Is 'History's First Global Property Bust' Coming Soon?

by Lothar Komp

Since the "LTCM crisis" of 1998 and the start of the meltdown of global stock markets in March 2000, central banks around the world geared up their money printing machines to postpone a systemic collapse. Within two years, starting in January 2001, Federal Reserve chairman Alan Greenspan pushed down U.S. short-term interest rates from 6.0% to 1.0%, with European central banks following. And while Fed governor Ben S. Bernanke repeatedly refers to the use of "helicopter money" as the next possible escalation, the Bank of Japan, with its zero-interest-rate regime, tries to assure the markets every day that it can print money even faster than its U.S. or European counterparts.

As a result, we are witnessing the biggest explosion in consumer and mortgage debt in history. The average American household's debt grew by 11% in the last year, for example, while its wage income grew by only 1.6%. The generation of trillions of dollars in new debt every year—about $2 trillions in the U.S. economy alone—helped to build up new bubbles which now pose an even larger threat to the financial system and the world economy, than the "new economy" stock market hype a few years ago.

In the center of these new bubbles is the global housing boom. Representing a combined financial asset value of roughly $50 trillion in the OECD countries—for the moment holding up a private debt mountain of similar dimensions—the housing market certainly has the potential to bring down the whole system. And everybody knows it might happen soon.

Following an unmistakable warning in the Bank for International Settlements (BIS) quarterly review for March 2004, on the systemic threat posed by global housing markets, a series of alarming statements on the same matter have been issued by financial officials and experts in Britain. On March 17, economics editor Pam Woodall of London's *Economist* magazine appeared at a conference organized by the Investment Property Databank, and declared that the global housing boom is teetering on the edge of a crash. "House prices look seriously overvalued in Australia, Ireland, Netherlands, Spain, the UK and U.S., and will fall by at least 20% in many economies over the next four years."

This time, Woodall emphasized, it wouldn't require large interest rate hikes, as in the late 1980s, to trigger a sharp fall in house prices. This is because the ratio of house prices to average income is now at record highs in the United States, Australia, and Britain. America in particular has just seen the biggest housing boom in its history, but "the U.S. has very little fiscal or monetary ammunition left to support its economy if house prices collapse. If the U.S. falls, it would be the first global property bust in history."

The *Economist* ran a March 13 feature headlined "Homing In on Trouble—Sell, Sell, Sell," emphasizing that "house prices are at record levels in relation to average income in America, Australia, Britain, Ireland, the Netherlands, and Spain." The prices of British, Irish, and Dutch homes, relative to incomes, are now 50% above their 30-year average, according to the *Economist* survey, while property is thus overvalued "by 23% in America, by 33% in Australia, and by 68% in Spain."

The Bank of England (BoE) is ringing the alarm bells as well. In its latest Quarterly Bulletin, BoE economist Olaf Weeken warns that British housing prices have risen too much since 1995 to remain at current levels. The average house price was about 25 times income from rental property in 2003. That's up from less than 15 in 1995, and far above the average of about 18 over the last 37 years. It's "a situation that in the past has often been followed by periods in which real house prices have fallen," stated Tucker. He added that British house prices increased 15% last year and 25% the year before:

"A big wind is coming" toward the vastly-overinflated global bubble in housing. Warnings are now being sounded in the British government, about the home-price explosion in Britain; but the American housing bubble could take down many large and small banks, as well as homeowners.

"There is little doubt that such rates of increase are unsustainable."

Fannie/Freddie Fiascos Debated

Once the global housing boom runs into trouble, we will not just see trillions of dollars of financial asset value disappearing—though that would suffice to bankrupt millions of private households, which have expanded their mortgage and consumer debts rapidly since 2000 in the belief in ever-rising house prices. It could also sink some of the world's largest banking institutions, followed by a domino-like collapse of smaller banks.

The two U.S. mortgage-finance giants, known as Fannie Mae and Freddie Mac, are of particular concern in this respect. Multi-trillion-dollar-asset institutions known as government-sponsored enterprises (GSEs), with only a few tens of billions in core capital, they are in fact not *explicitly* government-sponsored (their initial capital was provided by the government, during the New Deal). They buy up most of the U.S. mortgage debt from banks, keep some of these obligations on their books, and sell the larger part in the form of traditional bonds or asset-backed securities to investors around the globe. To "hedge" against sudden shifts in interest rates, which could lead to enormous losses on their holdings, Fannie and Freddie furthermore have become top players in the worldwide casino of financial derivatives contracts.

A debate has erupted in the United States about the "systemic risk" posed by the high concentration of the mortgage-debt balloon, and related derivatives bets, at these two mortgage-financing entities. The question has been raised whether the government should explicitly renounce any public guarantee for Fannie and Freddie's debt operations; the neo-conservative American Enterprise Institute, claiming Fed Chairman Alan Greenspan's support, has even called for a full privatization. The reasoning is that the widespread assumption of a public bail-out of the GSEs in the case of default is the primary cause of the incredible rise of their obligations; remove this cause, and the systemic threats just go away. Unfortunately, this isn't going to work, because for Fannie's and Freddie's problems, it's "too late to correct."

The U.S. National Association of Homebuilders (NAHB), in a March 24 press conference held to deny any possible "impending bubble in housing prices," expressed extreme concern at Sen. Richard Shelby's (R-Ala.) bill, said to be backed by Greenspan, that would provide for "receivorship" for Fannie or Freddie in a crisis. This, lamented NAHB, would attempt to protect holders of Fannie or Freddie's debt by quickly pushing up the mortgage interest rates underlying that debt. "Before you pull that plug," warned NAHB vice president David Crowe, "you'd better be sure you're bigger than the drain!"

A hint of the systemic threats posted by the U.S. housing market was revealed by Fannie Mae itself on March 15. In its annual report, the mortgage bank admitted to $14.4 billion of derivatives losses during 2001-03. Reported losses on closed derivatives contracts were $1.7 billion for 2001, $5.8 billion for 2002, and $6.9 billion for 2003. In a filing with the Securities and Exchange Commission (SEC) on the same day, Fannie Mae further announced that due to "volatility in the market last year" its derivatives *holdings* surged by an incredible 59%, to above $1 trillion. Fannie's short-term debt—due within 12 months—increased by 27%, to $484.1 billion.

Any problem at Fannie and Freddie would immediately hit numerous American and other banks. In a special report

March 1, the Federal Deposit Insurance Corporation (FDIC) issued a strong warning concerning the exposure of U.S. commercial banks and savings and loans to debt issued by Fannie Mae and Freddie Mac. Not only in the case of a liquidity crisis at one of the GSEs, but simply as a consequence of a formal withdrawal of their implicit public guarantees, this debt could plunge in value, thereby causing massive losses at commercial banks and Savings & Loans. Total, unsecured GSE debt held by FDIC-insured banks and savings associations amounted to $296 billion at the end of the third quarter 2003. On top of this, the same banks and savings associations held $763 billion of mortgage-backed securities (MBS) issued by Fannie and Freddie.

U.S. Home-Price Bubble Is Global

These holdings add up, on average, to 151% of their core capital of commercial banks involved; in the case of the savings associations, it's 181%. There are actually a number of FDIC-insured institutions which "have very high concentrations of GSE-related securities that amount to more than 500% of their TIER 1 Capital." This means that a 20% plunge of Fannie and Freddie debt titles could wipe out the entire core capital of such banks.

International investors, including not least the Asian central banks, would be hit hard as well. Just as an example, about 30% of the $92 billion in net capital flows into the United States in January 2004 constituted foreign buying of bonds issued by the GSEs.

But what about the derivatives counterparties? According to its annual filing with the SEC, Fannie Mae has 23 derivatives counterparties, and seven of those institutions, each holding between 6% and 16% of the total, account for 74% of Fannie's $1.04 trillion derivatives portfolio. Those "counterparties consist of large banks, broker-dealers and other financial institutions that have a significant presence in the derivatives market, most of which are based in the United States," Fannie Mae said. The counterparties were not named, but they are likely led by the usual suspects—JP Morgan Chase, Bank of America, and Citigroup.

The housing market time bomb is ticking. A number of authorities in Britain and elsewhere are now openly talking about systemic threats and are demanding a tightening of liquidity—that is, interest rate increases—in order to "cool down" the financial bubbles. But it's too late to cool them down. Bubbles can only be fed, or they burst. Any considerable rate increase could now bring down the worldwide pyramid of mortgage and other debt titles.

There are only two alternatives: the LaRouche approach of a "New Bretton Woods"-type global financial reform, including a bankruptcy procedure for existing financial obligations and a "New Deal" program to rebuild the physical economies; or a disorderly collapse that would then be used by the financial oligarchy to ram through Schachtian policies on a global scale.