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Bust will follow boom – but when?

By: [Fred Harrison](#)

Many think that the global real-estate bubble has nearly run its course. Fred Harrison disagrees. He thinks it has another three years to run. Here he tells us why.

From California's Silicon Valley through the hot spots of Europe all the way to the booming property market of Shanghai, house prices have hit record highs – driven upwards by easy money and the speculation it always causes. The effects of the boom have spread through the world economy, thanks to the impact the feel-good factor of rising house prices has on consumer spending, and hence on economic growth. But can the good times last? And what happens if they don't and probably the biggest bubble in history turns to bust? We may not have long to wait to find out. If history is any guide, property prices around the world will start to fall in three years' time and a global economic depression will follow in 2010 as consumer consumption collapses.

This analysis is based on a theory of the property cycle. I have drawn on 300 years of business-cycle history and reached one firm conclusion: housing booms precede recessions. That said, there is a big difference between this bubble and past bubbles. In the past, national economies have operated with a degree of independence. Today, we all sink or swim together: the major economies of the world are synchronised into a single business cycle and so are property prices.

In the US, house prices have doubled in the past five years, and as land becomes unaffordable to first-time buyers, builders are turning to the construction of smaller dwellings and condos. This echoes what has happened in Britain, and the story is repeated in countries such as Australia and the sun spots of southern Europe. Even in China, all along the coast erstwhile Communists are "flipping" properties just like their capitalist cousins in America – buying off-plan and re-selling apartments before the blocks are even constructed as prices soar. Consider the numbers. In the UK alone, the value of the housing stock reached £3.3trn in 2004, triple the value of ten years earlier, according to Halifax. Then look at all the developed countries put together: real-estate prices have risen by more than \$30trn over the past five years. That's equivalent to 100% of their combined annual GDPs. This eclipses the 1990s stockmarket bubble (an increase over five years of 80% of GDP), and Wall Street's bubble of the late 1920s (55%). But this bubble may not be done yet.

The 18-year cycle

House prices can't rise indefinitely for the simple reason that at some point they become unaffordable. Wages can't rise as fast as house prices can when a speculative frenzy is underway, so there will come a point when the average man can't buy the average house, and prices have to fall as a result. My research shows that this tends to work in 18-year cycles. There are usually 14 years of rising prices followed by four years of recession across the broader economy. I've looked at data across four continents and at 300 years of British economic history and it seems that this 18-year cycle is present across the globe, irrespective of the distinctive characteristics of each economy – whether the country is resource-rich (USA) or resource-poor (Japan), or whether the population is high density (the UK), or low density (Australia).

Governments always think they can in some way control boom and bust cycles, but so far they have failed. Why? Because their economic models are overly focused on labour and capital rather than on land and property prices, the things that really drive economies. Classical economists such as Adam Smith thought that because the supply of land is one of the few things that is by nature finite, it is land that ultimately determines our economic fate. So while we talk (endlessly) about investing in “bricks and mortar”, it is in fact the plot underneath the house that really makes the difference. In fact, the price of land is the best leading indicator we have of the state of health of the economy.

Look at what has happened to prices since 1979. In the Nigel Lawson boom/bust of the late 1980s and early 1990s, the price of new houses rose by 300%, but the price of raw land rose by 1,000%. Then both turned down, ushering in a recession that hit bottom in 1992. Then from 1993 until Gordon Brown moved into the Treasury in 1997, house prices stayed on an even keel. But while house prices subsequently escalated to an annual increase of 25% at their peak, the price of land launched into the stratosphere. Land prices have risen an extraordinary 1,700% since 1979.

So what next? Well, just like the 1980s boom, this will end in disaster for the wider economy, as people struggle to meet mortgage payments and have to slash all their other discretionary spending. Already there is a 51% upturn in the repossession of homes during the first half of this year and Lloyds TSB reported a 21% increase in bad debts over the six months to July compared with 2004 – clearly, people are already struggling. Cuts in consumption ultimately hit manufacturers. Indeed, the Purchasing Manager Index fell to 49.2 in July from 49.6 in June, the fourth straight month of contraction.

It all happens in 2008

So when will the crunch really come? History suggests that things will start to collapse in 2008 (18 years on from 1990 when the last bubble burst). But there are a few good reasons apart from the historical 18-year cycle that should make us think that the bubble will run to 2008. Government spending is still very high in the UK, for example – now that the Treasury has redefined its version of a ‘cycle’, Gordon Brown can raise borrowing to support his spending commitments. This should continue to offer some stimulus to the economy until 2007/2008, when it is scheduled to tail off.

John Prescott's plans to help first-time buyers and 'key workers' into the market should also help make it look more solid than it is, as should the fact that higher income earners are predicted to inject more than £8bn into property through self-invested personal pension funds from next April. There are similar stimulative measures afoot in Europe (the European Commission is promoting a Europe-wide mortgage market), which should keep prices moving there for a while as well. However, all the pressures on the market will converge on 2008 as the stimuli run out. And it isn't just the residential market that will be in trouble. The commercial property sector also has an ominous feel about it. Speculative skyscrapers are going up as much because of their iconic appearance as for the economics of the tenanted sector, and more and more capital is being tied up in real estate rather than put to work in research and development. All over Europe too, money that should be funding the factories and infrastructure that would raise EU productivity is instead seeking out windfall gains in real estate. This will also end in tears and the net result will be the arrival of recession by 2010, something that may well be aggravated in Britain by a new 'land tax'.

Lower interest rates won't stop the crash

Can anything be done to head off the depression of 2010? In my view, it's too late for the UK. The Bank of England is caught in a double-bind on monetary policy. If house prices are to be held at their current levels, debt levels will have to keep rising. That puts a continuing downward pressure on interest rates, which induces further upward twists in the price of houses. But if the Bank keeps cutting interest rates as unemployment rises and high street sales drop, it will aggravate stresses in the economy (inflation, for example). There is nothing it can do in the short term.

The fundamental reform that would re-balance the economy needs a much more long-term political strategy. It involves a drastic cut in the tax taken from people's wages and savings in order to encourage them to work and invest. Then, as FT columnists such as Samuel Brittan and Martin Wolf have recently argued, we should pursue the Adam Smith approach to public finance: revenue should be drawn from the rents of land (not on the value of land assets as discussed in the box below – this would only make things worse).

This reform – promoted by Winston Churchill a century ago, but thwarted by the landowners in the House of Lords – would turn taxation into a counter-cyclical policy. As land prices rise (as they do, in a growing economy), more revenue would flow into the public coffers to pay for better services. At the same time, tax policy would deter land speculation while rewarding enterprise – the opposite to what it does now.

In the meantime, the best thing investors can do for themselves is to shift their portfolios into assets that can quickly be liquidated. Don't believe anyone who says that the property market is going to recover strongly from here and don't believe anyone who says that even if it doesn't, the effect of housing on the wider economy is marginal. It isn't. It is absolutely key to the health of both the UK and the global economy.

Has Gordon Brown lost the plot?

Bank of England economist Kate Barker, in her report on the UK housing market last year, recommended a 'Planning Gain Supplement'. Deputy prime minister John Prescott has also signalled his support for what would effectively be a tax on developing land. Town councils want this 'roof tax' to pay for roads and schools. But Development Land Taxes have been tried and tested on three occasions since 1948. Owners withdrew their land to avoid these taxes, damaging the development industry and raising house prices still further.

The new tax, if it is introduced by Gordon Brown, would become operable in 2009/2010, just as building activity grinds to a halt. The ensuing recession in real-estate prices will be prolonged, as owners hold back their plots and wait for a new government to abolish the tax.