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Paulson Says Subprime Rout Doesn't Threaten Economy (Update5)

By Kevin Carmichael and Peter Cook - Jul 26, 2007

July 26 (Bloomberg) -- U.S. Treasury Secretary [Henry Paulson](#) said the meltdown in the subprime mortgage market reflects a reassessment of risk that doesn't pose a threat to the economy.

"I don't think it poses any threat to the overall economy," Paulson, a former chief executive officer of Goldman Sachs Group Inc., said in an interview today in Washington. "Risk is being repriced. As we get a broad reassessment of risk, we are getting volatility."

Investors are backing away from riskier assets, pounding stocks from Singapore to London and pushing yields on 10-year U.S. Treasury notes to the lowest since May. The [Dow Jones Industrial Average](#) lost 2.3 percent, the most in five months, to 13,473.57.

The housing recession, exacerbated by climbing foreclosures among subprime borrowers, is ricocheting through financial markets. Losses on securities tied to subprime mortgages -- loans made to people with poor or sketchy credit records -- are pushing up costs of funding for companies. Yesterday, Chrysler and Alliance Boots Plc failed to find buyers for \$20 billion of loans to pay for their buyouts.

"I do believe this is a wakeup call that lenders need to be very careful with the way they price risk, structure securities," Paulson said.

Volatility Jumps

The Dow dropped as much as 3.2 percent, before erasing some of its decline after the Treasury secretary's remarks. A benchmark for U.S. stock volatility, the [Chicago Board Options Exchange Volatility Index](#), surged to the highest level in 13 months today.

"Paulson's comments likely helped" stem losses in the stock market, said Michael Malone, a trading analyst at Cowen & Co. in New York.

Paulson, 61, said he's comforted by the strongest global economy he's ever seen, which is fueling demand for American exports. He called the U.S. labor market "strong" and said the outlook for corporate investment is "very good."

At the same time, there's little sign that the housing slump, which has restrained economic growth for the past year, is easing. Today, the Commerce Department reported that [sales of new homes](#) fell 6.6 percent last month, the most since January and more than economists predicted. [Orders for durable goods](#), excluding airplanes, cars and trucks, unexpectedly dropped in June, the government said in a separate report today.

'Major Correction'

"We have had a major correction in housing," Paulson explained. "When you have a correction of that magnitude, it will take a while to work itself out. In the subprime, that will take longer because as mortgages reset -- and the subprime issue at its heart is a pricing risk -- we have repeatedly said that this will be troubling for a number of individual home owners."

Today's figures suggest it will be difficult for the economy to sustain the pace of growth likely recorded in the second quarter, analysts say. The Commerce Department will probably report tomorrow that gross domestic product expanded at an annual pace of 3.2 percent in April to June, according to the median forecast of analysts surveyed by Bloomberg News.

Paulson is preparing for his fourth visit to China since succeeding [John Snow](#) a year ago. He said he'll press officials to make the yuan more flexible and ease the Chinese economy's dependence on exports.

"I am going to be making the case for currency reform, moving the renminbi more quickly," he said. "I am going to be making the case to opening up their economy, to moving forward with the pace of their reforms."

Chinese Expansion

China's leaders have failed to slow the economy, which grew at the [fastest pace in 12 years](#) last quarter, while the nation's [trade surplus](#) widened 87 percent in June from a year ago to a record \$26.9 billion.

Some U.S. lawmakers deem the yuan's ascent -- about 9 percent since the Chinese government ended a link to the dollar -- insufficient to narrow the trade gap. The Senate Finance Committee today approved legislation aimed at pushing China and other countries to raise the value of their currencies.

``We are not going to come up with a solution to the global imbalances or the trade imbalances we have with China unless they do some things to change the structure of their economy," Paulson said.

Paulson went to China more than 70 times as an executive at Goldman and as congressional calls to penalize China grow, he's made relations with the country a priority. He's lobbying its leaders to toughen copyright laws as well as allow the yuan to appreciate at a faster pace.

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