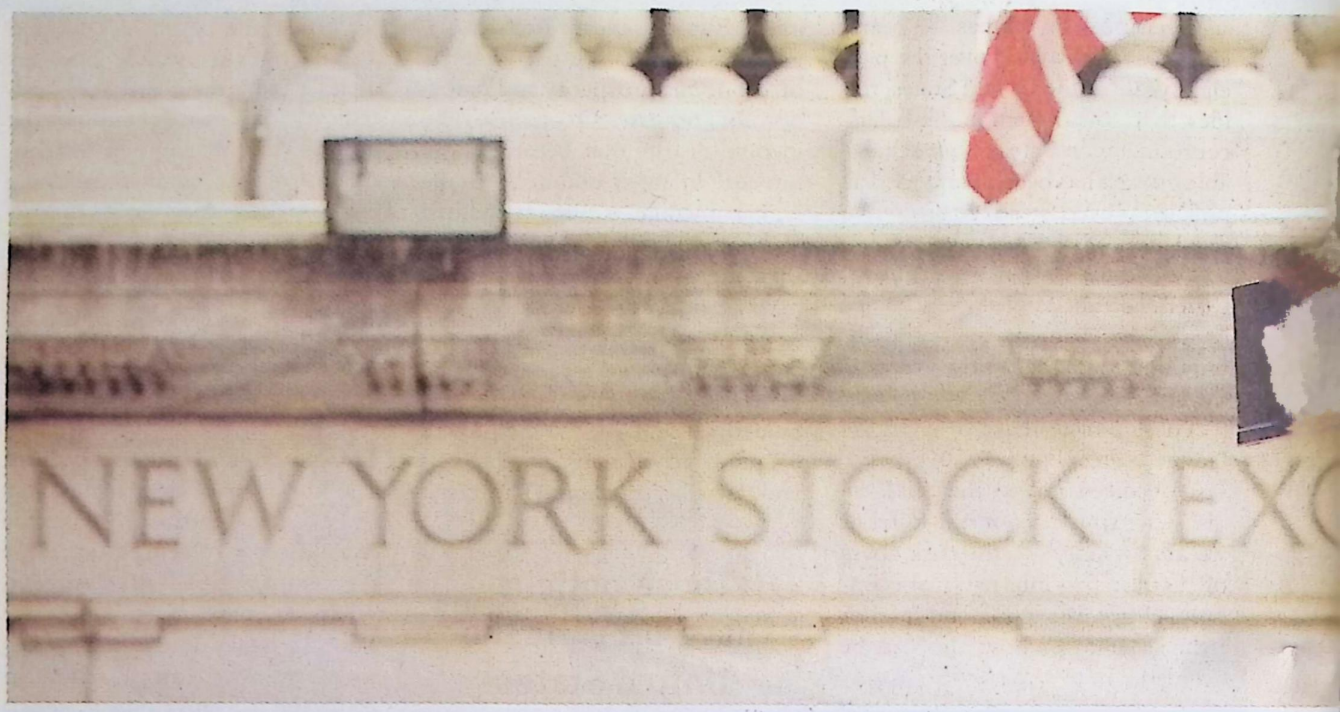


prices immediately for houses already built; the construction sector built houses as fast as possible but that led to higher construction costs and prices kept on rising. In addition, the spurt in construction resulted in the price of construction materials needed for the houses and apartment building also rising, adding further to the construction costs. Up went housing prices, up went the construction sector, and up went the lending to households to buy houses.

In the American financial system there are two large institutions, now called Fannie Mae and Freddie Mac, both of which had originated as government organisations to help fund housing, but were privatised as part of the financial sector reforms.

They worked in two ways: First they purchased mortgages made by banks, thus refinancing the lending bank and enabling them to make still more loans. Second, they guaranteed mortgages so that the lending bank did not face any risk and could cover its potential loss from default by paying the insurance premium to these two insurers. This pooling of the risk meant that lower interest rates could be made available to the guy that wanted to buy a house.

These two organisations got their money by borrowing from the capital markets. They borrowed from central banks around the world with the encouragement of the US Treasury, which assured everyone that this was as sound as a US government security. This channeled substantial foreign saving into the mortgage market in the United States, enabling more and more money to be directed to housing.

Those housing loans that went through Fannie and Freddie were called "prime" mortgages as they all met certain criteria laid down with respect to the size of the loan, relationship of income of borrower to the size of the loan, percent of the purchase price that could be covered, provision for insurance, and other technical rules related to construction.

But the availability of funds from the foreign lending to the US was so great that the financial institutions needed to increase the amount of lending and, hence, the so-called "sub-prime" mortgage market emerged. This market comprised loans that did not meet the conditions of Fannie or Freddie and so were generally riskier. Of course, such sub-prime loans could not be refinanced through the two institutions.

Another method was devised whereby the sub-prime mortgages were bundled together and, in complicated ways, financial instruments were devised so that persons who wanted to purchase these could buy instruments that had low or high risk. The higher the risk, of course, the higher the return offered. In this way, the sub-prime mortgages as well as the prime of conforming mortgages were refinanced.

As the prices of houses increased, Americans found that their houses were much more valuable. For example, I bought a house for $300,000 in 1995. I took a mortgage for 20 years for $250,000 and paid from my savings for the rest. In 2003, I had repaid $50,000 of the principal, so I owed $200,000. But