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World economy

The bursting of the American housing bubble

- IV Online magazine - 2007 - IV393 - October 2007 -

Publication date: Wednesday 31 October 2007

A speculative bubble can relate to assets that are real (property, land, etc.) or financial (shares, etc.) ; it manifests itself by an increasingly rapid rise in the prices of these assets. They end up by reaching such levels as appear excessive, even making an optimistic evaluation of the future profits which can be expected. The bursting of the bubble manifests itself by an opposite process, by a continuous and often brutal fall in these prices.

1. The effects of the bursting of a housing bubble

In the case of the housing bubble, it is accompanied, logically, by a drop in housing construction. This has been the case in the United States since the first quarter of 2006. The point to underline is that the bursting of a real bubble can have much more serious effects than the bursting of a stock exchange bubble. But, before entering into detail, it should be specified that these effects only represent so many risks: it is impossible to say if they will become concretised, and if so, on what scale.

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..or so you thought! Housing wealth goes AWOL in US

We can list three effects:

1) A "real" effect on economic activity. Overproduction of any commodity leads to a fall in the price of this commodity. Overproduction is then reabsorbed on two sides at the same time: on the side of offer, which falls (since the price drops, it is less remunerative to offer the product) and on the side of demand, which increases (since the price drops, it is more interesting to buy). In the case of real estate these two effects take a very long time to appear. In fact, it is impossible to reduce offer immediately: any building project which has been started will have to be finished, or else all the money invested in it will be lost. Which means that for months, or even years, new housing property will continue to arrive on a market that is already congested, making prices fall even further (in the present American crisis, there are already millions of houses which are not finding buyers). As far as demand is concerned, it will not necessarily increase, because potential buyers can defer their decision, waiting until prices fall even more. This delaying of a decision is possible, because we are not dealing with "daily" goods, whose consumption is a daily necessity, but goods whose wear and tear can extend over a particularly long period. If you are living in an old house , you can wait a little longer before acquiring a new one. So the impact of a housing bubble takes a very long time to be felt. However, this impact is important: the formula is well known: "when the building industry is going well, everything goes well"; it sets the tone, and that also works the other way round.

2) A financial effect. As a general rule, it is almost impossible to buy a house, or to have one built, without a loan: the sums concerned are too important for a household to be able to pay in full. So if there are difficulties in housing construction, they are bound to have effects on the financial sector. Institutions (specialized or not) grant these loans, with as "surety" the house that has been sold (mortgage). These institutions can in their turn borrow from others, which "refinance" them. The first financial danger lies there, the "domino effect": if these institutions, enticed by higher interest rates, have authorized these loans in a laxist way to not very solvent households, at the least difficulty these households will default on their obligations (see Appendix 1, on subprime credits). If they are very numerous to do so, the lending institution will collapse and it can take down with it the institution that refinanced it. This is what is happening in the United States, where 84 mortgage credit companies went bankrupt or ceased completely or partially their activity between the beginning of the year and August 17, compared with only 17 for the whole year 2006. In

Germany the IKB bank and the public institute SachsenLB were only saved by the skin of their teeth. Almost everywhere important losses related to subprime credits are being announced. As a result, the number of homes repossessed in July in the United States reached 180 000, twice as many as in July 2006, and there have been more than a million since the beginning of the year, which is 60 per cent more than a year ago. There is likely to be a total of whole 2 million repossessions in 2007.

The domino effect could even affect banks which do not grant mortgage loans, because banks lend to each other: if a bank has serious difficulties in real estate, another bank which does not could in its turn become suspect, if it had lent a lot of money to the first bank, which would perhaps not be able to repay it.

How to distinguish the banks that one should be wary of from the others? It is very difficult, not only because the banks dissimulate their exposure to risk, but also because it is not so easy to say in advance which debtor will default: where do you draw the line between debtors, who differ from each other only by a greater or lesser degree of insolvency? Furthermore, if the economic situation worsens, someone who had been up to that point a good debtor could become included in the category of risky loans. That is certainly one of the biggest problems created by a housing bubble: it is very difficult to differentiate, in the credits of the banks, the "bad credits" from the others. After the bursting of its own property bubble, Japan tried for years to do it, without succeeding. That explains the deep mistrust which now exists between banks, which poisons the atmosphere and undoubtedly contributes to the aggravation of the current crisis. On Friday August 10, in Europe and in the United States, something unprecedented occurred: in the space of 24 hours, banks became so wary of each other as to refuse to accord any kind of loan, forcing the central banks to intervene massively. In the space of four days, until August 14, 2007, the European Central Bank (ECB) had to provide the market with nearly 230 billion euros of liquidities. It should however be stressed that what is involved here is monetary creation and not sums taken from the pockets of this or that client in order to transmit them to the banks in difficulty (see Appendix 2).

In such a context, it is everyone for themselves: each bank, while trying to save itself, can contribute to a general collapse. A bank has, on the one hand, deposits (it owes this money to the depositors, private individuals or companies). On the other hand, it has

a) The credits of all sorts which it has granted to private individuals or companies, credits which represent so many debts owed to it;

b) The investments that it has made, in shares or bonds (a share is a title of property and gives the right to a part of the dividends distributed by a company; the bond-holder, on the other hand, is a creditor, who has lent money and awaits the payment of interest).

In the event of difficulties, the bank will be tempted to get out of this sphere of financing the economy: on the one hand, since suspicion has become widespread and prudence is necessary, it will restrict the mass of credits granted (this what we call the credit crunch); in addition, it will give priority in its investments to bonds rather than shares (which are considered to be riskier). This represents a double movement which can have serious consequences, because to forsake shares contributes to a stock exchange crash, and the restriction of credit can quite simply paralyse the economy and precipitate it into a recession. In the current American crisis, we have already seen a movement in favour of bonds; parallel to this, the institutions who have suffered losses on real estate will perhaps seek to compensate for that by selling shares in their possession, which should accentuate the fall in the price of these shares. As for the restriction of credit, which is essential, it should logically happen, but it is impossible to say in advance to what extent. In any case, the effect on investment by companies can only be negative, not to mention the difficulty they will have in being financed on a Stock Exchange where share prices are falling.

It is true that many American banks have taken their precautions, by transforming the credits that they had granted into titles of debt, which they sold. The advantage here is to avoid the concentration of risky debts on the banks' balance sheets. The disadvantage is to disseminate the risk throughout all the national, and even international, economy: billions and billions of risky debts have not disappeared, they have landed somewhere, but where? Mistrust becomes universal. The speculative funds are particularly the target of suspicion: now, there are 9,500 of them in the world, and they manage the trifling sum of 1400 billion euros.

3) An effect, finally, on the spending of American households. This effect is essential. It can be broken up into two aspects:

a) On the investments made by households, i.e. on their purchases of homes. American households will now have the greatest difficulties in financing the purchase of housing by obtaining mortgage loans from banks who have become extremely wary.

b) On everyday consumption. Here the effects that we listed above converge:

– Real effect: The building industry is already making massive lay-offs, to which have to be added the risks that are weighing on investment by companies. All this will lead to a rise in the rate of unemployment (which is low at the moment) and in fear of unemployment, which are all things that can negatively affect consumption.

– Financial effect: the restriction of credit restriction, which can weigh heavily on American households accustomed to consume on credit. And we also have to add the behaviour of indebted households who are afraid of losing their homes, who want to keep up their payments, and who for this reason cut down on their consumption. Let us not forget the "richness effect", which postulates that consumption by households does not depend only on their current income, but also on the evolution of their patrimony, i.e. on the value of the property and financial credits that they have. If this value goes up, they feel richer and are tempted to consume more. But if (as is currently the case in the United States), the opposite occurs, and their portfolio of shares and the value of their home both drop, we can expect a negative impact on consumption, especially for households accustomed to "back up" their consumer credits with the value of their home. The risk should not be underestimated: household consumption occupies an exceptionally important place in the United States, representing nearly 70 per cent of GDP (it is only 55 per cent in France). It is the pillar on which in the last resort everything depends, not only for the American economy, but even, as incredible as it may seem, for the economy of the entire world.

If the American economy went into recession, it would do so in a particularly delicate context, because up to now it has been living beyond its means, on credit, getting into debt on a grand scale. The rate of saving of American households is practically zero (this rate expresses the relationship between the savings of households and their disposable income); whereas, for example, that of French households amounted to 15.5 per cent in 2006. The rate of indebtedness of these American households reached in 2006 the extraordinary level of 140 per cent (this rate expresses the relationship of their debts to their disposable income). As for the external deficit (financed day after day by the rest of the world), which has become abyssal, it accounted for 6.5 per cent of GDP in 2006. These are features which are much more those of a power reaching its end, which is trying to maintain itself at whatever cost, than those of the superpower that is usually described.

If the American economy went into recession, the impact would be very great for the entire world, because it plays the role of locomotive for the world economy, and there is no other economy that can do that. As a result, emerging countries like China and India, because they have chosen insertion in liberal globalization and the "export-led" model, may see their economies breaking down, since they have become entirely dependent on their exports, in particular towards the United States. Thus, the share of exports in China's GDP, which was 10 per cent twenty years ago, has risen today to nearly 40 per cent.

B) Where does the American housing bubble come from?

It does not fall from the sky, it is not the consequence of speculation, of bad management or the result of the irresponsibility of "those who have played with fire". Actually, the American housing bubble is the crisis of the "new economy", the crisis of the new technologies bubble (2001) which continues to this day. In 2000, the bursting of the stock exchange bubble involved, as one could expect, a particularly severe fall in investment by companies and a rapid rise in lay-offs. But the recession did not turn into a real depression, thanks to spending by households. Enormous means were employed to achieve this. The first was an extraordinary fall in the lending rate of the American central bank (see Appendix 2), a rate that was in a very short space of time brought down from 6 per cent to one per cent (which was really in fact a negative rate, if account is taken of inflation). Prolonging a forward flight that had been under way for a long time in the United States, the credit tap was turned on to the maximum, which largely facilitated mortgage credit and launched the housing bubble. The medicine used to nurse the stock exchange bubble became the drug of the housing bubble: they got out of one bubble only to fall into the other one, and because they fell into the other one. Thus the rate of indebtedness of American households shot up from 107 per cent in 2001 to 140 per cent in 2006, opening the way to the crisis of over-indebtedness which we can observe today.

C) What lessons can be drawn?

The succession of bubbles (and of their effects) is a question of the system. From the beginning of the 1990s, we can note a succession of financial crises: Mexico in 1995, Southeast Asia in 1997, the "new economy" in 2001, and finally the current one. Financial crises of this type had not been known since the Great Depression. In the same way, the only precedent for the stock exchange new technologies bubble at the end of the 1990s is that of 1929: between the two, there is nothing comparable. The conclusion is inescapable: what is mainly responsible is the installation of liberal globalization, guided by the relentless search for profit. It is only with its installation that everything started (or rather, started again). This system is undermined by instability. When it works, it is to the benefit of a minority, at the expense of those who produce the wealth. When it does not work, it brings the entire population down with it.

If there is an American recession, it is necessary to act urgently. If there is not, that is not a reason to remain with our arms crossed: there have been sufficient warnings for us to take account of before it is too late. We have to start again from A to Z, to sweep away liberal globalization, the unbridled reign of the market, the inadmissible freedom that is left to the rapacity of profit. The American central bank (the Fed), the BCE, the Japanese central bank, etc., which are scandalized as soon as anyone evokes the slightest intervention on the economic terrain, did not hesitate to pour out billions of euros or dollars to save the system which is so close to their heart (See Appendix 2). So there is an economic duty of intervention, but this time in favour of the immense mass of the population, the workers, so that they do not have to bear the consequences of a crisis caused by the insatiable search for profit, an intervention that finally opens the way to a system oriented towards the satisfaction of real social needs.

Appendix 1
Subprime credits

The term indicates housing loans known as "at risk", because agreed to (often at fluctuating rates) for households with fragile solvency. With the general increase in interest rates, the repayment obligations of the borrower have become higher and higher. Some have found it impossible to keep up with them, As long as housing prices were rising, it was possible to put the problem off by again borrowing, with as surety a house that was worth more than before. With the bursting of the bubble and the fall in housing prices, that was no longer possible, there were no more loopholes.

Appendix 2
Injection of liquidities

The banking system is organized in a pyramidal fashion: at the summit there is the central bank, below that there are banks known as second-rank (for example, Societe Generale, BNP, etc). In the United States, the central bank is the Federal Reserve Bank (also known as the Fed). In Europe, there is an additional rank: there is the ECB, the central banks of the various countries and the second-rank banks. Deposits are for the second-rank banks "short" debts: the sums that they contain can be withdrawn by the depositors immediately or at short notice. On the other hand, the credits that they grant are for a "long" time (several months, perhaps several years). As for investments, they are not designed to be liquidated overnight. In short, the bank transforms "short" (in the short term) into "long" (in the long term). We can immediately see the problem that lies in the difference of time scale between the two: although a bank may have good debtors and good investments, it can find itself short of liquidities (i.e., to put it simply, euros issued by the ECB or dollars issued by the Fed). In such a case, it can address itself to the other banks (the inter-bank market), or, in a more general way, to the money market (where companies also intervene) or finally to the central bank. The latter can, if it decides to, grant credits in its currency to the banks of its zone. It does this at a certain rate, fixed in advance. We say that the central bank is "the lender of last resort" and that it "refinances" the second-rank banks.

The ECB and the Fed were thus forced to feed in liquidities, and for extraordinary amounts, the banks of their zones, because the inter-bank market had abruptly ceased functioning: mistrust was such that banks now refused to lend each other money. If the crisis of liquidity has been averted, that does not mean that all risk of a banking crisis has been. A particularly heavy constraint of profitability weighs on the banks: the capital which is invested there must be remunerated at the best rate and every credit that is not reimbursed and every bad investment is severely penalised. The losses related to the housing crisis will be deduced from profits, or will be covered by new capital inflows (if these are possible) or will lead to bankruptcy.

