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The US is Not on the Brink of a Financial Crisis

Prior to the collapse of the housing bubble and the resulting financial crisis, major news outlets had little interest in pieces warning about the bubble and the risks it posed to the economy. These days there seems to be a large demand for such pieces. Unfortunately, in choosing these pieces, news outlets seem little better informed today than they were in the years before the housing bubble collapse.

To take a recent example, the New York Times published a piece by William D. Cohan, a well-known author of books and articles on the financial industry. Cohan argues that the Federal Reserve Board has kept interest rates at unusually low levels in recent years.

He maintains that while low interest rates have helped boost economic growth in the short-term, it makes the economy vulnerable to financial crises in the longer term. If interest rates go up, then many debtors will be unable to pay their debts and we will again be facing a 2008-type financial crisis.

At the most basic level, Cohan's argument is extraordinarily misleading. He notes the current valuation of the $41 trillion bond market is considerably larger than the $30 trillion stock market and therefore deserves considerably more attention than it receives.

However, the bulk of the $41 trillion in outstanding bonds is not corporate debt, which is the focus of his piece. The federal government alone accounts for more than $17 trillion of this debt. The government agencies that support the housing market, Freddie Mac and Fannie Mae, account for another $6.7 trillion. Bonds issued by nonfinancial corporations only account for $6.2 trillion of the bonds outstanding.

While this is still a substantial sum, if we look at the debt service burden it is not especially large. Interest payments were equal to 23.1 percent of after-tax profits in 2017, compared to more than 25 percent in the late 1990s, not a period we associate with a corporate debt crisis. Furthermore, the tax cuts meant there was a big jump in after-tax corporate profits in 2018, making the debt service burden even smaller.

It is also worth thinking about what happens if some companies do run into problems paying off their debt. First, many would be able to issue more stock to get cash. That certainly would be true for most companies with the stock market at its current levels. In fact, it would be true for most companies even if the stock market fell by 15 or 20 percent.

But even in the cases where companies are unable to meet their debt payments and can't issue shares, we will not see the value of their debt fall to zero. In most cases these companies will still have assets that can be sold off to allow bonds to pay 70 to 80 cents on the dollar. This will substantially reduce the losses to bondholders.

To take an extreme case, suppose 25 percent of corporate bonds outstanding end up in default. Suppose that in these defaults companies can only repay 75 cents on the dollar. This implies that we have a bit less than $1.6 trillion in defaulted debt. With losses of 25 percent, the total loss to creditors would be less than $400 billion. This is less than 2.0 percent of an economy that is now over $20 trillion. That hardly seems likely to cause a financial crisis, even though it may lead to some unhappy investors.

It is important to remember that the 2008 crisis was first and foremost about a crash of a housing bubble. The financial crisis was secondary. Furthermore, the financial crisis was a direct outgrowth of the collapse in house prices, since houses are a highly leveraged asset.

Even in normal times it is standard to buy a house with a down payment of 10 to 20 percent. This means that homebuyers are borrowing 80 to 90 percent of the value of the house. In the bubble years it was common for people to buy homes with down payments that were zero or near zero. In many cases they actually borrowed more than the value of the house.

When prices fell 40 or 50 percent, as they did in many areas, the mortgages became nearly worthless as the cost associated with repossessing and selling the home could be very close to the amount of money obtained from the sale of the house. In this case, the losses on loans could be 70 percent or more.

But, skipping the financial aspects of the 2008 crisis, the loss of real demand associated with collapse of the bubble was enormous. The shift from boom to bust caused residential construction to drop by four percentage points as a share of GDP. That is equivalent to a

loss of $800 billion in annual demand in today's economy. This decline was a direct result of the massive overbuilding of the bubble years as construction went from two percentage points above normal in the boom to two percentage points below normal in the bust.

In addition, the wealth effect from the run-up in house prices led to a consumption boom, as the savings rate hit a record low of just over 3.0 percent of disposable income in 2005. When the bubble-generated housing wealth disappeared, so did the consumption it was fueling. By 2010 the saving rate was back to over 6.0 percent, roughly its current level, costing the economy an additional two percentage points in lost demand, or $400 billion in today's economy.

The total loss in demand was six percentage points of GDP or $1.2 trillion annually. There is no story in today's economy that can give you a picture anything remotely like the collapse in 2008.

Virtually the entire economics profession and business media completely missed the warning signs for the crisis in 2008. Ten years later they still don't seem to have a clue.

This column originally ran on The Hankyoreh (Korea).