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## The Coming U.S. Hard Landing

By Nouriel Roubin

**09/12/07 'ICH' --- --** The utterly ugly employment figures for August (a fall in jobs for the first time in four years, downward revisions to previous months' data, a fall in the labor participation rate, and an even weaker employment picture based on the household survey compared to the establishments survey) confirm what few of us have been predicting since the beginning of 2007: the U.S. is headed towards a hard landing.

The probability of a US economic hard landing (either a likely outright recession and/or an almost certain "growth recession") was already significant even before the severe turmoil and volatility in financial markets during this summer. But the recent financial turmoil - that has manifested itself as a severe liquidity and credit crunch - now makes the likelihood of such a hard landing even greater. There is now a vicious circle where a weakening US economy is making the financial markets' crunch more severe and where the worsening financial markets and tightening of credit conditions will further weaken the economy via further falls of residential investment and further slowdowns of private consumption and of capital spending by the corporate sector.

The US economic slowdown was already serious since early 2007 and will get worse in the next few quarters for a variety of reasons. A massive housing bubble - where home prices went to stratospheric levels because of a debt-driven asset bubble (a massive rise in mortgage debt of households) - has now turned into the most severe housing recession in the last 30 years and into a house price bust: for the first time since the Great Depression of the 1930s home prices are now falling on a year-over-year basis. Home prices will fall much more in the next two years - by at least 15% - because of five factors that will make the huge excess inventory of new and existing homes - already at historic highs - even larger: first production of new home is still excessive as demand for new homes has fallen more than the now lower supply; the credit crunch in mortgage markets will further reduce the demand for new homes; millions of households will default on their mortgages and go into foreclosure and once the creditor banks will repossess these homes they

will dump them in the market adding to the excess supply; about \$1 trillion of adjustable rate mortgages will be reset – at much higher interest rates – in the next 12 months: the households that cannot refinance them and/or afford the higher interest rates will sell their homes at distressed prices; and those who bought homes for speculative reasons with little equity will now try to sell their homes as prices are falling. So expect a much faster and deeper fall in home prices for the next two years.

A housing recession alone cannot lead to an economy-wide recession as housing is only 5% of GDP. But now the housing slump is spreading to other parts of the economy: the auto sector is in a recession; the manufacturing sector is sharply slowing down; demand for housing related durable goods (furniture, home appliances) is falling. Moreover, US private consumption – that represents over 70% of aggregate demand – is now under pressure. The US consumer is now saving-less, debt-burdened and buffeted by many negative forces. As long as home prices were rising it made sense for US households to use their homes as their ATM machines, borrow against their rising home equity and spend more than their income (negative savings). But now that home prices are falling there is the beginning of a retrenchment of consumption whose growth rate slowed down from a 4% average until the first quarter of 2007 to a weak 1.3% in the second quarter, even before the summer financial market turmoil.

There are now many negative factors squeezing US consumers and forcing them to retrench spending: falling home values leading to a negative wealth effect; sharply falling home equity withdrawal preventing households from overspending; a credit crunch in mortgages and consumer debt markets rising debt servicing costs for consumers; still high oil and gasoline prices; the beginning of a serious weakening of the labor market – as signaled by today's employment report and other data - that will significantly reduce income generation in the months ahead. As long as income generation and job generation was robust, one could dismiss the risks of a hard landing; but the signal from today's employment report is that the only force that was preventing a hard landing (jobs and income generation) is now starting to falter.

Thus, in the next few months you can expect a further slowdown of consumption growth from its already mediocre growth rate of 1.3% in the second quarter. Indeed, after an ok July, retail sales were weak in August: based on the Redbook Johnson and the UBS Securities/ICSC data same store retail sales in August actually fell relative to July; and in real terms such retail sales in August were lower than in August 2006. Thus, the deceleration in consumption in Q3 is already clear in the data.

And if consumption slows down the build-up of inventories of unsold goods will force firms to slow down production, employment and capital spending. Such

investment spending by the corporate sector was already weak in the last few quarters in spite of the high corporate profitability. Now you can expect further weakening of such real investment because of expected lower consumption demand, higher credit spreads for the corporate sector, uncertainty about the future given the volatility in the markets. The sharp re-pricing of risk that took place in the summer – with higher credit spreads for a broad variety of instruments – implies much higher borrowing costs for consumers, buyers of homes, corporations and financial institutions. Thus, the slowdown of private consumption and capital spending in residential, non-residential and corporate investment will get more severe.

On top of a weakening of the real economy the current financial markets turmoil will get worse – not better - in the next few months. This was never just a sub-prime problem as the same reckless and toxic lending practices in sub-prime – no down-payment, no verification of income and assets, interest rate only mortgages, negative amortization, teaser rates – were occurring in near prime mortgages, Alt-A loans, piggyback loans, home equity loans, and prime hybrid ARMs. About 50% of all mortgage origination in the last two years was made of this toxic waste and utterly junk lending practices.

And now what started as a credit crunch in the sub-prime mortgage market has spilled over to near prime and prime mortgages and to a variety of other credit markets: money markets, interbank lending markets, asset backed commercial paper, structured investment vehicles (SIVs) of banks, CDO markets, other securitization markets, and the LBO market. All these markets are now literally frozen with a dearth of liquidity, serious refinancing problems and severe credit problems. The mess in the SIV products is particularly serious and dramatic as it is generating severe liquidity and capital problems for both banking and non-banking institutions.

And this liquidity and credit crunch will get worse in the weeks ahead as this financial markets crisis is much more severe than the liquidity crisis of 1998 when LTCM – the largest US hedge fund – almost collapsed. In 1998 you had only a liquidity problem as the economy was strong – growing at 4% plus - and we were still in the rising cycle of the internet boom. Today, in addition to severe liquidity problems in the financial system (a near total freezing of the entire financial system liquidity plumbing), we have serious credit and insolvency problems too. The credit and solvency problems derive from a massive credit boom that lead to excessive borrowing that, in turn fed for a while rising asset prices that are now going bust, in a typical Minsky credit cycle. It is a insolvency problem as you have now millions of US households that are near insolvent and will default on their mortgages; dozens of sub-prime mortgage lenders who have already gone bankrupt; dozens of home building companies that are under distress; many financial institutions in the US and abroad - such as hedge funds and other highly

leveraged institutions – that have already gone belly up; and the rise in credit spreads will also lead soon to a rise in corporate defaults that had been artificially low in the last few years given the excessively easy credit conditions. So we do not face only a most severe liquidity crisis; we are also observing a serious credit crisis and credit crunch. And you cannot resolve credit problems – as opposed to liquidity problems – with liquidity injections. That is why the forthcoming cuts in the Fed Funds rate by the Fed will be ineffective in stemming the real and financial problems of the economy.

Indeed, the forthcoming easing of monetary policy by the Fed will not rescue the economy and financial markets from a hard landing as it will be too little too late. The Fed underestimated the severity of the housing recession, its spillovers to other sectors, and the contagion of the sub-prime carnage to other mortgage markets and to the overall financial markets. Fed easing will not work for several reasons: the Fed will cut rate too slowly as it is still worried about inflation and about the moral hazard of perceptions of rescuing reckless investors and lenders; we have a glut of housing, autos and consumer durables and the demand for these goods becomes relatively interest rate insensitive once you have a glut that requires years to work out; serious credit problems and insolvencies cannot be resolved by monetary policy alone; and the liquidity injections by the Fed are being stashed in excess reserves by the banks, not relevant to the parts of the financial markets where the liquidity crunch is most severe and worsening. The Fed provided liquidity to banking institutions but it cannot provide direct liquidity to hedge funds, investment banks, other highly leveraged institutions and parts of the credit markets – such as asset backed commercial paper – where the crunch is severe. Thus, the liquidity crunch in most credit markets remains severe, even in the usually most liquid interbank markets.

Unfortunately, financial globalization together with securitization and mushrooming of complex credit instruments has lead to greater opacity and less transparency in the financial system. And this lack of transparency breeds unmeasurable uncertainty rather than priceable risk. Risk can be priced as you have a distribution of probabilities on various events. But unmeasurable uncertainty causes higher risk aversion under conditions of market distress. This generalized uncertainty is now coming from two sources: first, we do not know the size of the overall losses in credit markets: sub-prime alone could lead to losses of \$100 billion or much higher depending on how much home prices will fall. And other losses from other illiquid financial instruments remain unmeasured in a world where institutions were marking to model rather than marking to market and where credit rating agencies were mis-rating complex credit instruments. Second, as securitization implies that financial risks have been spread out of banks and to the corners of the global financial system we do not know which firms are holding the toxic waste and thus which firms will go belly up next. It is like walking blind in a

minefield where you have no idea of where the mines are. This uncertainty breeds large fear – after the massive greed of the previous credit and asset bubble has now burst – and lack of trust of financial counterparties, even otherwise respected ones: everyone wants to hoard liquidity and hold the safest assets as even large financial institutions do not trust each other and are unwilling to lend to each other. This greater opacity of financial globalization and securitization implies that the re-pricing of risk that we have observed in the last few weeks is a permanent rather than a transitory phenomenon. And the sharp spike in the cost of credit will further weaken an already weakened economy. This is thus the first real crisis of the new world of financial globalization and securitization.

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