

The Ultimate Subprime Borrower: Uncle Sam

by [Gary North](#)

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The headlines about subprime mortgage lending are all the rage these days.

Subprime loans were not big news before this year. When the mortgage brokers were raking in big bucks in loan-origination fees, and the subprime lenders' stock prices were soaring, the mainstream media were uninterested. Now that the companies are going bankrupt along with 10% of their victims, the stories are everywhere. "Default! Default!" "Whose fault? Whose fault?"

The mainstream media never sound warnings when warnings might possibly do some good (but probably not, manias being what they are – maniacal). However, when the horse is out of the barn, "missing horse" stories are everywhere.

A sad story on subprime lending appeared in the *San Jose Mercury News* (March 14).

Homeowners like [J W.] may be affected. [She] is an 80-year-old retired Gilroy homeowner who said she's not sure her current loan was subprime, because she says she has excellent credit. But her loan has many characteristics of those subprime borrowers typically get, including a hefty penalty if she refinances within the first two years; and a negative-amortization "teaser" rate of 1.75 percent

that's causing her loan balance to grow with each passing month.

Her home of 35 years would have been paid for by now if she had not refinanced three times to remodel and pay debts.

"Here I ended up owing \$590,000 on it," she said with a rueful laugh.

This woman, had she been willing to match her spending with her income, would now be \$590,000 richer and not be facing eviction from her home. But she did not understand this simple concept:

"If your outgo is higher than your income, your upkeep will be your downfall."

There are millions of Americans just like her. It takes a recession to bring them and their creditors back to reality.

They are going to get a dose of reality soon enough.

Who is at fault? As Pearl Bailey sang half a century ago, it takes two to tango.

This woman played the fool, no doubt about it. She spent \$590,000 of her capital. She just had to have a nicer home, so she remodeled with borrowed money. She just couldn't find a way to pay her bills, so she borrowed even more. It was tax-free income! She could even deduct her interest payments from her gross income. Whoopie!

Here is an elderly woman in debt up to her ears, who was borrowing to pay her bills. She still thinks she has good credit, but she borrowed at subprime rates. She doesn't know the difference. She is about to lose her home.

A fool and her money are soon parted.

But far bigger fools are the companies, now busted, that loaned maybe half a trillion dollars to people just like this woman. (The total subprime mortgage market is over a trillion dollars.) Some well-dressed commission-seeking salesman extended money to her, even though she

was over half a million dollars in debt. Now her creditor is facing judgment day.

On February 23, I reported on the [Implode-O-Meter website](#), which lists mortgage lenders that have gone bankrupt since December, 2006. There were 23 of them. By March 7, there were 36. On March 14, there were 38. On March 17, there were 41. Watch this number rise!

These companies paid fat commissions to well-dressed salesmen for making large loans to high-risk borrowers. The salesmen did this brilliantly. That was the easy part. Getting repaid is the hard part. That is not the salesmen's responsibility. That is management's responsibility. Management in at least 41 companies did not have a clue about how to do this.

Then who is to blame? Answer: Alan Greenspan and his Ph.D.-holding accomplices.

E-Z CREDIT

The easy money policy of Greenspan's Federal Reserve, beginning in the summer of 2000, lured in the suckers: creditors and borrowers. The FED sent a false signal to the credit markets. "Look at the low interest rates today. See? Lenders are ready to lend!" But interest rates were not low because income-seeking private creditors were ready to lend their own money and forego present consumption. Rates were low because the central bank was creating fiat money to buy Treasury bills. There was additional money for buying T-bills, but no reduced consumption of goods and services by lenders. Result? Economic growth and misallocated capital.

This period of monetary expansion ended under Bernanke, beginning in February, 2006. The result a year later is defaulting mortgage lenders and defaulting homeowners.

Why should anyone be surprised at this? Because they do not understand Ludwig von Mises's theory of the business cycle, despite the fact that it first appeared in print in 1912. [I have written a chapter on Mises's explanation.](#)

In order to keep the expected recession of 2001 from becoming a major recession, the FED started printing money in advance in late 2000.

Then, to keep 9-11 from causing a stock market collapse, which was beginning to happen, the FED accelerated the rate of monetary inflation.

The short run conquered the long run. This is basic to politics. It is also basic to central banking monetary policy. The central banks defer the day of reckoning. They deal with the immediate problem and hope that they can find a way later to repeal the laws of economics and avoid both a recession and rising price inflation.

We are now facing the results of Greenspan's decision, from June, 2000 to January, 2006, to defer the day of reckoning.

In the meantime, millions of home owners have used their home's monetary inflation-generated equity to spend, just as the U.S. government did with the FED's fiat money. They also used the money to pay off debt, just as the U.S. government did when it sold T-bills to the FED to pay the interest on the existing U.S. debt.

The creditors imitated the FED: "Lend!" The debtors imitated the U.S. government: "Borrow!" The money supply rose. The national debt rose. The stock market rose. Home prices rose. It was all so easy.

A handful of nay-sayers warned: "The bills will eventually come due." But Ph.D-holding economists replied:

"Deficits don't matter." So did the politicians.

The nay-sayers shot back: "Deficits will matter." The economists and the politicians replied calmly: "That will be then. This is now."

In the subprime mortgage market, the bills are coming due. Deficits do matter. The future is now.

CLASS POSITION AND TIME PREFERENCE

A generation ago, Edward Banfield, a Harvard political science professor, wrote a book, *The Unheavenly City*. In that book, he offered a profound insight: A person's class position is established by his view of the future. Present-oriented people are lower class. Future-oriented people are upper class.

As soon as I read that, I made a connection. Ludwig von Mises

described the interest rate in terms of time-preference. People with high time-preference want to consume in the present. They discount the future sharply. They pay very high interest rates for consumer loans. They must be offered even higher interest rates to persuade them to save.

In contrast, people with low time-preference are willing to save when offered a much lower rate of interest. To get them to borrow, you must make money available at very low rates.

By combining Banfield's insight with Mises's insight, we can explain why there are pawn shops in ghettos, commercial banks in middle-class neighborhoods, and merchant banks in international money-center banking districts. We can also explain why their respective dress codes are different.

Millions of present-oriented Americans have used their homes as ATMs. Instead of sticking a credit card into a slot and retrieving Federal Reserve Notes, they called a mortgage re-finance company and signed a contract promising to repay the loan, subject to losing their homes should they stop paying.

The credit card withdrawal is a signature loan, meaning a signature-only loan. Your signature is on your credit card application. Your collateral is your fear of bankruptcy.

The mortgage loan is both a signature loan and a recourse loan. Your collateral is your fear of bankruptcy coupled with your fear of losing your home. You borrow against your home's equity: sales price after sales commission.

Subprime mortgage loans were made to people who do not fear bankruptcy very much and who had no equity. They regard the loss of their home as they would regard eviction from a rental unit. Some of them are used to evictions.

When you think about it, a Treasury bill is a signature loan. No one can foreclose on the Federal government, so it surely is not a collateralized loan. With the U.S. government with an unfunded debt liability – on-budget and off-budget – to the tune of \$71 trillion, it surely is not an equity loan. It has to be a signature loan.

Who would allow himself to go in the hole by \$71 trillion? Not a future-

oriented debtor, surely. If Banfield is correct, the U.S. government is a low-class debtor.

But it can borrow at low, low rates. Why? Because the creditors do not perceive that there is going to be a default. This default will be on a scale never seen in financial history.

You may think, "But that can't be true. Why, the best economists on earth have not issued a warning." The best economists on earth – as certified by themselves and their peers – believe that deficits don't matter, that the day of reckoning is always decades away. Call them Dr. Micawber. "Something will turn up."

Because voters have allowed the U.S. government to run up gigantic debts to them, they are like the subprime mortgage lender who extended credit to that 80-year-old woman with no equity. They think it's a great idea to get a promise of repayment. "We can't go wrong. Our future is secure."

Here is the [on-budget debt Implode-O-Meter](#) for the U.S. government.

I don't know of an off-budget debt Implode-O-Meter. A good summary is here: [Prof. Kent Smetters's testimony before the House Budget Committee](#) (Feb. 17, 2005). He estimated that, as of 2007, the unfunded liability of the U.S. government would be over \$71 trillion. (See Table 2).

This means that "we, the people" are expecting a miracle in our old age.

When dealing with the largest debtor in history, it is not wise personal financial planning to rely on miracles.

The typical voter thinks he will be repaid for all his loans – called "contributions" – to Social Security. He thinks that money extracted for Medicare will be repaid if he gets sick in his old age. So, he is a lender. The money is extracted by force, but he and his peers vote for politicians who oversee the extraction system.

Taxpayers pay today in the hope of repayment in the future. They are very much like all those subprime mortgage companies that loaned money to subprime borrowers. Those companies are now falling like pins in a bowling alley. "Strike!" Down they go, all in a heap.

Taxpayers will find that default is more convenient than repayment for subprime borrowers.

CONCLUSION

Like the 80-year-old woman who borrowed her way into home disownership, so are millions of American homeowners. They, too, think they have a perpetual ATM machine: their homes. They also think they have a backup ATM machine: the U.S. government.

At some point, they will insert their credit cards, and the cards will be rejected: "insufficient funds."

There is only one alternative: the cards will not be rejected, but the funds will not buy much. Inflation is the default method of choice for governments.



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