EIR Economics

Housing Bubble's Fate, Is Banking System's Destiny

by Richard Freeman

From 1992 through 2005, Federal Reserve Board chairman Alan Greenspan built the biggest housing bubble in history. The bubble saturates every part of the U.S. economy. Especially from the beginning of 2001—when he threw the housing bubble into high gear—through October 2006, Greenspan transformed the housing sector from its vital but demarcated role of providing decent, affordable housing, into a distorted giant that was made to become the prime prop for both the physical and financial sides of the U.S. economy.

Using such risky gimmicks as minimum-payment mortgages and cash-out refinancing, Greenspan jacked up the price of homes, in "hot" housing regions, by $20,000-$100,000 per year, and most importantly, jacked up the level of mortgages that could be attached to homes, so that bankers could attach mortgages of $400,000-$5 million to vastly overvalued properties. Homes were only tertiarily dwellings; primarily, they were financial assets, from which bankers and speculators could make killings, engorging many fees up front.

Part of the housing bubble's income streams was diverted into other segments of the economy. The cash extracted from the inflated value of the nation's homes is the biggest source of funds for consumer spending, far larger than credit cards. In a somewhat related vein, according to a study by Merrill Lynch, funds derived from borrowing against the value of homes, and related activities, accounted for 55% of the so-called GDP growth in the U.S. economy during 2005.

The tail is wagging the dog.

Currently, financial institutions make $3 trillion in mortgage loans (originations) each year. These finance the purchase of homes, but also find their way into consumer spending and speculation. The banks have fallen head over heels into housing lending and investment, finding unparalleled profit there. As this article will show, U.S. commercial banks and savings and loan associations combined, have lent or invested *half of their total outstanding assets into real estate.*

The matter deepens. Several levels of speculation, including trillions of dollars of mortgage-backed securities and derivatives, were built upon this bubble. Most suggestively, some of the biggest buyers of these instruments are the central banks of China, Japan, and Britain, which have provided substantial funds to the U.S. housing bubble.

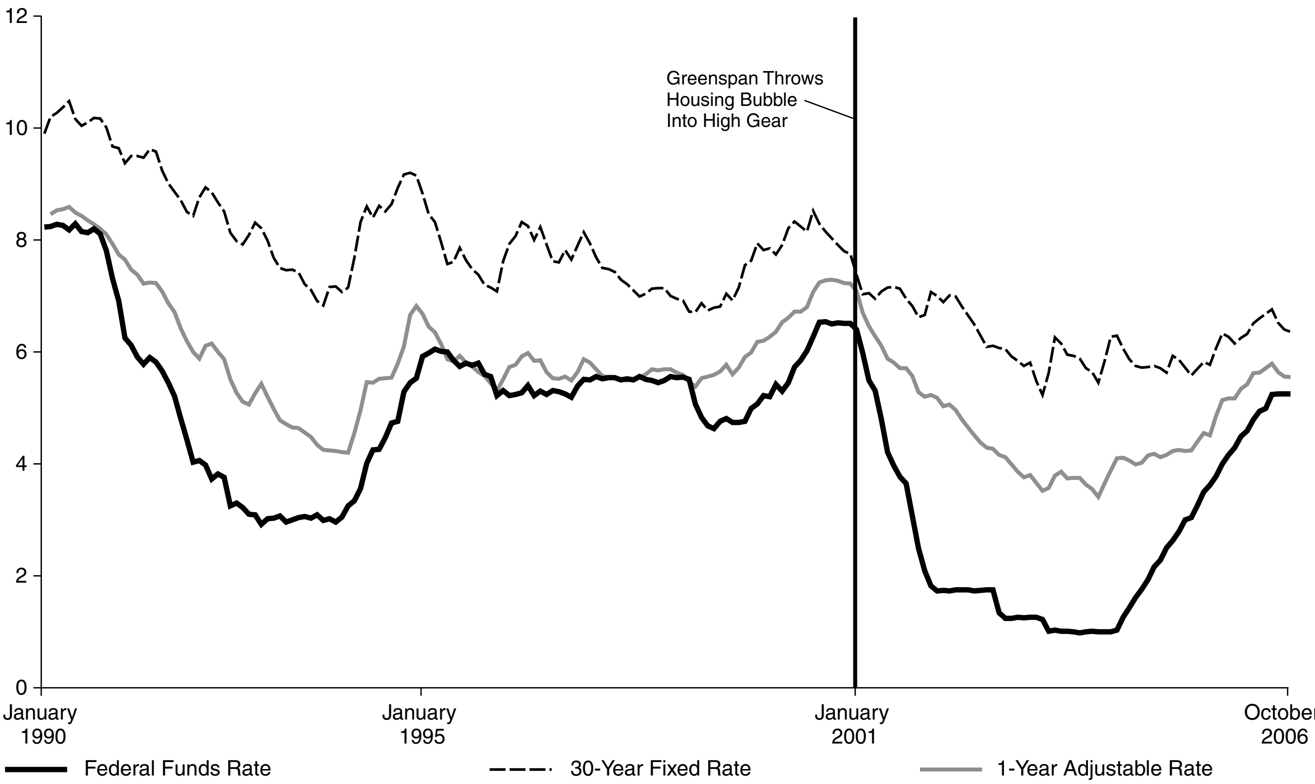
Now, the Greenspan housing bubble is disintegrating. Home sales and prices are plunging. During October 2006, new single-family home construction starts—which are the bulk of new home construction starts—fell 31.8% nationally, compared to October 2005. RealtyTrac, which tracks foreclosures, reported Nov. 17 that during the first ten months of 2006 through October, more than 1 million U.S. household home properties entered some stage of foreclosure, an increase of 27% from the comparable period in 2005. *Households experiencing job loss and pay cuts simply do not have the living standard to afford usurious mortgages. This is the key factor that is the undoing of the housing bubble.*

In its Nov. 17 issue, *EIR* showed on the physical-economic side, that the bursting of the housing bubble potentially will eliminate between 1.5 and 1.7 million jobs, during the next 12 months—in residential construction directly, and in housing-related areas (see "Bursting Housing Bubble To Take 1.5 Million Jobs").

In this article, we concentrate on the rupture of the financial bubble, causing the certain decimation of the housing sector per se, the $15 trillion-plus mortgage market, and consumer spending. Above all, as the U.S. banks have invested half of their assets in real estate, the bubble's disintegration will cause a meltdown of the banks, and the dollar-based world financial system. The financial system's *systemic* disintegration will intensify the physical-economic collapse, and vice versa.

FIGURE 1

Greenspan Drove Down Interest Rates To Build Housing Bubble



Source: U.S. Federal Reserve Board of Governors, "Table H.15: Selected Interest Rates."

The newly elected Democratic-controlled Congress will stare this situation in the face as it takes office in January. In his Nov. 16 international webcast, Lyndon LaRouche, the world's leading economist, presented the principles of bankruptcy-reorganization for the sick world financial system, spelling out the process to restart the U.S. economy and reverse the crisis.

Sir Alan 'Bubbles' Greenspan

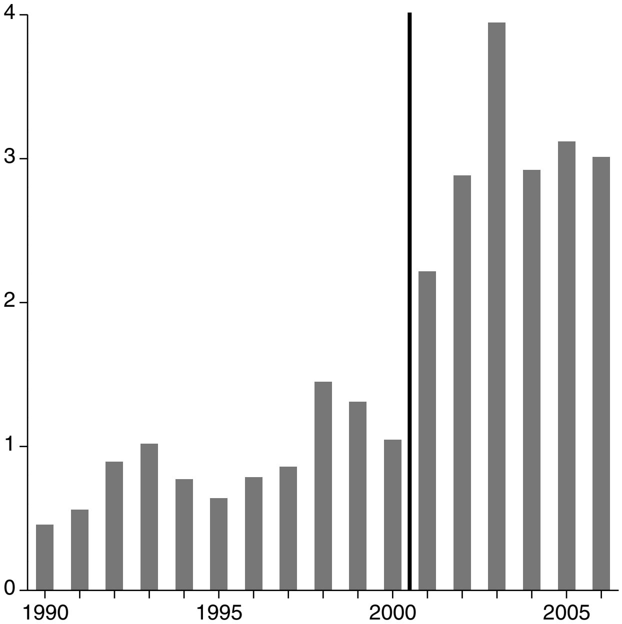
Former Fed chairman Greenspan, the apostle of fascist Ayn Rand, has a single capability: building bubbles. These bubbles suck the economy dry.

In October 1987, the U.S. stock market crashed, and Greenspan, who had assumed the Fed chairmanship only in August of that year, responded with a stratagem that had two steps: 1) pump money into the banking system; and 2) build up derivatives to counteract the falling stock market bubble. Today, the derivatives market has grown to more than $500 trillion in notional value worldwide: They are a cancer eating the world financial system.

During the 1990s, Greenspan used the Fed to pump up the "Information Technology"/dot.com bubble, and secondarily, the housing bubble. Greenspan lauded the benefits to the economy of what he misidentified as "technology." In March 2000, the NASDAQ stock market index, heavily laden with IT stocks, crashed, leaping from its peak of 5,040 to 1,800, a fall of 64%. The stock market crash threatened to implode the world financial system. After turning on the printing presses to "stabilize" the system temporarily, Greenspan deliberately decided to build the housing bubble to replace the IT bubble. Starting in 2001, Greenspan pushed through 13 cuts in the Federal funds rate (the rate at which banks lend overnight money); by August 2003, the Federal fund rate stood at 1%, its lowest level in 40 years. By design, this pulled down the interest rate on 1-year adjustable rate mortgages, and 30-year fixed-rate mortgages (see **Figure 1**).

Greenspan knew that banks would fatten up from the real estate bubble. Working with such secondary housing market giant agencies as Fannie Mae and Freddie Mac, Greenspan saw to it that a huge volume of money swept into housing. He was completely aware of, and helped engineer, the spillover effect of the housing bubble into other sectors of the economy. Speaking before the Senate Banking Committee July 16, 2002 Greenspan boasted that his money-pumping had created

FIGURE 2
Annual U.S. Single-Family Home New Mortgage Loan Originations
($ Trillions)



Sources: Office of Federal Housing Enterprise Oversight (Ofheo); *EIR.*

"very low levels of mortgage interest rates," which has been instrumental in "buoying spending." Greenspan said, "the very low level of mortgage interest rates . . . encouraged households to purchase homes, refinance debt . . . and extract equity from homes to finance expenditures."

Home Mortgage Originations

Greenspan, in concert with the bankers, altered the character of the home and the housing market. A home, ultimately, is a place to raise productive and creative human beings, where children are nurtured and educated. It should be well-built, and affordable for the lower 80% of the population. Since 2001, this has not been true. Many new homes of the McMansion variety are tarpaper shacks, constructed with inferior materials, but having, for show, gold faucets in the bathrooms.

Alongside the change of the home to inferior quality, the financiers and Greenspan profoundly altered the very character of the housing market in such a far-reaching manner, that it became nearly a different species, almost unrecognizable from the standpoint of the pre-2001 housing market. There were changes in the volume of mortgage loans, the types of mortgages, and the spread of the loot from the housing sector to different sectors of the economy.

Figure 2 shows the new mortgage loan originations, which represent the volume of new mortgage loans that the financial institutions make each year to an individual or individuals. The individual can use the mortgage loan either to purchase a home (that home may be either a newly built home, or an existing home), or to refinance the mortgage on the home that the individual is currently living in (usually, extracting cash from the loan). Until 2001, the volume of new home mortgage originations had never exceeded $1.45 trillion in the United States for any single year. But once Greenspan went into high gear, he and the banks drove new home mortgage originations to the level of $2.22 trillion in 2001, and $3.95 trillion in 2003. During 2004 and 2005, new home mortgage originations were approximately $3 trillion per year. In the span of 2001-2005, $15 trillion in new mortgages were originated, *three times* the financial volume of the mortgage market in the previous five-year period.

An upwardly rigged volume of mortgage financing/originations is the *sine qua non* for a speculative housing market. A speculator can buy a home for $250,000 and sell it for $400,000, because the mortgage financing is *always available* and the requirements to get a loan are easy—easier in fact, than getting a driver's license. Once a price bidding war for homes is set off—and if the home owner is brainwashed that his home is an easily marketable asset, like platinum—then he will either sell his home for a profit, or he will take out a new loan against the artificially inflated value of his house, and use some of that borrowed money for consumer expenditures. As for the banks, they have manufactured the ideal situation, being able to attach larger and larger mortgages to the same property, as it trades several times, and earn ever larger interest income.

For example, consider a home whose selling price doubled from $250,000 to $500,000. The bank that finances the transaction now stands to make a new loan twice as large. Even if, to consummate the deal, the bank must offer a slightly lower interest rate on the $500,000 mortgage than it did on the $250,000 mortgage, it would still earn much more total interest income. Each year, the banks' collective mortgage interest income reached new records. On top of that, the banks had earned several fees, for each of the tens of thousands of mortgages they transacted.

Exotic Mortgages

A record level of mortgage loan originations could only be fully achieved, if the number of people who "qualified" for such loans could be increased. This was accomplished by desecration of loan standards.

The fixed rate, 30-year mortgage was the standard mortgage loan in the United States until 1982. In that year, the Congress, at the banks' behest, passed legislation that would permit the banks to issue variable or adjustable rate mortgage loans (ARMs). The interest rate on the ARM floats, and is usually reset every six months. If benchmark interest rates, to which the ARM interest rate is calibrated, are rising, the ARM interest rate could and does soar into the double-digit level.

Around 2001, the banks went beyond ARMs, and resorted to using "exotic" or non-traditional mortgages, which are so dangerous that they border on the criminal. We give the example of two exotic mortgage loans.

- *Interest-Only Mortgage.* These are mortgages in which the home purchaser is permitted to take out the first few years of a long-term mortgage—a period of anywhere from 2 to 5 years—at a fixed, low, teaser rate of interest of 2-3%. During this initial period, the home buyer pays no principal, only interest at this lower rate. After the initial period is over, the mortgage "resets," and the home-buyer must start paying principal, and also pay an adjustable rate of interest, which is higher than the teaser rate. This leads to a shock, as the amount of monthly payment required often jumps by 50% or more.
- *Minimal Payment Loan.* This loan is even more devastating than the interest-only loan, having the additional feature that during the mortgage loan's initial period of 2-5 years, the borrower not only pays no principal, but also pays only *part* of the interest. The amount of interest he does not pay is recapitalized, i.e., added into the loan. Thus the loan amount due becomes *larger over time.*

Speculators utilize these loans to buy and sell property. The speculators figure that they will be in and out of the properties (and thus the loans), within a year, and will never have to pay the loans. However, when the housing market crashes, and the speculators can't sell their properties, as is happening in Arizona with sales falling by 34%, the speculators are stuck with the loans, which they can't pay. The other type of person who takes out this type of loan is the person with bad credit, who contracts the loan in the hope that he or she could own a house. Within months, that person is often in the process of foreclosure.

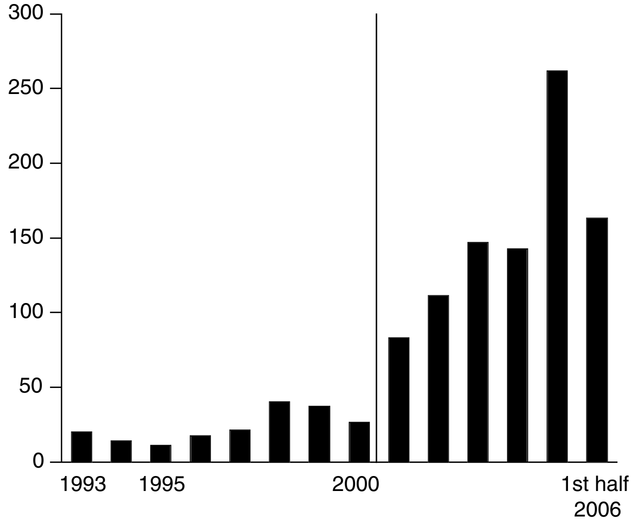
Nationally, nontraditional or exotic loans increased to 39% of all mortgage loan originations made during the first half of 2006, compared to 33% of all mortgage originations during the last half of 2005, the Mortgage Bankers Association reported Oct. 23. Until 2001, fewer than 4% of homebuyers took out the risky nontraditional loans.

Cash-Out Refinancing

With these wing-dings as impetus, the housing bubble took off. From 2000 through 2005, the volume of total homes sales (combined new and existing homes sales) in the United States leapt by 34%, reaching a peak of 8.36 million total homes sales in 2005.

What were the funds generated in the housing bubble that spilled over into the U.S. economy, and how did that occur? As reported earlier, during 2005, some $3 trillion in new home mortgage loan originations were issued. A portion of that $3 trillion financed the just referenced record total homes sales; the remaining portion of that went into cash-out refinancing.[1]

FIGURE 3
Cash-Out Refinancing Grows
($ Billions)



Source: Freddie Mac.

Prior to 2001, cash-out refinancing was relatively minor. But that changed when Greenspan launched the housing bubble big-time in 2001. **Figure 3** depicts how cash-out refinancing rose almost vertically, reaching a level of $261 billion in 2005. One quarter of a trillion dollars is a substantial figure; if even three-fifths of that is spent, it is more than the yearly increase in credit card borrowing, and has a big impact on the economy. (Note that the figure on the amount of cash extracted from cash-out refinancing comes from Freddie Mac, and may be an understatement. It should be kept in mind that some of the information drawn from cited sources may have some problems of reliability; the overview we are presenting here should be seen as an approximation.)

Alongside cash-out refinancing, the "wealth effect" as it is called, has reflected streams of funds that the housing bubble poured into the economy. In scores of key regions throughout the United States, the market value of a household home rose as a result of the housing bubble. Between 2000 and 2005, American households' total asset "wealth" jumped from $47.5 trillion to $62.2 trillion, the greatest increase in America's history. *Directly, 54% of that asset increase,* is attributable to the housing bubble (see **Table 1**). A joint study by the Joint Center for Housing at Harvard University and Macroeconomic Advisers (commissioned by the National Association of Realtors), suggests that every $1 increase in the value

1. A cash-out refinancing functions as follows: Assume that a person owns a home that has a market value of $200,000. Through housing appreciation, two years later it is worth $300,000. Assume that the person had a $200,000 mortgage on the home. He goes to a bank and refinances the mortgage to $300,000, corresponding to the market value of the home. He uses $200,000 of that money to pay off the $200,000 first mortgage. That leaves $100,000. This amount is said to be cashed-out or extracted from the value of the home. The homeowner can employ the $100,000 for whatever he wants.

TABLE 1

Housing Bubble Dominated Increase in Household Total Assets, 2000-05

	Household Total Assets ($ Trillions)	Household Real Estate Assets ($ Trillions)
2000	$47.5	$11.4
2005	$62.3	$19.5
Increase from 2000 to 2005	$ 14.8	$ 8.1

Household real estate assets' increase as percent of the household total assets' increase: 54%

Source: Federal Reserve Board of Governors, "Table Z-1: Flow of Funds"; *EIR.*

TABLE 2

Housing-Related Factors as Percent of Growth in GDP

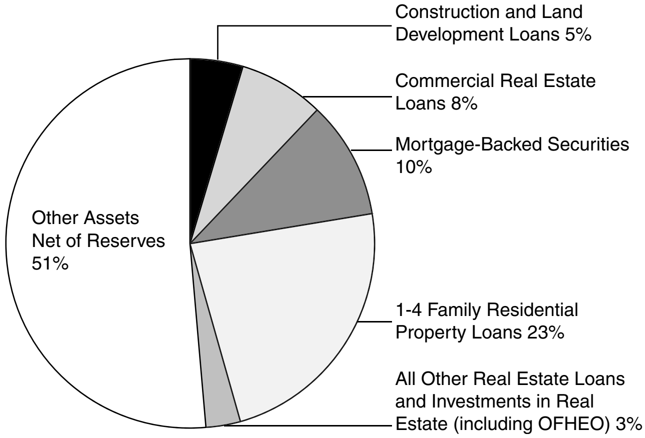
2001	26%
2002	36%
2003	38%
2004	40%
2005	55%

Source: David Rosenberg and Kathleen Bostjancic, in the Aug. 15, 2005 issue of Merrill Lynch's *Economic Commentary,* and in the Feb. 10, 2006 issue of Merrill Lynch's *The Market Economist; EIR.*

FIGURE 4

Real Estate Assets as a Percent of U.S. Banks' and Savings & Loans' Total Assets

(Total Assets=$11.75 Trillion, Sept. 30, 2006)



Source: U.S. Federal Deposit Insurance Corp.

of real estate assets leads to consumer spending of about 5.5 cents. This increase in real estate asset wealth in 2005 would have generated several hundred billion dollars that could be used for consumer spending.

But cash-out refinancing and the real estate wealth effect are merely two of several avenues by which the housing bubble gushed funds into the overall economy. Additional avenues include home equity lines and realized capital gains from home sales, etc. In adding all the avenues together, *EIR* concluded that during 2005, the housing bubble created $750 billion in funds that were generated by, or borrowed against, the inflated values of homes; a sizable portion of this $750 billion was used for consumer spending. This was an immense kick and prop to the economy.

Two Merrill Lynch economists, David Rosenberg and Kathleen Bostjancic, did a helpful study adding up all the factors by which the housing bubble affected the economy, and compared the sum to the annual growth of Gross Domestic Product. The study concluded that during 2005, the housing bubble accounted for 55% of so-called Gross Domestic Product growth (see **Table 2**).

However, most revealing is that *Alan Greenspan has himself, personally, been studying how much funds the housing-bubble generates into other portions of the economy for at least 15 years.* In September 2005, he and Federal Reserve economist James Kennedy, issued a study.[2] Kennedy compiled a table for the study in which he projects that during 2005, some $750 billion in funds were extracted in one way or another against housing, a portion of which could be used in the general economy. The study, which comports with what is known—but seldom reported by published analysts—indicates that Greenspan has known all along what effect he was creating.

In the physically collapsing U.S. economy, consumer spending fostered by the housing bubble was one of the only forces holding up the economy from deeper collapse. What happens to the economy as the major source of funds for consumer spending evaporates, when the housing bubble pops?

The Banking System

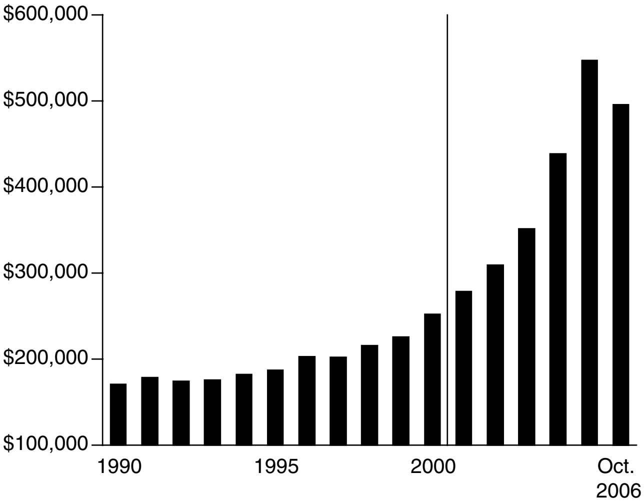
The capstone of this process is the banks' integrated relationship with the housing bubble. In tandem with Greenspan, the banks engineered the housing bubble; they made superprofits from it; now, they are so inseparable from the housing bubble, that the bubble's fate is theirs.

As of Sept. 30, 2006, as **Figure 4** shows, U.S. commercial banks and savings and loan associations amassed combined assets of $11.75 trillion. A bank's assets consist of two principal kinds: its ownership of bonds and securities, such as a U.S. Treasury bond, or a mortgage-backed security; and the bank's loans. (For the borrower, the loan is a liability; for the

2. "Estimates of Home Mortgage Originations, Repayments, and Debt on One-to-Four Family Residences," by Alan Greenspan and James Kennedy.

FIGURE 5

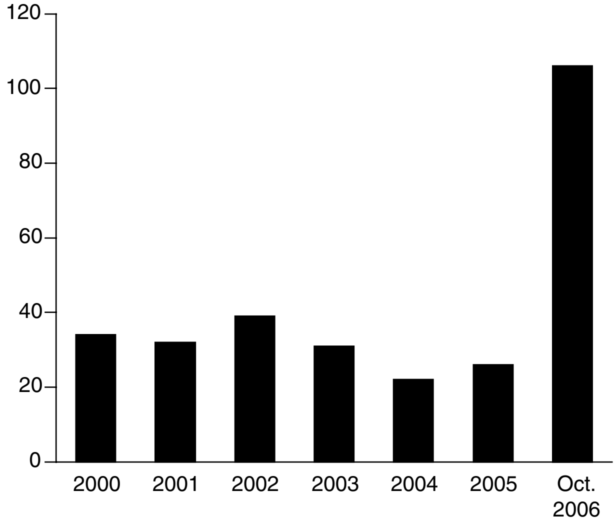
Average Sale Price for Single-Family Home in Loudoun County, Virigina



Source: Dulles Area Association of Realtors.

FIGURE 6

Average Number of Days on the Market for Unsold Single-Family Home in Loudoun County, Virginia



Source: Dulles Area Association of Realtors.

bank, it will get back its principal and some interest, hence this is an asset.)

Of the banks' total assets, 48.7%—which represents $5.73 trillion—are indissolubly tied up with real estate, according to the Federal Deposit Insurance Corporation. Put another way, one out of every two dollars of assets in the entire U.S. banking system is mired in real estate, the highest real estate concentration the American banking system's history. Figure 4 shows that 23% of all the banking system's assets are loans to 1-4 family residential properties; another 10% are ownership holdings of risky Mortgage-Backed Securities; and so forth.

A deepening of home foreclosures—now over the one million mark for the year—leads to the possibility of mass defaults if households can't pay their mortgages. The latest announced round of Ford Motor layoffs, for example, defines a reality of firings and pay cuts, which means that millions of households will exceed 60 days in arrears on mortgage payments. Default is a process the banking system cannot digest, and just for that reason, in September, Freddie Mac announced that it was putting together the equivalent of a SWAT team, that would operate with banks across the country in an attempt to stop defaults. Freddie Mac's effort represents the futility of King Canute trying to hold back the sea.

What defaults will do to a U.S. banking system with $5.7 trillion in real estate paper, is unmistakable. If even one-twentieth of that real estate paper defaults, it will wipe out the equity of the banks.

This is a form of bankruptcy. The danger goes far beyond the United States. The United States is the center of the dollar-based world financial system, and a breakdown of that system will bring down every large bank in the world. Simultaneously, the failure of trillions of dollars of housing-based derivatives will decimate the derivatives market.

The fate of the housing bubble, and the banking system, is writ large in Loudoun County, Virginia, which Lyndon LaRouche has identified as ground-zero for the bursting of the bubble. There is not a unitary national real estate market, but regions, including some where speculative investments are most active. **Figure 5** approximately represents that prior to Greenspan's 2001 push of the housing bubble into overdrive, the average price of a Loudoun County home was $251,000 in 2000. By 2005, the average price had risen to $547,000. But a new downward trajectory is operating now; by October 2006, the average home price had dropped to $495,000.

Figure 6 shows the number of days a Loudoun home is on the market. In 2005, it was 26 days; in October of this year, it is 106 days.

The insane decision by Greenspan to build the housing bubble, has extended the bubble's reach into every nook and cranny of the economy, interconnecting to consumer spending, the banking system, etc. Effectively, Greenspan is now on a national tour, talking up housing. Speaking about the housing bubble at a Charles Schwab investment conference Nov. 6, the discredited Greenspan said, "The worst is behind us."

He is wrong; the worst is just ahead.