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How a U.S. Credit Crunch Went Global

By Adam Smith

Anyone who clinged to the notion that the risks lurking in America's mortgage pool were a local concern has now been proven wrong. The U.S. subprime mortgage market — turned sour by borrowers with poor credit struggling to meet payments as interest rates rise — is fast becoming a global worry. With huge chunks of this debt packaged up and sold to financial companies across the world, bad loans are roughing up banks and markets just about everywhere.

The French bank BNP Paribas on Thursday froze three of its funds, worth a total of around $2.75 billion, exposed to the subprime sector. The same day, NIBC, a midsize Dutch bank, said the subprime snafu had contributed to a $189 million loss in one of its U.S. investment books in the first half of this year. And dodgy real estate loans have made a big dent in forecasted earnings this year at German lender IKB.

Keen to limit risk in this kind of climate, European banks have taken to hoarding their cash, nudging up the rate they charge to lend each other money. Worries that caution would make it tough for banks to borrow forced the European Central Bank to mobilize. On Thursday, the Frankfurt-based ECB, which sets monetary policy for the entire eurozone, loaned the region's banks a record $130 billion. And it's not the only central lender with the jitters. Similar concerns prompted Japan's main bank to pump a trillion yen — more than $8 billion — into its money market on Friday. The U.S. Federal Reserve and Australia's central bank have both made similar moves.

The ECB may have had no choice but to step in, but dramatic swoops like that have a habit of spooking the markets. Sure enough, major indexes in Europe and Asia skidded Friday, with investors seeking the safe haven of government bonds. The question the most market participants want answered: how much more bad debt is out there? Unfortunately, no one really has a clue. "I don't think there's anyone that could confidently put their hand up and estimate within 40 or 50 billion dollars," says Nick Parsons, head of markets strategy at nabCapital in London. U.S. Federal Reserve Chairman Ben Bernanke last month said losses stemming from the subprime market could hit anywhere between $50 to $100 billion.

While it's a good thing that debt these days gets distributed around the world, it means more institutions could be hit than might otherwise. Expect some of those problems to come in the most unlikely places: Few outside of the Netherlands had heard of NIBC before it came down with its subprime headache. If it's taken a mess over mortgages to raise its profile, says Parsons, "it's not what the marketing men had in mind."

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