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As everyone now knows, the current financial market turmoil spreading across the Atlantic economy and beyond started with rising defaults in the United States mortgage market. How did the US come to experience a gigantic house-price bubble?

The explanation starts with US trade deficits and their financing. The US has been running an increasing trade (or more accurately, current-account) deficit since the early 1980s, with only one short interruption. The excess of imports over exports is paid for by newly printed dollars or Treasury bonds.

In countries running trade surpluses (like China and Japan), exporters to the US sell their dollars to their banks in return for domestic currency. This increases the demand for domestic currency, which - if the central bank does not intervene - tends to appreciate in value. As the currency appreciates, so too does the wage level, which impairs the economy's competitiveness. So to maintain export competitiveness and to boost employment, the central banks buy the dollars from exporters in return for newly created domestic currency; this functions as high-powered money - increasing domestic demand, raising the ratio of "financial" to "real" transactions, and encouraging speculation in domestic and foreign assets.

At the same time, the central banks use their increasing stocks of dollars to invest in US assets in order to earn a return. The return flow pushes up the value of the dollar (just the wrong direction for reducing the US trade deficit) and also pushes up asset values in the US, including property and Treasury bonds. Higher bond prices go with lower yields, and therefore lower interest rates. Lower interest rates push up consumption, domestic debt and imports in the US, and cause the country's deficit to grow even bigger.

The banks' choice

This mechanism has generated impressive economic growth in both deficit and surplus countries; but it is inherently unstable. Large trade imbalances generate larger increases in financial transactions and rising financial fragility, as rapidly increasing central-bank reserves (due to the US current-account deficit) provide the fuel for inflationary pressures and for mushrooming growth of the financial sector relative to other sectors. Banking crises, foreign-exchange crises, housing crises and the like become more likely (see Richard Duncan's book, The Dollar Crisis [Wiley, 2005], and his "Blame the dollar standard", FinanceAsia, September 2007) [subscription only]).

More specifically, central banks, faced with rising reserves denominated mostly in dollars, have a choice of three types of dollar assets:

(a) the bonds of the US government, in the form of Treasury bonds

(b) the bonds of "quasi-government" agencies, or government-sponsored enterprises (GSEs), like the mortgage lenders Fannie Mae and

Freddie Mac

(c) asset-backed securities issued by the private sector.

The banks' preference is for government bonds, the safest. But the supply and therefore the price of Treasury bonds depend on the state of the US budget deficit. When it is in or near surplus the supply is low and the price relatively high - therefore the returns are relatively low; and so the central banks switch their purchases to (b) or (c).

The turbo-charger effect

In the late 1990s, with both the US current-account deficit and foreign central-bank reserves continuing to increase, the US budget went into surplus thanks to the internet bubble and fast overall growth. The supply of government (Treasury) bonds therefore fell. Foreign central banks switched their demand to the next safest US asset, quasi-government bonds, in particular those of the mortgage lenders. So Fannie Mae and Freddie Mac enormously expanded their bond-issuance and mortgage-lending in the next several years, initiating the housing-market bubble.

But then the US budget went into deficit after the collapse of the stock-market bubble and the George W Bush administration's tax cuts, and the Treasury needed to sell more bonds. To cut a long story short, it engineered a halt to the issue of any more quasi-government bonds (to curb competition with government bonds), and foreign central-banks' demand switched back to government bonds.

By 2004 the property boom initiated earlier was generating rapid and broad-based economic growth in the US (enough to get Bush re-elected). So tax revenues increased and the US budget again went into surplus. The supply of new Treasury bonds fell.

Foreign central banks, with still fast-rising dollar reserves meeting a smaller supply of US government and quasi-government bonds, therefore switched to the third category of US assets, so-called asset-backed securities (ABSs). Between 2003 and 2004 the issuance of ABSs in the US more than doubled, and then almost doubled again in 2005. A large part of these ABSs was backed by mortgages - mortgages issued not so much by the quasi-government mortgage lenders as by private banks and other financial organisations.

To generate new demand, the latter developed new kinds of mortgages aimed at people previously not able to obtain mortgages on conventional terms: the so-called "sub-prime" mortgages, or "liar" loans, or Ninja loans (no income, no job). The mortgagees were told that continuously rising house prices would allow them to "extract equity" from the rising value of the house and in this way meet the higher repayments when the repayment terms toughened in a year or two. The private banks developed techniques of "securitising" the mortgages, techniques known by the impressive-sounding term "structured finance", by which combinations of highly risky mortgages could be packaged and sold - and given AAA ratings by the rating agencies on the pretext that the risk was widely dispersed (hence the ironic appellation, Ninja AAA loans).

This mechanism constituted a turbo-charger on the US house market. House prices escalated, the bubble intensified.

It was not only foreign central banks which accumulated dollars and sought to buy US dollar assets; so too did commercial banks, insurance companies, pension funds and the like. And they were not only non-US investors; US investors were also seeking to buy the same "risk-free" assets.

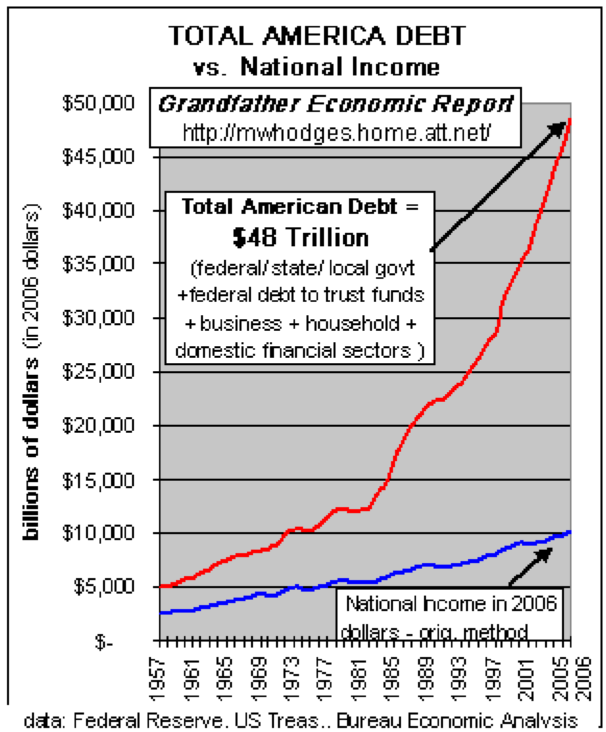
Meanwhile, US consumption soared, spurred on by equity extraction from rising house values, and so therefore did the US trade deficit. The jump in US imports helped to fuel a global economic boom in 2004-06; to which China's fast growth, itself fuelled by exports to the US, contributed via improved terms of trade for commodity producers in developing countries. The world economy grew at its fastest rate in decades in 2004-06. Globalisation was cheered to the rooftops; the views of "anti-globalisation" activists were being confounded (so the argument went), as free-market capitalism was evidently working to bring widely disbursed economic growth and associated benefits, even in parts of Africa.

The cost of collapse

The bursting of the property bubble in the US in 2006 triggered a sequence in which, slowly, banking and financial operators became aware that the foundation of the debt pyramid was quicksand. The US house buyer/consumer (below the top 20% of households) was increasingly insolvent, or nearly so. The large international banks, hoping for the best, waited until the summer of 2007 before they began to acknowledge that many of their complex debt instruments (ABSs) were non-performing: the debts could not be repaid, yet the banks were counting them as revenue-yielding assets. But in August 2007 they jammed on the brakes and cut lending, including to each other - and in many other parts of the Atlantic economy (not just the US) as well.

The knock-on effect of the falls in house prices and the rise in repossessions in the US mean that all other mortgage markets are in trouble - including cars and credit-cards. Unemployment is growing, consumption is stagnant.

The figure to watch is the ratio of total US debt to GDP. The ratio of rising debt to GDP has fuelled US growth in the past several decades (it went from 240% in 1990 to 340% in 2006). If total debt/GDP suddenly flattens, the US will experience a recession. If US debt/GDP falls, the world will experience a recession, because its fall will go with a fall in US consumption, which accounts for at least 20% of world consumption. The crisis has already spread to housing markets and mortgage lenders in the US, Germany, France, Spain, and South Korea. It will soon affect China and Japan, which are the two biggest holders by far of US national debt and stand to lose the most from a steep dollar devaluation. They are also large net exporters to the US, and will suffer from a fall in their US exports as the US contracts.



Meanwhile, oil has hit a record $84 a barrel, up from $24 in 2003; this generates a strong inflationary dynamic because of the effect on transport costs (equivalent to a general tariff increase). The price of uranium has jumped more than ten times since 2000, from $3.18 per kilogram to $38.6 per kilogram in 2007. The existing 440 nuclear reactors in the world require 82 million kilograms of uranium per year; but mines supply only 45.5m (the balance comes from national stockpiles and decommissioned nuclear weapons). Production from existing mines is falling; yet another ninety nuclear plants are either under construction or in planning. As though this was not enough, the price of wheat is at record levels and world wheat stocks at their lowest for decades; which adds to the other sources of inflationary pressure, in the form of higher food costs.

Saudi Arabia looks set to greatly reduce the weight of dollars in its reserves, accelerating the fall of the dollar. Its action would probably trigger a stampede out of depreciating dollar assets by other Gulf oil exporters (which currently have the fourth largest holdings of US national debt, after China, Japan and Britain).

The turmoil might even induce a shift in the neo-liberal consensus about the role of government in governing the market. Even the industrial and financial sectors might become more sympathetic to the idea of more limits on some kinds of markets (including for executive remuneration) - limits decided through a political process, in line with a social-democratic vision. After all, the Nordic countries achieve astounding prosperity with a denser regulatory regime and substantially less inequality of income and wealth than in the more neo-liberally-oriented countries.

The Guardian's Larry Elliott issues a useful caution here: "The sad fact is that only a deep recession is likely to generate enough national self-disgust at the destructive get-rich-quick value system oozing out of the City [of London] to create the political pressure for reform" (see "When money lenders cry for hand-outs", Guardian, 10 September 2007).

The consequences of waiting for a deep recession will be greater than anything seen so far.

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