Economic Analysis

April, 2008

A Publication of the BEA Economic Research Department

Household debt crisis – a looming threat to the US economy

US economic activity slowed in late 2007 as the credit crisis spawned by the sub-prime mortgage debacle intensified. Banks cut back their lending to individuals and companies, causing the annualized rate of GDP growth to fall to a tepid 0.6% in the fourth quarter last year, significantly lower than the 4.9% recorded in the previous quarter. The worsening outlook has prompted the US government to take unprecedented measures to stimulate the ailing economy.

US households are the rescue target …

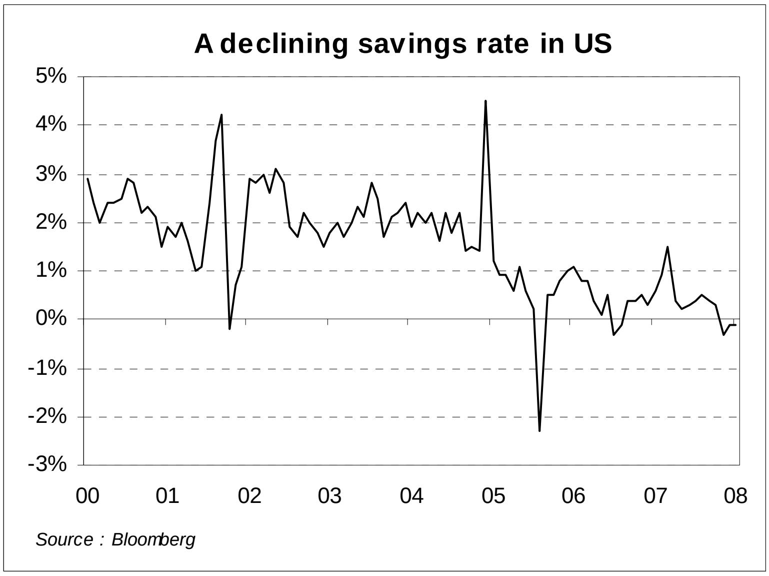
A wide range of new measures have been introduced by the US Treasury Department and the Federal Reserve (the Fed) in an attempt to prevent the sub-prime woes from spiraling into a full-blown economic meltdown. First, Congress and the Administration have agreed on a US$152 billion economic stimulus package. This includes tax rebates of up to US$600 per individual and US$300 for each dependent child. Second, the benchmark Fed Funds Rate (FFR) has been slashed by a combined three percentage points in six rate cuts since September 2007 to the current 2.25%. Moreover, liquidity is being pumped into financial institutions by expanding the range of securities accepted as collateral for loans issued by the Fed and by increasing investments in the mortgage market by Fannie Mae and Freddie Mac – the two largest US home finance companies. The Fed's support of the bailout of the failing investment bank Bear Sterns marked yet another step to stave off a broader confidence crisis in financial markets.

All of the above strategies are aimed at keeping household spending afloat. It is hoped that the tax rebates will boost consumer spending, which has been depressed by sliding home prices and tight credit. The funds provided by the Fed through initiatives such as the Term Securities Lending Facility are aimed at easing the credit squeeze in the market. Without such infusions, the scarcity of funding for new mortgages could cause house prices to fall further, feeding a vicious downward spiral.

Meanwhile, the rate cuts have lowered the cost of borrowing for companies at a time when lenders are demanding higher margins. This has helped to bolster the sagging stock market, which could well have fallen much more than it has to date without the Fed moves. The Dow Jones Industrial Average had fallen 13% at the end of March from its record high in October 2007. Without the Fed support, the cumulative negative wealth effects of falling property and share prices may have further dragged the economy.

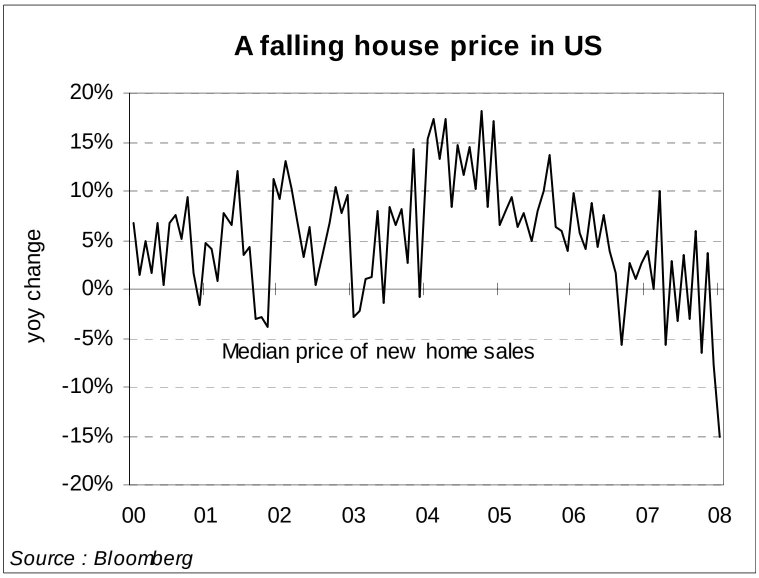
⋯ as they are vulnerable to negative shocks

Policymakers pay close attention to the financial condition of American households, as a sharp pullback in consumer spending could plunge the economy into deep recession. The cumulative effect of low interest rates for several years and lax controls on mortgage approvals had fueled a housing boom in 2004 and 2005. Rising home values encouraged American households to refinance their homes and spend, spend, spend. Thus, the US savings rate fell to near zero in recent years. Meanwhile, the pace of indebtedness accelerated and the ratio of household debt to disposable income now stands at over 130%. Liabilities held by US households may well have risen to an unsustainable level.



At the early stage of the sub-prime mortgage crisis, the Fed refused to cut interest rate in hopes that high borrowing costs would motivate US households to change their lavish spending habits and save more to pay off the growing debt burden. However, the collapse of the sub-prime mortgage market quickly undermined this strategy. The resulting credit crunch triggered a sharp decline in property prices and a rise in personal bankruptcies. The Fed had no choice but to shift its focus away from fostering debt repayment through increased savings toward preventing a massive write-off of consumer debt.

Sinking property and share values led to a fall in net household wealth in the fourth quarter last year for the first time in five years. At the end of February 2008, the median price of new homes sold had fallen by nearly 20% from its peak in March 2007. Plunging home values have induced a growing number of homeowners to walk away from their homes, instead of paying back their mortgages. The percentage of loans that entered the foreclosure process reached a record-high of 0.83% in the fourth quarter of 2007. And this situation could get worse as the mortgage rates on some 1.5 million loans are scheduled to reset this year, lifting monthly mortgage payments by over 10%.



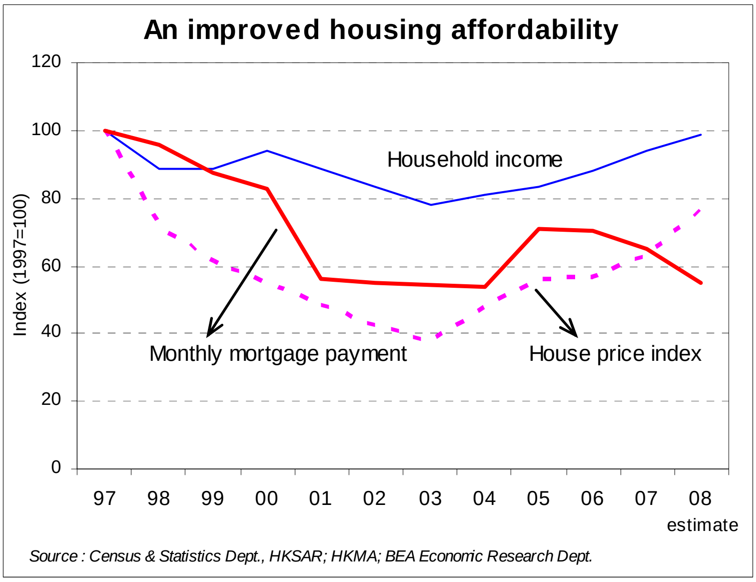
The deterioration of household balance sheets has spread to other economic sectors as well. Consumer confidence and non-farm payrolls have both fallen in recent months. The ISM non-manufacturing index slid to below 50 throughout the first quarter this year, suggesting that the service sector – which accounts for almost 90% of the domestic economy – is shrinking. This has led to increasing worry that monetary and fiscal stimulus may not be sufficient to prevent the country from falling into recession.

The US is entering a lengthy recessionary period on consumption pullback …

Federal Reserve Chairman Ben Bernanke warned that the number of homeowners with mortgage liabilities greater than the value of their homes is growing. Many in this position will conclude that it is simply not worthwhile to make further mortgage payments, and walk away from their properties[1]. His comment has highlighted the downside risks ahead. A default blowout, similar to what Hong Kong had lived through after 1997, could haunt the US economy for a long while.

Household spending in the US has remained stable over the past 15 years. However, the growing negative equity problem could force consumers to cut spending, or worse – declare bankruptcy. Compared to business investment, household consumption carries larger inertia. Thus, it could take quite some time before consumer confidence is fully restored. Consumers are likely to push the US economy into recession in the first half of this year, and slower growth could linger into 2009.

… which will weigh on HK's economic growth



The Fed is expected to cut rates further in its continuing effort to revive the US economy, pushing the FFR down to around 1.0% - 1.5% by the end of the year. As for Hong Kong, with local bank savings rates falling near zero, individuals will be looking for investment products that offer better returns. This would be positive for Hong Kong's property market, whose prices have yet returned to their highs in mid-1990s, though household income has risen back to the 1997 level amid a buoyant economy in recent years. Low interest rate and fierce competition in the mortgage market have pushed down monthly mortgage payments, which are estimated to be 40% less than that in 1997. The reduced mortgage burden, coupled with a double-digit growth of private rentals since June 2007, will urge existing renters to switch to home buying, thereby sustaining interest in the Hong Kong housing market this year.

Nevertheless, the fear of a recession in the US – still our largest overseas end-user market – will keep buyers wary. Since exports contribute more than 20% of our economy, Hong Kong GDP growth is expected to slow from 6.3% in 2007 to 4.5% this year.

[1]In his speech titled "Reducing Preventable Mortgage Foreclosures" delivered on March 4, 2008, Ben Bernanke mentioned that "with low or negative equity, … a stressed borrower has less ability (because there is no home equity to tap) and less financial incentive to try to remain in the home. In this environment, principal reductions that restore some equity for the homeowner may be a relatively more effective means of avoiding delinquency and foreclosure".