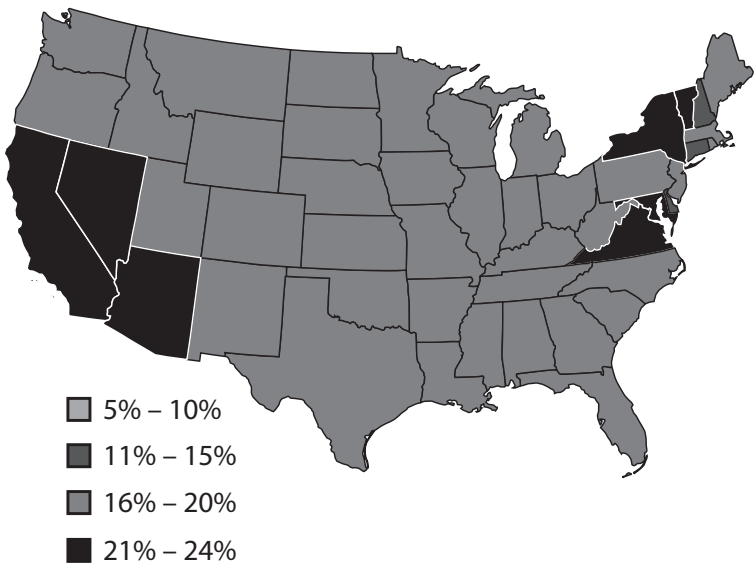
The delinquency rate for sub prime mortgages increased to 25 percent in the second quarter of 2008, which was about 6 times higher than that of prime loans. An estimated 1.3 trillion sub prime mortgages are currently outstanding. That is as large as the entire California economy. The sub prime mortgage foreclosure rates in USA are getting worse (Figure 9).

FIGURE 9: Projected State Foreclosure Rates for Sub Prime Loans

Projected  
State Foreclosure  
Rates for Subprime  
Loans Originated  
1998-2001



Projected  
State Foreclosure  
Rates for Subprime  
Loans Originated  
1998-2001



Source: Center for Responsible Lending, 2008



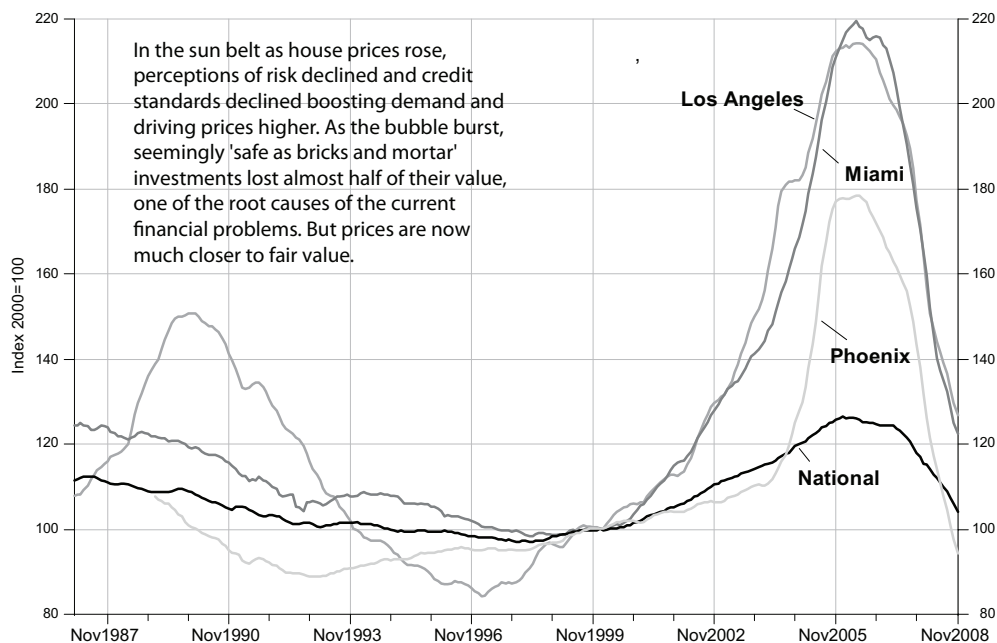
# IMPACTS OF THE SUB PRIME CRISIS

## The Bursting of the Housing Bubble

From 2000 to 2006, the USA observed a rapid rise in housing prices. In some areas housing prices doubled, which increased far beyond the rate of fundamental economic growth. The housing bubble was mainly the result of oversupply of US dollars, leading to “over flows of dollars” in the housing market through the provision of low interest rates by the US Federal

Reserve. The Federal Reserve cut interest rates by a total of 550 basis points between 2001 and 2004. The low return on the stock markets and treasury bonds further pushed money to flow into the housing market to boost the housing bubble. Much of this money was lent to the households who otherwise would not be qualified for mortgage loans. In 2008, the housing bubble burst. Housing prices fell significantly in many parts of United States (Figure 10).

FIGURE 10: Housing Price Changes in USA



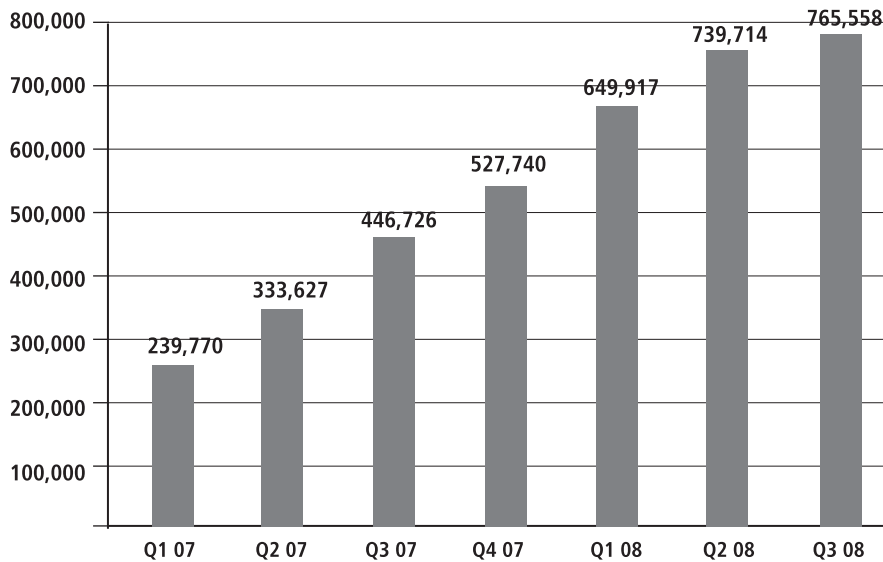
Source: McKibbin, Warwick (2006)

# The Broken Dream of Homeownership

The global financial crisis started with the sub prime mortgage lending crisis in USA. The foreclosure rates deteriorated rapidly. In the third quarter of 2007, sub prime adjustable rates mortgages (ARMs) only accounted for 6.8 percent of the US mortgages outstanding but accounted for 43 percent of the foreclosures. In October 2007, the delinquency rate of sub prime ARM mortgages almost tripled the rates

of 2005. In January 2008, the delinquency rate increased to 21 percent and further increased to 25 percent in four month time. During 2007, lenders started foreclosure proceedings on about 1.3 million properties, a 79 percent increase over 2006. The properties with foreclosure activities faced steady increase in USA (Figure 11). It is estimated that the foreclosures will increased to 2.4 million in 2009 alone and 9 million during the period of 2009-2012.

FIGURE 11: Properties with Foreclosure Activity in USA



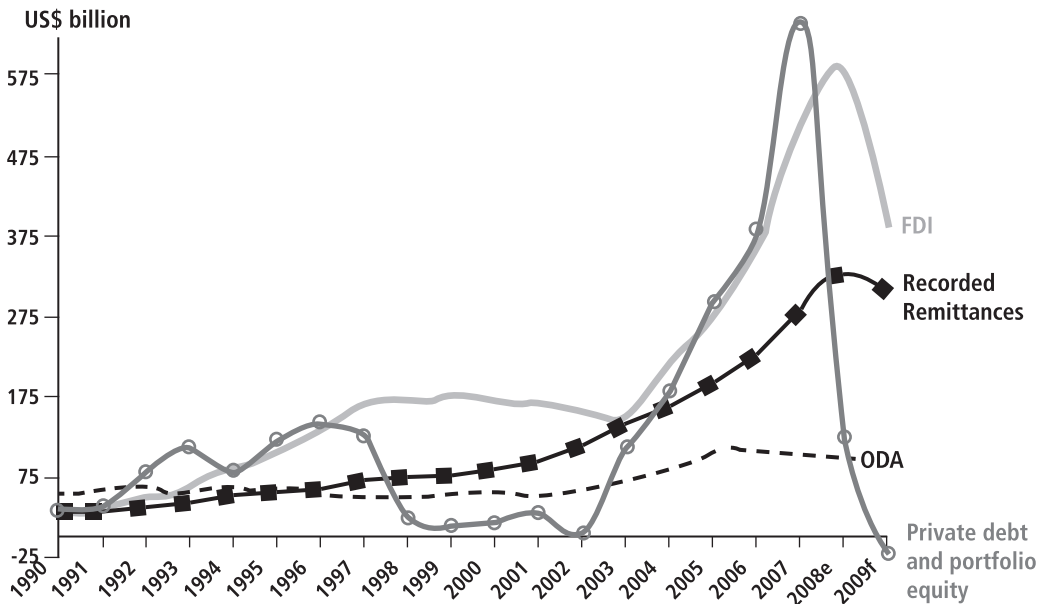
Source: [http://upload.wikimedia.org/wikipedia/en/4/4c/Foreclosure\\_Trend\\_-\\_2007.png](http://upload.wikimedia.org/wikipedia/en/4/4c/Foreclosure_Trend_-_2007.png)

## Impact on Remittances

To many developing countries, remittances are an important source of finance. Recorded remittances to developing countries were USD 336 billion in 2008. This is three times as large as overall official development assistance to developing countries. The real figure can be even higher. In some countries, remittances are close or even higher than foreign direct investment. In Lesotho, Moldova, Tajikistan,

the remittances exceed one-third of national income (Figure 12). The global financial crisis affected the work and income of migrants and subsequently led to the decrease of remittances. Remittances to developing countries decreased 6 percent in 2009. The impact on Europe, Central Asia, Latin America and Middle East was more obvious. Remittances to Europe and Central Asia, Latin America and Caribbean, and Middle East decreased respectively 20.7 percent, 12.3 percent and 8.1 percent.

FIGURE 12: The Importance and Fall of Remittances



## Impact on Foreign Direct Investment

The global financial crisis led to a deterioration of foreign investment. In the face of the global economic slowdown, tighter credit conditions and falling corporate profits and consumers' confidence, many companies began to curtail production, lay off workers, and cut capital expenditure, which have implications for foreign direct investment. Developed countries were severely affected by the global financial crisis and faced an economic slowdown and did not have more money to invest in foreign countries. Companies have less financial capacity to invest both internally and externally. They scaled back investment due to the pessimistic prospective, high level of perceived risks and uncertainties.

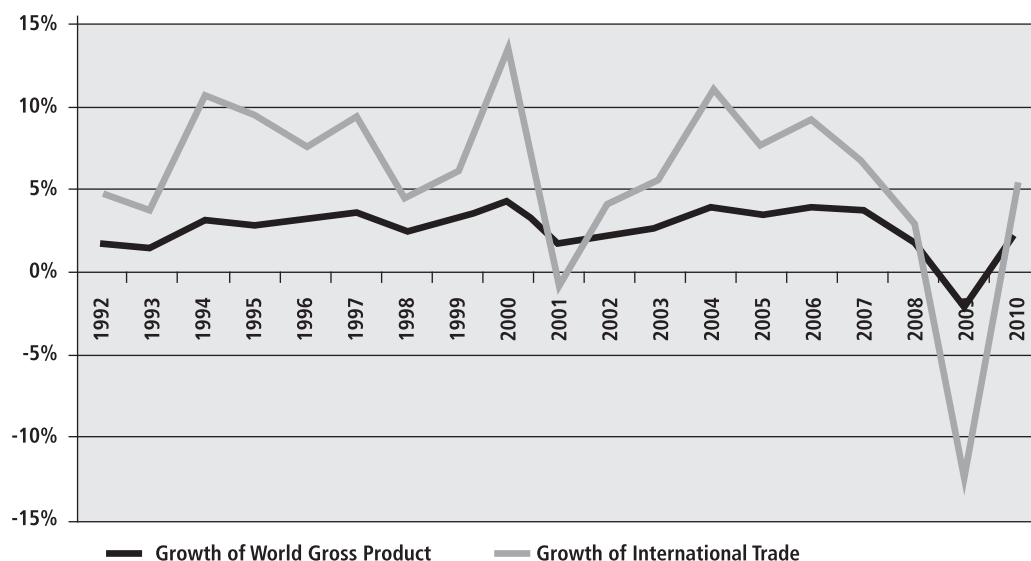
On average, global foreign direct investment fell by more than 20 percent in 2008 while

foreign direct investment in developed countries declined by about 33 percent.

## Impact on International Trade

The international trade reached a record level of USD 16.1 trillion before the global financial crisis in 2008. IMF estimated that the international trade measured by total exports of goods and services declined by 11.9 percent and that of developed countries fell by 13.6 percent in 2008. World merchandise trade experienced a further unprecedented decline of 23 percent in 2009, reflecting the most severe decline in global trade (Figure 13). Imports of the United States declined 25.9 percent during 2009. Federal Reserve Bank of Dallas publication shows that the scale of international trade decline exceeded the losses during the 1930s.



FIGURE 13: **Growth of International Trade and World Gross Product**

Source: UN-DESA

## Oversupply of Currencies Distorts the Real Economy and the Welfare of People

The oversupply of currencies can be reflected in the rapid growth of the financial assets compared to the value of total outputs measured in national accounts in the last few years. In 2006, the global financial assets were equivalent to four times world GDP. On any one day of April 2007 the average daily turnover of interest rate and non-traditional foreign exchange derivatives contracts reached USD2,090 billion, 71 percent higher than three years earlier. That is 50 times the value of world exports during the same time. Hedge funds have increased from USD 39 billion in 1990 to USD 1,900 billion in 2007. The profits of financial institutions in the United States incredibly reached 41 percent of the total profits after tax in 2007, up from 5 percent in 1982. In New York, one third of all salaries paid were in the financial sector. The world was overflowed by US dollars. The oversupply of currencies created the financial and economic bubbles and distorted

the real economy. A wave of excess global credit creation has created the wall of money which was then recklessly lent. This was not appropriately regulated but much of this took place under the auspices of Alan Greenspan as chairman of the Fed, who put forward the view that financial markets could regulate themselves, and it was not the job of the Fed to intervene to prick the bubble of excess lending and 'irrational expectations'. This view of limited regulation has been shown to be flawed.

Smart Investing Daily Editor Sara Nunnally criticised that "the US government was printing money like mad". This creates a huge oversupply of US dollars and devaluation of the currency. The bailout commitments now stand at USD 11.8 trillion, which is far higher than the original plan of USD 800 billion. Despite the worldwide worries over the huge debt of the US federal government, the Obama administration signed a bill in February 2011, which further increased the public debt ceiling from USD 12.394 trillion to USD 14.294 trillion. This is a second

increase in less than two months time. The Financial Management Services of the US Treasury estimated that the total obligations of the US government exceed USD 90 trillion. The US government now has the world's No. 1 highest debt to GDP ratio, which is well above that of Zimbabwe. The total US debt plus unfunded obligations are more than 625 percent of GDP. This world No. 1 debt ratio is at serious odd with prudent financial and economic principles. It could erode people's confidence in US economy and US currency. It could cause a new round of crises.

With the diminishing purchasing power of US dollars and other world reserve currencies, people suddenly felt that they are impoverished by the devaluation of US dollars and other world reserve currencies. They can buy much less goods and services with the same amount of money. People's welfare is hugely negatively affected by the high government debt, and depreciation of currencies. This will affect their confidence in US dollars and other world reserve currencies. The inflation and devaluation of US dollar will erode people's confidence in real economy and lead to a vicious cycle.

The depreciation of US dollars and other world reserve currencies hurt the export-oriented countries most. Many export-oriented countries work hard to export their goods and earn US dollars. Eventually, they find their wealth holding in US dollars or other world reserve currencies losing value. The more you export the more you lose. The more you interact with the international world through trade and services, the more you lose; simply because these goods and services are traded in US dollars or other world currencies. When countries realised that all their losses are simply caused by the use of US dollars or other world currencies in their trade and services, they began to find ways to avoid the use of these currencies.

The depreciation of US dollar made countries to seek alternatives to protect the loss of their wealth. India transformed its USD 6.7 billion into 200 metric tons of gold (it bought 200 metric tons of gold from IMF at the cost of USD 6.7 billion), which is the biggest single central bank purchase in the last 30 years. Brazilian Central Bank President Henrique Meirelles said that they were considering the gradual elimination of US dollar in trade with China, Russia and India. Russia is considering trade in national currencies. Latin American countries consider establishing a regional currency called "sucre". Gulf countries plan to establish a Gulf currency.

When countries find that dollars hurt their real economy and wealth, they find ways to avoid the currency in their economy and trade to avoid further losses. The recovery of US economy requires people to have more savings. But individual people have less interest to save in dollars in order to avoid their losses due to the inflation and depreciation of US dollars. Lack of savings will dry up investments. It in turn leads to the tendency to print more dollars, leading to higher inflation, which makes people and countries to avoid using US dollars. It becomes a vicious cycle. Therefore, it is very important to take concrete measures to control the expenditure, deficit, and supply of US dollars to restore people's confidence in US dollar. This is essential for the US economy but also for the global economy.

## **The Rapid Increase of Unemployment**

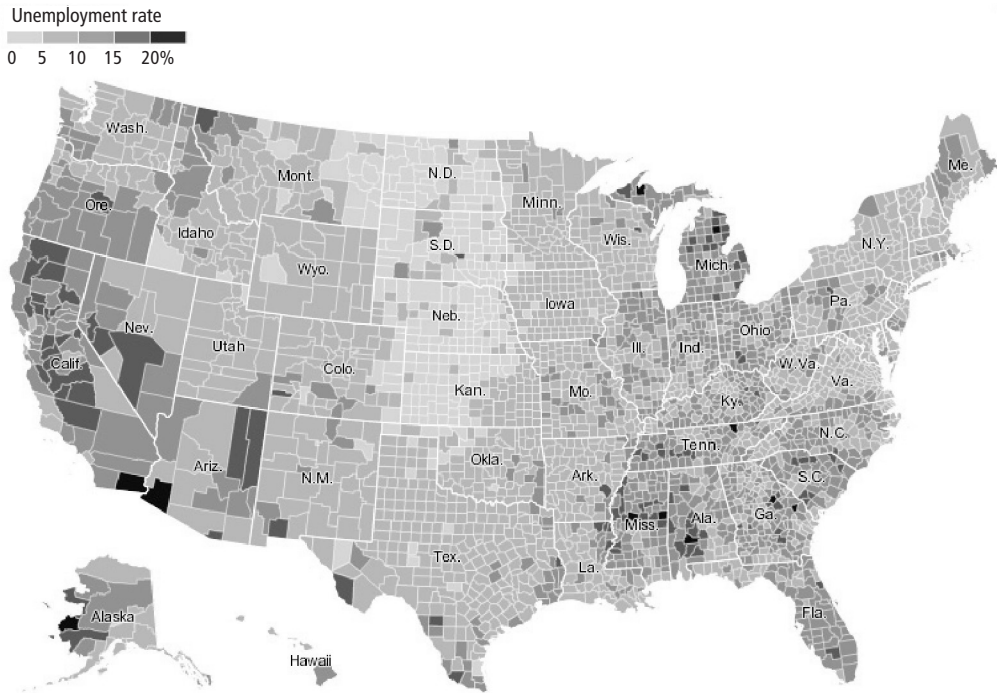
International Labour Organisation (ILO) reports that the global financial crisis could increase world unemployment by an estimated 20 million. It will bring the total world unemployment to over 200 million in 2009. However, the situation seems far worse than that.

IMF's estimate shows that the unemployment caused by the global financial crisis is more than 30 million, which pushes the total world unemployment to more than 210 million. The unemployment caused by the global financial crisis can be far more than this figure too. In China alone, the global financial crisis led to the closure of more than 67,000 small and medium-sized enterprises and more than 20 million people lost their jobs. Another 300,000 small enterprises are partially closing down.

The hardest-hit parts have been the manufacturing sectors in China. The same is true for the United States. The manufacturing

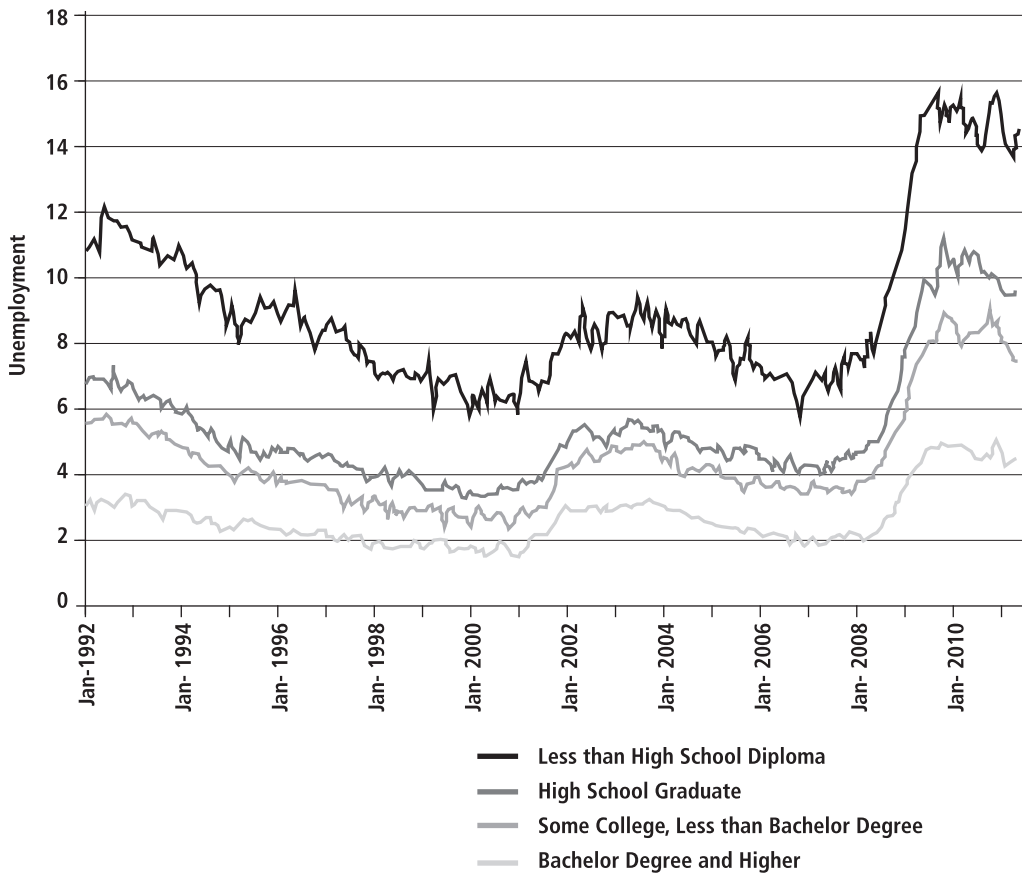
regions such as Michigan, Ohio and Rhode Island, and regions which had huge housing bubbles such as California, Florida and Nevada have highest unemployment rates. In El Centro, California, the unemployment rate is as high as 22.6 percent (Figure 14). The unemployment rates have a negative correlations with the level of education. It causes more job losses among the less educated than those with high education. Those without high school diplomas are hit hardest. The next worst hit group are high school graduates. In other words, the poor people are hit hardest by the crisis (Figure 15).

**FIGURE 14: Geographic Distribution of Unemployment Rates in USA in 2009**



Source: New York Times

FIGURE 15: **Unemployment Rates for Workers 25 Years and Older, by Education in USA**



Source: New York Times



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UNCTAD (2009) Assessing the Impact of the Current Financial and Economic Crisis on Global FDI Flows

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The subprime crisis refers to the collapse of subprime mortgage markets in the United States due to the sharp rise in foreclosures beginning in 2006, which led to the failure, merger, and government bailout of leading American financial institutions and enterprises. This report examines the causes and impacts of subprime crisis. The report examines the elements causing the crisis, particularly the over-spending behaviors of both governments and individuals and deregulation and lack of monitoring. The over-spending beyond the income/revenue capacity leads to the imbalance between income/revenue and spending and eventually causes the sub-prime crisis and further the global financial and economic crisis. The report then examines the impacts of the crisis.

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