

A United Steelworkers District Three Publication

#3

# The Meltdown Chronicles

## BUILDING THE BOOM, FINANCING THE CRASH: HOUSING IN THE ECONOMIC MELTDOWN

By Kim Pollock



One of the reasons for the recent economic crash is that workers and companies producing real things like houses are increasingly at the mercy of banks and financial institutions. Instead of producing useful things for people, many of the players in our economy are determined to make profits out of profits, money out of money.

And nowhere can this been seen more clearly than in the recent rise and fall of the US residential-housing industry. Housing is of course a major contributor to the US economy. Economist Nouriel Roubini for instance calculates that from 2001 to 2006, residential construction drove employment-creation topping 1 million workers. He suggests that 28 percent of employment *growth* in the US over that period came from housing; when you add in indirect job-creation, for instance in lumber mills or subdivision construction, the effect totalled roughly 41 percent. And that doesn't even in-

clude industries such as home appliances or construction-related vehicles which are also impacted by housing construction; when you add them, housing's impact on employment rises to about 45 percent.

### *Finance and credit drove housing up...*

In the recent economic boom, housing's rise was significantly driven by financial decisions – then *driven down* by them. Economists call it financialization.

First there were low interest rates. The Federal Reserve,

the US central bank, used low rates to pull the economy out of recession. The federal fund rate, 6.54 percent in August 2000, was steadily cut to a low of 0.93 percent in December 2003; it was still only 1.03 in June 2004. At the same time home sales and prices were dramatically *rising*. Many people were encouraged to borrow against the rising values of their homes, using the cash to buy new appliances, vehicles, furniture, even new *houses*.

This created a massive bonanza for mortgage lenders. With rates so low, millions of families suddenly saw a



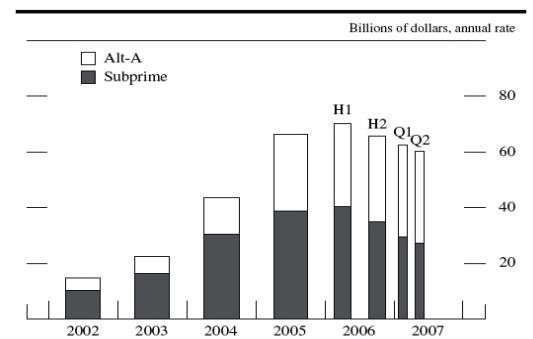
home of their own as a real possibility. And lenders made it even *easier* with so-called subprime loans – no money down, scant credit checks, low initial interest rates.

In fact, the subprime sector was soon the fastest-growing sector of the mortgage market, with \$587 billion in sales during 2004, compared to \$390 billion in 2003. By the end of 2004 over 30 percent of loans were in this category; leading subprime dealer Ameriquest alone did \$50 billion in business. And although few people seemed to notice at the time, it was ominous that subprime lenders also sold over \$200 billion worth of mortgage-based securities to financial institutions.

*“D.R. Horton, the biggest US residential builder, reported in November 2005 that its quarterly profits were \$565 million”*

With all this grease on its wheels, housing was soon booming as well. New-home starts rose by 35 percent from under 1.9 million in 2000 to a peak of nearly 2.5 million in 2005, while the annual value of construction *doubled*. And builders were not only putting up more homes; they were building growing numbers of bigger and more expensive homes to satisfy a growing luxury market, as well. Big builder Toll Bros. offered a 4800 square-foot model, while the number of homes of over 3000 feet rose by 62 percent from 2001 to 2006.

Gross issuance of alt-A and subprime-mortgage-backed securities, 2002–07



NOTE: Alt-A includes such products as mortgages with limited income verification and mortgages secured by non-owner-occupied properties.  
SOURCE: Inside MBS & ABS.

*... generating billions in profits...*

As the boom grew, so did profits. Mortgage companies were profiting and so were home builders – D.R. Horton, the biggest US residential builder, reported in November 2005 that its quarterly profits were \$565 million, “the largest quarterly profit in homebuilding history.” Annual profits topped \$1.5 billion; other big builders reported similar huge profits. With wages flat, as we shall see and even with growing investments in land and equipment, huge salaries for corporate managers and lavish dividends for shareholders, the company had billions of dollars in retained earnings.

What to do with all this cash?... Again, enter finance capital.

As companies’ output, sales and profits soared and the US moved out of recession, share prices were also rising. And when D.R. Horton and many other corporations began pumping billions in unspent and uninvested profits into the markets, they were driven up *even more*. Investors were making a killing; the lure of big profits encouraged more corporations and investors to speculate.

So mortgage brokers, home builders, investors and bankers were profiting; people were moving into their new homes and furnishing them with new consumer items. More people had jobs. Everything was good, right? Perhaps, but there were already some cloud on the horizon.

The Meltdown Chronicles



United Steelworkers  
District 3  
Special Report

... but what goes up, must come down!

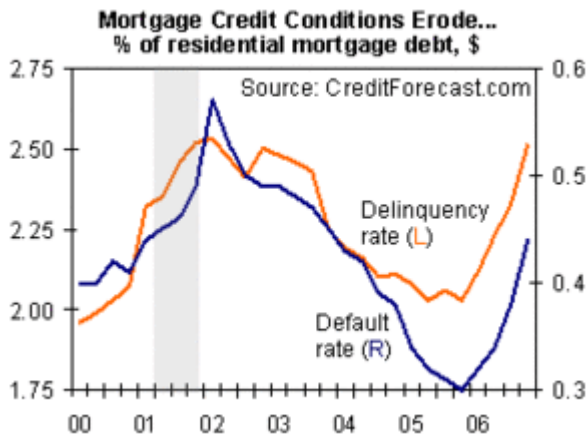
One was that a lot of the money fuelling the boom was *borrowed*. A lot was borrowed by consumers, for instance: while people’s spending went up, wages were stuck at near-recession levels. Many families filled the gap by borrowing, not just against home prices but also on their credit cards. A lot was borrowed by speculators, as well. At the time of its collapse in March 2008, Bear Stearns, for example, “had \$11.1 billion in tangible equity capital supporting \$395 billion in assets, a leverage ratio of more than 35 to one. And its assets were less liquid than those of many of its competitors,” reported *Fortune*.

In addition, rising demand from consumers and corporations across the economy created *inflation*. The central bank’s usual antidote to inflation is higher interest rates. After mid-2004, the federal funds rate rates climbed from about 1 percent to over 5 percent by August 2008. Higher interest rates of course cut into demand for new homes by raising mortgage rates.

---

*“Many families filled the gap by borrowing, not just against home prices but also on their credit cards”*

---



And at the same time, higher rates made worse one of the downsides of those subprime loans. It’s called *resets*. Those loans offered initially-low interest rates. But after a year or two the rates reset higher, often much higher. Even with rampant home-price inflation driving up home prices, many new purchasers discovered they couldn’t really afford their mortgages, especially with higher interest rates pushing up their reset mortgage costs even more.

In late 2006 and early 2007, defaults on mortgages began rising sharply, especially for those with poor credit histories. The default rate had fallen to 5.37 in May 2005; now it rose to 10.9 percent – higher even than November 2001 when economic growth resumed after the recession.

By February 2007 at least 20 subprime lenders had shut down, scaled back or sold themselves to larger companies since the start of 2006. In April 2007, leading lender New Century said in a bankruptcy filing it wanted to sell most of its assets within 45 days. About 3,200 people, more than half its workforce, would be out of work. New Century said it was selling its mortgage billing and collections unit to Carrington Capital Management LLC for \$139 million.

Then in September Ameriquest announced that it was closing. Citigroup Inc, the largest US bank, said it had agreed to buy Ameriquest’s wholesale mortgage lending and payment collection assets for an undisclosed price. Ameriquest had already been the first major subprime lender to downsize, deciding in May 2006 to close its 229 retail branches and cut 3,800 jobs.

**The Meltdown Chronicles**



United Steelworkers  
 District 3  
 Special Report

Meanwhile the home builders kept on borrowing to buy more land and build more houses. Companies like D.R. Horton were still making profits – although its profits were increasingly made on stock investments and mortgages rather than construction. Horton’s retained earnings for 2006 hit almost \$4.9 billion, while its land inventory rose from \$4.3 billion in 2002 to \$11.3 billion in 2006. But Horton was also finding it harder to sell the homes it built. In 2005 for instance the company sold more homes than it built; by 2006 that was reversed and by 2007, it found itself building 10,000 more homes than it sold. Horton – like many other big builders – was in trouble.

---

*“By the end of the year Horton’s first priority was debt reduction; in 2008 it began a fire sale, selling lands and houses for a fraction of what it paid for them.”*

---

In 2007 it began cutting its inventories, building fewer houses and laying off of contractors. After a small profit for the first quarter of 2007, Horton lost almost a billion dollars in the second. By the end of the year Horton’s first priority was debt reduction; in 2008 it began a fire sale, selling lands and houses for a fraction of what it paid for them. The company admitted that it had paid too much and couldn’t profitably build on many of its properties; it effectively warned shareholders that it was not sure it would survive.

Meanwhile, of course, the residential-home industry’s problems were now bumping back through the economy the same way its good fortunes had at the start of the boom. Lumber shipments tumbled, along with the sales of appliance stores, home furnishing producers, appliance dealers and subdivision builders. More layoffs meant even less consumer demand. Less consumer demand meant even fewer orders for new homes. And so on down.



But this was far from the end of it. Banks had already been hit with the realization that thousands of their outstanding loans were non-performing, costing them millions in collection and foreclosure costs. This is what was happening when banks like IndyMac, Washington Mutual and Wachovia began closing their doors.

Worse, most financial institutions faced the additional headache of holding billions in devalued or even worthless securities – all those repackaged mortgages which had been sold to investors, then resold profitably to others and so on. Now amid fears the speculative boom was ending, investors were pulling back. The last person holding a security was stuck with it. This is what was happening when Citibank, Merrill Lynch and other massive financial corporations began writing down billions of dollars worth of securities in late 2007.

**The Meltdown Chronicles**



United Steelworkers  
District 3  
Special Report



And as investors learned that almost *everyone* held subprime paper, panic spread. No one could be sure whether money they lent was secure. And it turned out that trillions of dollars in borrowed cash had gone into subprime loans. That's what was happening when major investment banks like Bear Stearns and Lehman Bros. began to tumble in 2008. When major investors called in their loans, Bear Stearns for instance went almost overnight from making speculative profits of 40 and even 80 percent to bankruptcy. When even institutions as apparently solid as quasi-public mortgage dealers Freddie Mac and Fannie Mae and insurer AIG became suspect, the flood-gates opened and the finance and credit system fell.

Not only D.R. Horton but many other corporations and wealthy investors found that their "fortunes", based on money invested on speculative assets, were gone. Retained earnings, which totalled \$4.9 billion in 2006, had dwindled by September 2008 – even *before* the major market meltdown that would soon follow – to \$1.2 billion. By now the firm had sold off over 30,000 lots at an estimated 25 cents on the dollar in the previous year and its new home starts, once over 50,000 a year, were down to 12,000; other builders reported similar results.

The impact of growing financialization on companies in the real economy has been drastic, in other words; but the impact on workers has been equally dramatic. Many of those who took out subprime loans have lost their homes. By the end of 2008, some 2.3 American homeowners faced foreclosure, while 860,000 actually lost their homes. Another 18 percent will lose their homes this year, according to estimates by Moody's Economy.

Other working families simply declared bankruptcy, their credit cards maxed-out. Millions more lost their retirement savings when the markets collapsed. Now even more are taking the hit for the speculators via job loss. Of the 600,000 jobs lost from January to September, many were in housing-related industries: residential building saw an 11.8 percent fall in employment; residential specialty contracting 10.5 percent, wood products 10.0 percent, furniture 8.4 and building supplies stores 6.7 percent.

Workers are paying the costs of rampant financialization and out-of-control speculation, in other words. Not only are they losing jobs, homes and savings; they're being asked to foot the bill in the form of corporate bailouts. Surely one of the lessons is that it's time for a wholesale revamping of the regulatory regime that governs financial dealing. Governments should direct more corporate profits back into production, research and worker training rather than the stock

---

*"By the end of 2008, some 2.3 American homeowners faced foreclosure, while 860,000 actually lost their homes"*

---

#### The Meltdown Chronicles



United Steelworkers  
District 3  
Special Report

District 3 Office  
300-3920 Norland Ave.

Phone: 604-683-1117  
Fax: 604-688-6416  
Website: www.usw.ca



uswu2952

The text of this special report was prepared by Kim Pollock, Canadian research representative for United Steelworkers. Layout was by John Mountain, also a Canadian research staffer of USW, with production assistance from Rosanne Grazier. We are all based in the District 3 office in Burnaby, BC.

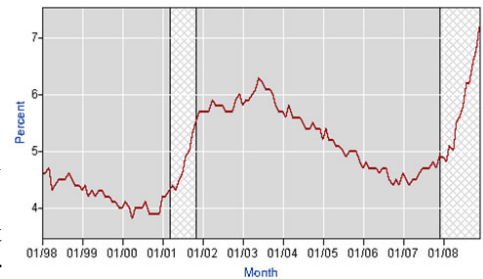
market. And taxpayers should demand an equity position and insist that government provides permanent oversight of corporations that get taxpayers' help.

The government should also insist that banks begin to actually *lend* the money they have already received in the form of alleged bailouts. So far it appears that bankers intend to sit on that cash or use it to buy up other banks rather than either purchase so-called "troubled assets" or re-stimulate the credit system. And it seems that the US bailout bill passed in December doesn't actually *require* them to do so. Unfortunately, as Harold Meyerson wrote in the *Washington Post* on January 14: the government "has thrown money at the banks, which resolutely refuse to lend it to businesses and homeowners, no matter how creditworthy they may be."

In addition, we're facing the very real risk of a deflationary spiral into a deep recession as companies continue to lay off more workers and cut output. The government must encourage new investments in capital-intensive projects such as alternate energy, infrastructure, public buildings and public services. Especially if it insists on domestic sourcing of inputs for these projects, government would start reversing the deflationary spiral. People with good-paying jobs in industry can afford to buy consumer goods; it's a much sounder basis for economic growth than the failed consumer-spending boom.

In short, surely it's time we all got back to work producing useful things for people and starting pouring less wealth into the pursuit of money by money.

Unemployment rate (seasonally adjusted)



Note: Cross-hatched area represents recession.

### The Meltdown Chronicles



United Steelworkers  
District 3  
Special Report

For a background on Housing and Finance Capital in the 2008 Economic Melt-down, please visit: [http://www.usw.ca/UserFiles/File/D3\\_documents/Building\\_the\\_Boom\\_26\\_01\\_09.pdf](http://www.usw.ca/UserFiles/File/D3_documents/Building_the_Boom_26_01_09.pdf)