Disaster in Slow Motion?

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Article:

Watching the U.S. housing market's slide over the last couple of years has been like watching a large ship sink into the ocean. It's been slow and excruciating, and it's hard to know how to stop it. But at least an isolated ship sinking out at sea affects nothing around it. The housing slump is taking other industries down with it.

The big question mark for the economy has been whether the financial shenanigans that first inflated and then deflated the housing bubble would spill over into the rest of the financial sector. For many months it looked like the credit crisis would leave banks largely unscathed, and wreak havoc mostly on the less-regulated investment banks and hedge funds that started this mess. It appeared that the crisis would be a phenomenon primarily of Wall Street rather than Main Street. But more and more, the effects are being felt throughout the banking system.

The Federal Deposit Insurance Corporation, which insures deposits in commercial banks, reports that the number of banks at risk has increased sharply this year. In 2006 there were only 50 "problem institutions," but there were 117 in just the first half of this year. The assets of at-risk banks have risen from $8 billion in 2006 to $78 billion so far in 2008. (Even so, that represents well less than one percent of the assets of all FDIC institutions.)

Not surprisingly, a riskier environment for banks has led to a tightening of credit standards and a reduction in the supply of credit, which is bad news for anyone selling durable goods like furniture. Sure enough, the Federal Reserve Board's quarterly survey of loan officers indicated that in the second quarter of this year, 81 percent of domestic banks tightened lending standards on loans for commercial real estate.

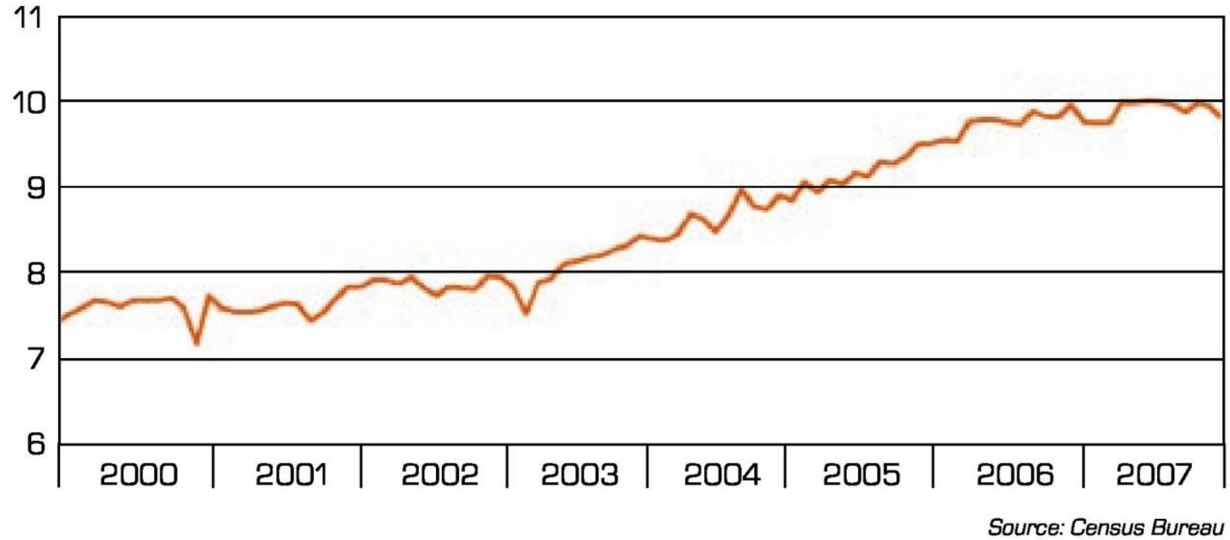
But the tightening wasn't limited to real estate. Over 60 percent reported tightening standards for other commercial loans to businesses.

The Fed's survey results for commercial loans were similar to those from the first quarter, in which significant tightening took place as well. But the new wrinkle in the second quarter was the sharp increase in banks tightening standards for consumer loans. In the first quarter, only 30 percent of banks reported tightening standards for credit-card loans. In the second quarter, 67 percent tightened standards.

The survey also found that 36 percent of domestic banks were less willing to make consumer installment loans than they were three months earlier. Only two percent reported being more willing.

The jump in these figures for consumer loans suggests that the credit crunch is still expanding. First it was real estate, then commercial loans, and now consumer loans. The effects are being felt throughout industries that sell goods on credit. Consumer spending on durable goods (corrected for inflation) fell at an annual rate of 4.3 percent in the first quarter of this year, followed by another drop of 2.5 percent in the second quarter.

Retail Sales:
Furniture & Home Furnishings Stores
Billions of dollars, seasonally adjusted, not corrected for inflation



Of course, the durable-goods industry of greatest interest to readers of this publication is the home furnishings industry. And the news is bleak. According to preliminary data for August, retail sales by furniture and home-furnishings stores were 8.3 percent lower than in August 2007. In fact, every month since last December has seen furniture retail sales that were lower than a year earlier. Annual sales didn't decline in the 2001recession, but it's nearly a certainty that they'll decline this year. And none of these figures is corrected for inflation, which means that they actually understate the weakness in furniture sales.

Given the wreckage throughout the national economy, the biggest surprise is that it's yet to slide into recession. After shrinking in the fourth quarter of last year, the economy has actually grown this year, though just barely. Few analysts expect a change during the rest of the year.

What else can we expect for the future? Most of the loan officers surveyed by the Federal Reserve expect further tightening of credit standards, so the credit crunch isn't over yet. But there are some encouraging signs.

Mortgage rates have fallen after rising a bit in recent months. Measures of housing affordability are rising after falling steadily even while home prices were falling. Home sales appear to be leveling off. This ship will eventually right itself, but it's going to be a slow process.