US housing crisis could spark serious economic downturn

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The US economy could experience a deep recession as a result of the housing crisis, according to National Bureau of Economic Research president Martin Feldstein.

Feldstein told the annual symposium of central bankers and economists at Jackson Hole Wyoming over the weekend that the housing sector was at the root of three distinct but related problems confronting the US economy.

The decline in house prices and the fall in home-building could lead to a recession across the economy; the sub-prime mortgage crisis could lead to a freeze in much of the credit markets; and the decline in home equity loans and mortgage refinancing, triggered by the fall in house prices, could cause further declines in consumer spending.

Feldstein's remarks, which came at the end of the three-day discussions, were aimed at ensuring a rate cut by the Federal Reserve at the next meeting of its open market committee on September 18, if not before.

In his opening speech to the gathering, Federal Reserve chairman Ben Bernanke insisted that while the Fed would act to limit the adverse effects on the broader economy of the disruptions in financial markets, it would not be appropriate to protect lenders and investors from the consequences of their financial decisions.

While he accepted this argument, Feldstein insisted that "it would be a mistake to permit a serious economic downturn just in order to avoid helping those market participants."

He noted that while the Fed and other central banks had emphasised their roles as lenders of last resort and had provided increased liquidity there were many important financial institutions, including investment banks and large hedge funds, which did not have access to Fed funds.

While the Fed had encouraged the commercial banks to lend to them, Feinstein said, it was not clear whether this policy would succeed "since much of the credit market problem reflects a lack of trust, an inability to value securities, and a concern about counterparty risks. The inability of credit markets to function adequately will weaken the overall economy over the coming months. And even when the credit market crisis has passed, the wider credit spreads and increased risk aversion will be a damper on future economic activity."

Even with the best policies to increase liquidity, future demand would be weakened by lower levels of housing construction, depressed consumer spending and impaired credit markets.

Calling for a "major reduction" in the federal funds rate—possibly by as much as 100 basis points (1 percentage point)—Feldstein said the sharp decline in US residential construction provided an "early warning of a coming recession" and that if the "triple threat" from the housing sector materialised "the economy could suffer a very serious downturn."

In the course of his speech, Feldstein cited statistics which showed the potential impact of the collapse of the housing bubble on the US economy. Up until the year 2000, real house prices and rents had stayed together, after which real house prices surged to a level 80 percent greater than the equivalent rents.

This divergence was fuelled by the policy of cheap credit pursued by the Fed, which cut the federal funds rate to just 1 percent in 2003 and then promised to increase it only very slowly thereafter.

If house prices were to fall enough to re-establish the traditional relationship with rents, there would be "serious losses in household wealth" and a consequent decline in consumer spending. With housing wealth

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now estimated at $21 trillion, a 20 percent decline in nominal prices would reduce wealth by $4 trillion leading to a possible cut in consumer spending of about $200 billion or 1.5 percent of gross domestic product (GDP)—enough to push the economy into recession.

A decline in nominal prices of 20 percent would mean that home-buyers could end up with a mortgage debt greater than the value of their house. This would lead to defaults that would increase if house prices were expected to fall further.

"Once defaults became widespread, the process could snowball, putting more homes on the market and driving prices down further. Banks and other holders of mortgages would see their highly leveraged portfolios greatly impaired. Problems of illiquidity of financial institutions would become problems of insolvency," Feldstein said.

There was also a potential for a "substantial decline" in consumption because of the decline in home equity withdrawals. Under conditions of rising home prices and falling interest rates, home-buyers were able to refinance their mortgages and obtain an increase in funds which was used to pay down other debts or finance additional consumer spending.

In 2005, some 40 percent of existing mortgages were refinanced, with national flow of funds data indicating that between 1997 and 2006 these mortgage equity withdrawals were greater than $9 trillion, an amount equal to more than 90 percent of disposable income in 2006.

In a clear indication of possible action on interest rates by the Fed, Frederic Mishkin, a Federal Reserve governor, told the Jackson Hole symposium that policymakers should not wait until a decline in house prices led to a fall in GDP but should "react immediately to the house price decline when they see it."

Mishkin warned that while housing and mortgage markets had not been "close to the epicentre of previous cases of financial instability" the current situation in the US "could prove to be different."

While the crisis has been centred in the United States, the fallout has extended around the world. Germany has been one of the countries hardest hit with two banks having to be bailed out because of their exposure to US subprime mortgage debt.

The head of the German Bundesbank, Axel Weber, a leading member of the governing council of the European Central Bank, told the symposium that the turmoil in financial markets had all the characteristics of a classic banking crisis. The only difference was that it was taking place outside the traditional banking sector.

Weber noted that the classic conditions leading to a banking crisis—borrowing short and lending long—had been created by off-balance sheet transactions in which so-called conduits and structured investment vehicles, set up by the banks and other financial institutions, borrowed money on the commercial bond markets.

These entities were inherently vulnerable to a sudden loss of confidence on the part of their funders because there was a "maturity mismatch" when short-term finance was used in invest in long-term mortgage-backed or asset-backed securities.

If the sentiments expressed at the Jackson Hole summit are any guide, the Fed will concede to growing market demands for a significant interest rate cut on September 18, if not before. But even if such a cut does bring a halt to the current turmoil—and there is no guarantee of this happening—it will only do so by creating even greater problems for the future, in the same way the present crisis resulted from previous decisions to boost the economy and financial markets with an injection of liquidity.

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