

HOW LONG WILL LAND MARKETS CONTINUE TO SPIRAL UPWARD?

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Henry George's presentation of political economy and the laws of production and distribution describe the business cycle as an outcome of flawed socio-political arrangements. More recent research by Fred Harrison, published in his book "The Power In The Land", identified a repeating 18-year land market cycle going back hundreds of years. If we accept Henry George's analysis, the tendency of such cycles to repeat is based on the pervasive power of existing socio-political arrangements to overcome whatever mitigating measures have been employed by government—short of the reforms George proposed. Our Australian colleague, Bryan Kavanagh, has undertaken the task of analyzing the historical data to "provide an empirical test of George's theory that rent-seekers are responsible for recurrent recessions and depressions." His paper, "The Coming Kondratieff Crash," was published in the Autumn 2001 volume of *Geophilos*, and he boldly warned that Australia was "teetering at one of the portentous property market peaks observed by Henry George." The Australian economy has not exactly fallen into a recession, but there are clearly signs that a downturn is underway - at least in some parts of Australia. The lesson, perhaps, is that Australia is not one economy but many regional economies that are at different places in the land market cycle. If this is true of Australia, the case is even stronger for the United States.

Among the dynamics at work in the U.S. is the behavior of banks and their regulators. After the last round of regional real estate crashes at the end of the 1980s, the banks adopted somewhat more conservative criteria for lending on real estate. A new wave of mergers of already huge banks has also greatly increased the asset base of the surviving entities, shielding them from the threat of insolvency even as they absorb losses associated with troubled real estate portfolios.

Just where the U.S. is in the land market cycle is hard to assess. Rising land prices, generally, is a concern of real estate analysts and some economists. Already, land prices have started to fall in a few markets, such as San Francisco and Silicon Valley. Rental rates for Class-A office space in San Francisco have fallen from \$80 per square foot in the fourth quarter of 2000 to \$35 in the first quarter of 2002. Vacancy rates are now above 15%. By contrast, Washington, D.C. has a vacancy rate of under 8% with average rents of around \$38 per square foot. Concern over the economy and declining purchases of industrial and consumer goods has caused businesses to curtail plans for expansion or resulted in release of employees and the offering of large amounts of space for sublease. Additionally, a considerable amount of new construction has come onto the market during the last year and a half. Boston rivals San Francisco as the market at risk for a collapse if banks are forced to take over and liquidate these new buildings.

The situation for residential housing markets is also difficult to assess. All across the nation well-capitalized builders

have engaged in land-banking in anticipation of steeply rising prices. Thus, the supply of developable land is being artificially reduced, driving up land prices even higher. Provided people will be employed and earning high enough incomes to afford new homes, these builders are in a position to enjoy good profits. To some extent, stability of demand requires that the Federal government and local communities continue to allocate tax revenue to subsidize the sale of housing units to low- and -moderate income households or accept losing these residents to more outlying areas where land is less costly. Affordable housing at the low end is key to the ability of existing homeowners to sell and move up to larger, more expensive homes.

Mark Zandi, an economist and founder of *Economy.com* released a report in June echoing other analysts on the strength of the nation's housing markets. Total sales for 2002 are forecasted at over 7 million units, provided employment and interest rates remain stable. The nation's homeownership rate has reached 68% of all households, pulled upward by minorities who are finally gaining broad access to low cost credit. A potential underlying problem may exist, however, associated with the risks being taken by the entities that invest in residential mortgage loans. A larger and larger share of home purchases occur with very little contribution of equity in the transaction and with almost no cash reserves in the bank after closing. Sophisticated automated underwriting systems evaluate potential borrowers based on their employment and credit histories; however, the fastest growing segment of the financial services sector is "subprime" lending by companies that often charge very high rates of interest and make loans to homeowners that result in combined mortgage debt exceeding the market value of the underlying real estate (i.e., the collateral). An as-yet undefined portion of this business is predatory in nature, marketed to the most vulnerable segment of the market - seniors, the poor and those who have historically had problems managing credit.

The picture is complex, and forecasting when the land markets will peak and whether a correction will be gradual and moderate or rapid and deep is beyond my abilities. What I do know is that the amount of debt being carried by U.S. households is at a record level for those households who receive the lower 4/5ths of total household income. Overall, U.S. households are paying around 14% of after-tax income on mortgage and consumer debt. The further down the income ladder one goes, the higher is the ratio. Since 1985, the amount of debt carried by those least able to absorb any loss in income has been increasing each year. Personal bankruptcies surpassed 1.25 million in 1999 (up from an average of around 200,000 in the late 1970s).

Others are far more optimistic. Harvard University's Joint Center for Housing Studies concludes that although price increases are likely to subside there will not be a widespread crash. (continued on page 13)

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One reason is demographics. New household formations between now and 2020 will add nearly 25 million households seeking apartments and homeownership. The overwhelming majority of these households will be minorities and immigrants. If these new households are employed and receiving incomes sufficient to compete in the housing market, a period of stability may develop. At the moment, housing prices all across the U.S. seem to be moving up to levels that require incomes sufficient to carry ever higher levels of debt. The stock market is experiencing a serious market correction. So, it seems, is the commercial real estate market. San Francisco is showing signs that the residential market is also on the verge of a correction. What we will learn - and learn fairly soon - is whether those who have purchased homes recently have done so at the very top of the land market. Equally important, we will learn whether the economy can absorb these downturns without the high level of loan defaults, foreclosures, fire sales of real estate, bank closures and unemployment that have accompanied previous land market crashes.

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