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"Falling Home Prices Could Trigger a U.S. and Global Recession"

The meteoric increase in home prices in the United States during the past five years has been the mainstay of economic growth, not only in the United States but in the rest of the world as well. This year, home prices in the United States have reversed course. As the downward slide in home prices gathers pace in the months ahead, the U.S. economy is likely to weaken substantially. This weakness could contribute to the possibility of a global economic recession in 2007. [See: "Current Federal Reserve Policy Could Accelerate Inflation"]

Global Economic Engine

Between 2001 and 2005, the median U.S. home price increased at an average annual rate of nearly nine percent, according to National Association of Realtors (N.A.R.). By comparison, the median U.S. home price advanced at an average annual rate of just over four percent between 1996 and 2000. In 2005 alone, the median home price jumped by 12 percent, marking the largest gain in nominal home prices since the late 1970s.

Although annual average gains of nine percent are seemingly benign, the pace of median home price appreciation doubled between 2001 and 2005 compared to the previous five years. In addition, the average annual increase in the median home price masks enormous gains in many areas of the country where prices more than doubled between 2001 and 2005. Because about 68 percent of all households in the United States own a home, the sharp rise in home prices boosted household equity.

Very low interest rates in the United States, by historical standards, combined with the proliferation of non-traditional mortgage products and easy credit access allowed many U.S. households to convert household equity gains into income gains through mortgage refinancing. According to statistics produced by Freddie Mac, one of the United States' largest mortgage lenders, cash-out mortgage refinancing accounted for about 50 percent of all mortgage refinancing between 2001 and 2004. In 2005, cash-out mortgage refinancing accounted for 73 percent of all mortgage refinancing. In the first half of 2006, cash-out refinancing accounted for a staggering 87 percent of all refinancing.

Substantial household income gains supported by rising home prices and increasing home equity propelled exceptionally strong personal consumption expenditure growth in the United States, which averaged three percent between 2001 and 2005. During the same period, real Gross Domestic Product (G.D.P.) in the United States expanded at an average annual rate of 2.4 percent. Because real personal consumption expenditure grew more rapidly than real G.D.P., economic growth in the United States was overwhelmingly driven by personal consumption growth between 2001 and 2005.

The strong real growth of personal consumption expenditure in the past five years fueled not only above trend economic growth in the United States, but it also fueled exceptionally fast economic growth in other countries that filled Americans' insatiable appetite for consumer goods. In Asia, China, Japan, South Korea and Taiwan are all among the United States' top ten countries for import origination. Consumer goods dominate these countries' exports to the United States.

Strong personal consumption growth in the United States during the past five years was the key factor behind China's rapid economic growth between 2001 and 2005, which averaged nine percent, in real terms, annually. During the same period, real economic growth in South Korea averaged 4.5 percent. In Taiwan, real economic growth contracted by 2.2 percent in 2001. Thereafter, the country's annual average rate of real economic growth exceeded four percent. Although Japan remained mired in deflation during most of the past five years, the strong growth of personal consumption in the United States lifted the country's economy out of recession starting in 2003. In addition to fueling strong economic growth in the United States and Asia, the growth of personal consumption expenditure in the United States also led to surging global energy demand and rising international energy prices.

The Fall of Housing Prices

It is inevitable that U.S. home prices will fall. According to the N.A.R., in the first quarter of 2006, median U.S. home prices increased by a further ten percent, compared to the same period in 2005. In the second quarter of 2006, median U.S. home prices advanced by less than four percent, compared to the same period in 2005. As with rising median home prices between 2001 and 2005, the sharp slowdown in the growth of median home prices in the second quarter of 2006 masks very sharp declines in home prices in many states including California, Massachusetts, New York, Arizona and Florida.

Conventional wisdom holds that rising interest rates are the culprit behind falling home prices in the United States. Rather than

interest rates, increasingly unaffordable house prices and rising inventories of unsold homes have been pushing home prices lo. Equally important has been soaring energy prices that have reduced household disposable income. Statistics from the N.A.R. indicate that housing is at its least affordable level in at least 20 years. Other measures of affordability, which compare house income with home prices, show the same magnitude of decline in home affordability.

With home prices out of reach for a growing portion of the U.S. population, inventories of unsold homes have steadily risen. According to the U.S. Department of Commerce, inventories of unsold homes reached an 11-year high in July 2006. During the year, these inventories increased by over 20 percent. The Department of Commerce also reported that home sales declined 13 percent since July 2005. Though these statistics are fraught with sampling errors and subject to large revisions, the trend durir the last 12 months has shown home inventories rising rapidly and home sales growth slowing sharply. According to industry experts, these statistics are underestimating the growth of unsold home inventories and the contraction of home sales.

Apart from households that are seeing slowing or contracting income growth, banks in the United States are also very exposed falling home prices. With home prices falling, especially in what were once the hottest housing and mortgage markets in the Ur States, mortgage default rates have leapt higher. In California, mortgage defaults increased by 67 percent in the second quart 2006, compared with the same period in 2005, reaching a three-year high. Falling home prices have also undermined collatera values for mortgage lenders. The combination of rising defaults and falling collateral values is beginning to weaken the balance sheets of mortgage lenders, including several of the United States' largest banks. Balance sheet problems and Federal Reserve directives to more closely monitor loan risks associated with non-traditional mortgages is drying up mortgage credit -- another factor that is weighing on home prices and inventories of unsold homes.

Growing weakness in the banking sector is very alarming. Banking sector and economic crises in many countries over the past years can be traced to overly exuberant credit growth used to finance either capital investment or real estate speculation or bo Japan offers a stunning example of what can happen after a real estate bubble bursts. Japan's real estate bubble collapsed in tl late 1980s, producing first a prolonged economic recession and then a prolonged period of deflation. Ironically, as a result of th U.S. real estate bubble, Japan finally recovered. As in the United States, few in Japan believed that a speculative bubble was forming in the real estate sector.

When the Global Engine Stalls

During the next several months, home prices in the United States are likely to continue declining. This decline could accelerate 2007. Rising inflation will eventually force the U.S. Federal Reserve to raise short-term interest rates again, although probably until after the November mid-term elections. In the meantime, rising international energy prices and the approach of North America's winter will further reduce disposable income, leading unsold home inventories higher and home prices lower.

After the mid-term elections, the Fed may be so far behind the inflation curve that a series of rate hikes will be needed to lowe inflation expectations and prop up the value of the dollar. Uncertainty surrounding the direction of interest rates will also push home prices down and inventories up. Declining home values will continue to reduce household income, forcing personal consumption expenditure lower. Some economists have noted that rising wages will offset the negative impact on household incomes of falling home prices. Wage gains during the last five years, however, have been markedly less than home price gain: [See: "[Current U.S. Federal Reserve Policy Could Accelerate Inflation](#)"]

Between 2001 and 2005, nominal wages in the United States increased at an average annual rate of less than three percent. D the same period, real wages increased at an average annual rate of less than one percent. Although nominal wages may grow slightly faster in the months ahead, rising inflation will limit real wage and income growth. By the second half of 2007, much weaker growth of personal consumption expenditure may push unemployment higher, further undermining household income. Simply put, if home prices continue to decline, the U.S. economy could fall into recession in 2007 dragging the rest of the work with it.

China, Japan, Korea and Taiwan, which supply the United States with consumer goods, are the countries most vulnerable to a l economic downturn led by weakening personal consumption growth. Other countries, such as Britain, France and Germany, wh are also among the United States' top ten trading partners, will also face an economic downturn as capital goods exports from these countries to the United States weaken. Canada and Mexico, which along with China are the United States' top three tradi partners, will also follow the United States into economic recession. Although oil is a significant component of Canadian and Me exports, these countries also ship significant amounts of consumer durables to the United States.

Commodity producing countries will also fall into recession if home prices in the United States continue to decline. A global economic recession will significantly reduce demand for base metals. Energy and gold prices, however, will probably remain we supported by extreme global geopolitical instability and dollar depreciation. A global economic recession in 2007 will also have significant negative impact on equity markets worldwide. Judging from recent global equity market performance, investors app generally unaware of rapidly rising global investment risk driven by the bursting bubble in the United States' housing market.

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