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Collateral Damage From A U.S. Housing Bust

There continues to be a hot debate as to whether the U.S. housing market is overvalued or whether "it is different this time." In my commentary of June 4, "Housing: It's Different This Time" (http://www.northerntrust.com/library/econ_research/weekly/us/), I gave reasons as to why I think housing is an economic accident waiting to happen when interest rates rise start to rise in earnest. Others, such as Goldman Sachs ("House Prices: A Threat to Global Recovery or Part of the Necessary Rebalancing," Global Economics Paper No: 114, July 15, 2004), have estimated that U.S. housing prices are about 10% overvalued. On the fairly-valued side is the Fed of New York ("Are Home Prices the Next Bubble," Economic Policy Review, forthcoming), which says that housing is not overvalued *at current interest rate levels*. But are current interest rate levels sustainable? I think not. U.S. interest rates are destined to climb in the next 12 months.

This week's commentary is a "what if." What if the U.S. housing market goes bust? Of course the healthy home construction business will get ill. Contractors will be begging for business and former mortgage brokers will return to driving cabs. Because homeowners' in-house ATMs will have run out of cash, it will be easy to get a parking place close to the shopping mall's anchor store. But the most serious collateral damage from a housing bust would be a wounded U.S. banking system. As Chart 1 shows, that home mortgage debt accounts for a record 32% of total U.S. nonfinancial debt. To put this in perspective, U.S. Treasury debt held by the public accounts for only 18% of total domestic nonfinancial debt. U.S. commercial banks have become major investors in mortgage-related debt. As Chart 2 shows, about 60% of U.S. banks' earning assets are mortgage-related – a post World War II high. In 1986, the percentage was only 30.

Chart 1

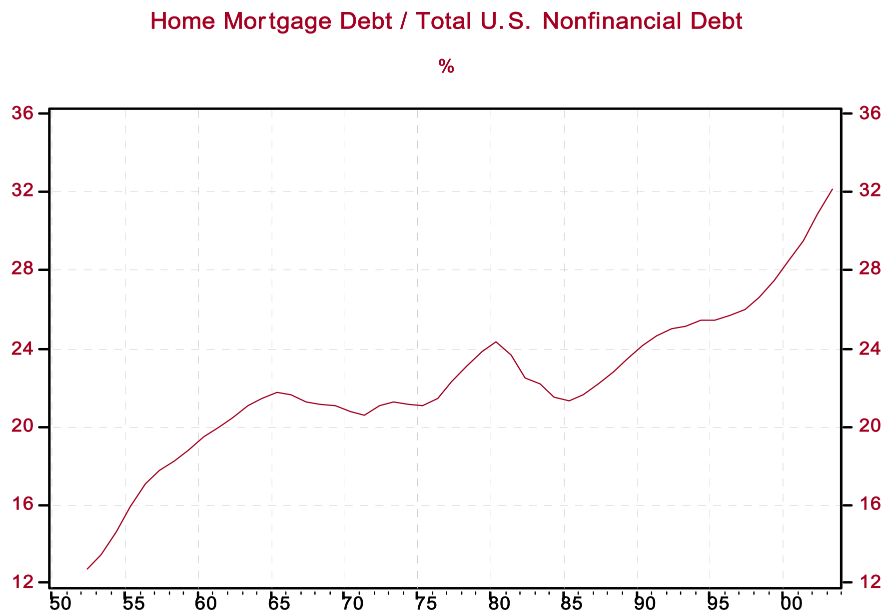
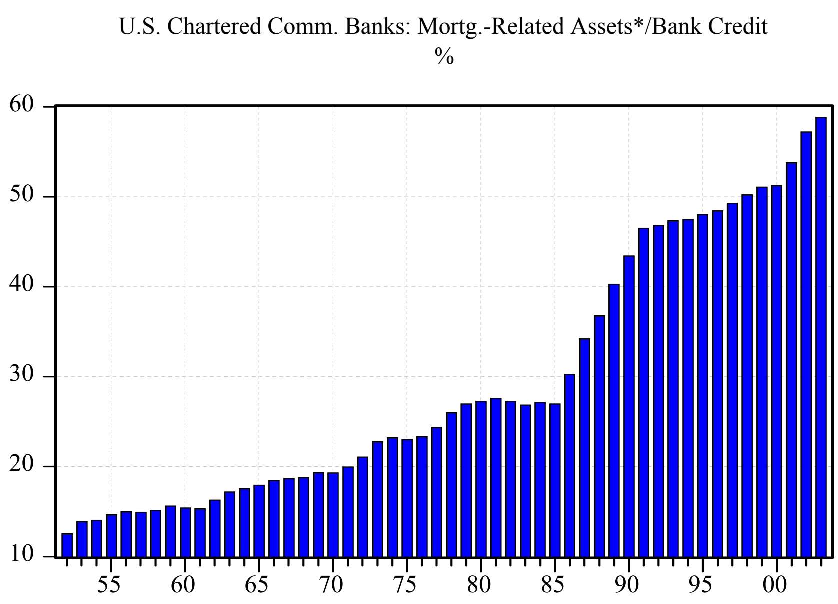


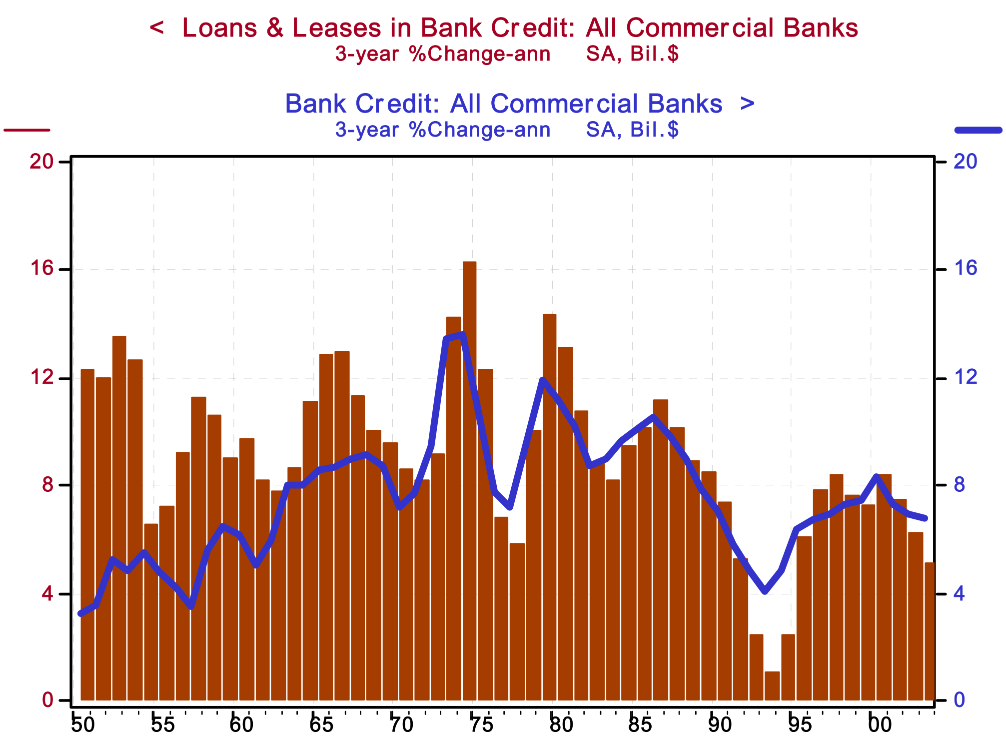
Chart 2



* includes mortgage pool and collateralized mortgage obligations, direct mortgages, and liabilities of gov't.-sponsored agencies.

So what if the U.S. banking system falls on hard times? History suggests that as goes a nation's banking system, so goes its economy. The banking system is the transmission between the central bank and the economy. When that transmission system breaks or does not function properly, the stimulative effects of monetary policy become dulled. Central banks cut interest rates to very low levels, which, under normal circumstances, would create a boom in nominal aggregate demand. But when the banking transmission system is not functioning properly, those low interest rates engineered by the central bank don't seem to reach the wheels of the economy. For example, after the 1929 U.S. stock market crash, the U.S. banking system also crashed. This broken banking system coincided with the worst recession in U.S. history. After the Japanese stock and real estate markets crashed in the early 1990s, the Japanese banking system was put on life support. This coincided with more than a decade of Japanese economic stagnation. Chart 3 shows the post World War II history of U.S. commercial banks' total earning assets and the subset, loans. In the three years ended 1993, growth in banks' loans was only 1.2% annualized, the slowest growth in the post-war period. Three-year growth in banks' earning assets was only 4.1% in 1993 – the slowest since the very early 1950s. As you may recall, in the early 1990s the U.S. banking system became dysfunctional because of the lumps it took after the collapse of the commercial real estate market. The U.S. housing market was not exactly thriving either in places like California, Connecticut, Massachusetts and New York. The collapse in these markets turned S&Ls into dinosaurs. To make a long story short, coinciding with depository institutions, for all intents and purposes, not extending any new credit to the private sector, the U.S. economy encountered some severe "headwinds," as Fed Chairman Greenspan described it.

Chart 3



Source: Federal Reserve Board /Haver Analytics

After the U.S. stock market bubble burst in 2000, there were massive corporate bankruptcies. U.S. banks were clever enough to offload a lot of their commercial credit risk to other parties before the bankruptcies occurred. Thus, the U.S. banking system was bloodied by the bursting of the late 1990s stock market, but unbowed. Banks were willing to able to keep lending – if not to corporations, then to households with their homes as collateral. All of which brings me to where I came in. If the U.S. housing market goes bust, the U.S. banking system is likely to fall on very hard times as the value of all that housing collateral drops.

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Note: This, along with many recent commentaries, has been pessimistic. I am going to take a few weeks off to attempt to adjust my attitude by trying out my new sailing kayak on the waters of Green Bay and Lake Michigan.