

## The False Subprime Mortgage Argument

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### Abstract

*Recessions result from the fall of real income, a loss of consumers' purchasing power. Subprime mortgages are loans made to homeowners perceived to have high credit risk. Loans expand the money supply and hence the economy. Therefore, subprime mortgages (loans) could not cause income to fall.*

**Keywords:** *Subprime, mortgages, crude oil, recessions, central banks*

It has been argued, by some, that subprime mortgages caused the 2008 economic crisis. According to Bernanke (2007), "Subprime mortgages are loans made to borrowers who are perceived to have high credit risk, often because they lack a strong credit history or have other characteristics that are associated with high probabilities of default."

Failure of subprime mortgages was merely a symptom of the economic crisis and a bellwether that should have alerted policymakers of an impending real income crisis. Economic interactions are extremely complex, involving many abstractions of outputs and prices of goods and services (Teigen, 1978). Such abstractions often confuse policymakers and pundits. Teigen notes that the only way to deal with economic complexity is to use simple economic models.

As a result of economic abstractions, policymakers and pundits failed to properly identify the core problems and challenges affecting the economy. Without proper identification of root causes, government officials argued that doing nothing was not an option. Thus, they developed solutions to find the root causes of the crisis. The result is that four years after the Great Recession they were unable to restore the economy to pre-recession employment levels; thus, they were still grappling with the consequences of the 2008 economic crisis.

Recessions occur when the real output (income) falls for two or more consecutive quarters. Hence, the root cause of recessions is a decrease in real income. When real income falls, consumers' purchasing power diminishes and they purchase fewer goods and services. So, what causes real income to fall?

Income,  $Y(=MV/P)$ ,<sup>1</sup> falls when the price level,  $P$ , (inflation) increases or the money supply,  $M$ , controlled by the government, in the U. S., the Federal Reserve (Fed), and velocity,  $V$ , decrease. Between 2003 and 2008 high crude oil prices induced imported inflation, which increased the general price level. When the Fed drains money,  $M$ , from the banking system, the money in circulation decreases leading to less demand for goods and services, causing the interest rate to rise, and reducing gross domestic product, GDP, production, and employment.

### **High crude oil prices adversely affect consumers' purchasing power**

Historically, in the United States spikes in crude oil prices preceded recessions (Hamilton, 2005; Kubarych, 2005). Additionally, most crude oil price spikes can be attributed to exogenous events such as military conflicts (Hamilton, 1985; Kubarych, 2005; Weir, 2006). Thus, a large body of research suggests that spikes in crude oil prices have considerable adverse effects on the economy (Jiménez-Rodríguez & Sánchez, 2004), particularly if monetary adjustments are not made to compensate for decreases in real income due to higher energy costs.

Minsky (1984) noted, "...the capitalist market system is inherent though intermittently unstable (p. 106)." He claimed that in the Keynesian theory, variations in investment determine variations in economic activities and that the prospect of profits from production depends on the current state of demand and out-of-pocket costs. Demand, however, is a function of income. Therefore, when crude oil prices reduce consumers' purchasing power, it also affects business profits, and hence investments and jobs.

Furthermore, when there is violence or rumors of violence in oil-producing regions, speculators bid up futures prices of crude oil. Speculators believe that regional instability curtails the supply of crude oil and hence demand will exceed supply causing future prices to rise in the future. So, they bid up future prices by purchasing crude oil futures, at predetermined future prices, to be delivered at some agreed future date. If the predetermined future price is less than the market price at the delivery date, speculators profit from the transaction; if it is more, they incur a loss.

Speculators in the virtual futures market often purchase more crude oil than demanded by consumers in the real physical market. Excess demand in the virtual speculative futures market raises prices in both the virtual and the real physical market. Therefore, speculators can collude to raise prices in the real physical market by simply demanding more crude oil in the virtual market than is needed in the real market. Thus, speculative and not real demand determines the price of crude oil.

Fig. 1.1 below shows that as the induced speculative (virtual) demand,  $D_s$ , increases, the demand curve for crude oil shifts outwards causing artificially higher crude oil prices. This is why even during recessions when real demand for crude oil is low the price of crude oil does not decrease

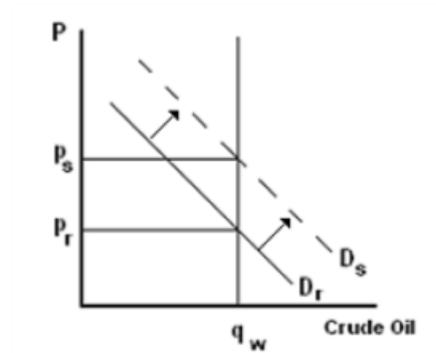
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<sup>1</sup> Quantity Equation of Exchange

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significantly and may even rise. In Fig. 1.1, the real demand price, based on consumers' needs, is  $P_r$  and the speculative demand price, based on traders' calculus, is  $P_s$  for the same quantity demanded,  $q_w$ .



**Figure 1.1** – The Effect of Speculators on the Price of Crude Oil

As the speculative price,  $P_s$ , of crude oil rises, consumers (and the nation) pay more for energy, transportation, and energy-related commodities from their fixed income. Thus, there is a wealth transfer effect from consumers to speculators, energy conglomerates, and energy-producing nations. As a result, consumers, and the nation, have less disposable income to purchase other goods and services. It is this loss of real purchasing power (income) that adversely affects aggregate demand and, if prolonged, causes recessions.

Clubley (1998) noted that the vast majority of futures crude oil trading is done by the oil industry itself. She also indicated that studies by NYMEX suggested that the oil industry accounts for about 85 percent of trading. Therefore, the oil industry controls the crude oil futures market as well as the pricing of refined crude oil products.

The ability of oil traders (the oil companies) to bid up crude oil prices through NYMEX is not beneficial to average Americans. It jeopardizes the nation's economic well-being and long-term security. Random releases of crude oil from the countries reserve would subject speculators to losses and hence reduce speculative behaviors.

### **Restrictive monetary policy adversely affects consumers' purchasing power**

Restrictive monetary policy is also a key precursor of economic slowdowns/recessions; it decreases the nation's real income and hence output. It is a policy used by central banks to control inflation; they argue that low and stable inflation tends to increase income. However, the 2008 Great Recession refuted this argument. It proved that when there is less money in circulation real income and demand for goods and services fall. Restrictive monetary policy occurs when the Fed uses open

market operations to sell securities (buy money), thus raising federal funds rates (interest rates) and draining money from the banking system and the public; which prevents monetary expansion.

The banking system can also prevent monetary expansion and hinder economic recovery by hoarding reserves, which is more feasible after Congress passed legislation allowing the Fed to pay interest on reserves (IOR). The problem, however, is the large emphasis by many central banks on controlling inflation; they perceived low and stable inflation as the primary goal of monetary policy (Cecchetti, 2000; Laidler 2004). As a result, central banks have gradually abandoned monetary for interest rate targets. Unfortunately, targeting interest rates fails to account for the level of the money supply in circulation required to establish robust demand and full employment.

Ironically, the argument that subprime loans caused the 2008 Great Recession implies that monetary expansion (credit) does not benefit the economy. However, most economists agree, and the facts validate that monetary expansion influences the course of the real economy (Bernanke and Gertler, 1995; Laidler, 1997; Mishkin, 1996).

According to Keister and McAndrews (2009), the quantity of reserves in the U.S banking system grew dramatically during and after the 2008 economic crisis. They also indicated that many commentators viewed the surge in excess reserves as banks hoarding funds rather than providing credit to households, merchants, and firms.

Most people believe that monetary expansion principally occurs through the actions of the central bank, the Fed. According to Dornbusch and Fisher (1978), it is the interaction between the Fed, commercial banks, and the public that determines monetary expansion; it is through the credit channel that banks and the non-bank borrowers expand the money supply. Before the 2008 Great Recession, U.S. bank reserves were around 50 billion dollars; after they rose to 1.6 trillion dollars.

## **Conclusion**

Under the Constitution, Congress is responsible for determining monetary policy (Labonte, 2012; Hetzel, 1986; Melzer, 1984). Hetzel noted that in light of Congress' constitutional responsibility, there is little examination of congressional attitude towards monetary policy. Kane (1984) argued that institutional arrangements, such as transferring monetary responsibility to the Fed, allow Congress to informally control monetary policy while dissociating itself from the unpleasant consequences of monetary policy (Fedbashing).

Productivity, employment, and a rising standard of living are contingent on monetary expansion which constitutionally is the responsibility of the US Congress. Thus Congress is responsible for monetary policy, for creating conditions for stable prices and full employment. Therefore, when the US economy fails Congress has not performed its constitutional responsibilities.

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