

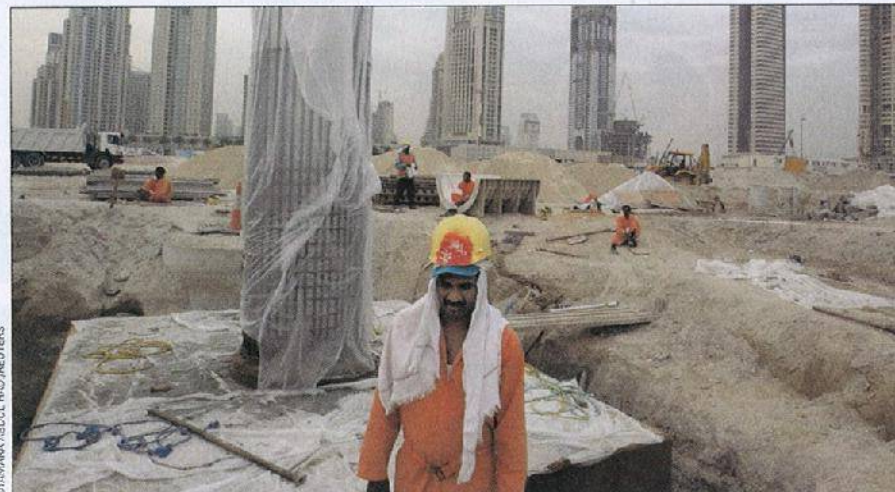
Expect a global house-price slump next year

We are in the final growth year of an 18-year cycle, says Fred Harrison

Betting against the UK property market has been a losing proposition for years. And even though inflationary pressure, rising interest rates and troubles in the US and Spain have sent tremors through the UK market, most expect a soft landing. After all, we've been here before. In mid-2005, annual price growth was slowing, almost turning negative. And yet, as I forecast in MoneyWeek in August 2005, the UK was about to launch into the final phase of the cycle – a two-year period I dubbed the Winner's Curse, characterised by gazumping and reckless lending. Prices surged in 2006, as speculators sought capital gains from real estate.

But the good times won't last much longer. By the start of next year, prices will stall, before falling. I believe UK prices will fall by 20%-30% – and as we're seeing in Spain, Ireland and the US, the pain will not be limited to the UK. The crash will be a global event leading to a depression. The signs are everywhere: overblown real-estate markets in India and China, record prices for property in Latin America and Africa, the rush to erect record-high skyscrapers in the Gulf states – all point to property markets heading for a synchronised bust-up.

Economists say this is unlikely while the economic 'fundamentals' are sound. But let's examine these. First, employment, which remains buoyant. The implication is that the jobs market is independent of housing; and if there is a connection, the causal influences work from pay packets to house prices. But this is wrong. Unemployment figures start to rise after the economy has turned down, not before. Construction is a leading sector in the economy: when it heads south, so do jobs, dragging down other sectors as the ripple effects multiply. In the US, 100,000



The rush to fill Dubai's skyline with skyscrapers points to a global property bust-up

jobs were lost in construction last year; while this year, services dependent on housing have already begun to retrench.

But what about interest rates? House prices, we are told, rose because interest rates were low; while they have climbed in the past year, rates are low compared with the 1980s and are therefore affordable. By this theory, the zero interest rates in Japan ought to have meant huge rises in house prices. In fact, prices fell over the past decade.

Then there is the question of supply and demand. Experts claim house prices will be cushioned because there is a severe shortage of homes for sale. Again, the evidence contradicts this. In Spain, in recent years, supply has exceeded demand by a large margin. Last year, Spanish builders built 800,000 units compared with less than 200,000 in the UK. That should mean Spanish prices rose more slowly than in Britain. But in the past five years, despite the recent slowdown, prices have grown faster than in the UK.

The real driver of house prices

Property prices are largely determined by the finite supply of land where people want to live, work and play. Expand demand for land and rents rise – it's as simple as that. That's because in locations that matter – like the beaches of the Costa Brava – land is not infinitely reproducible. We can't shift plots from Poland (where they are underused) to Marbella (where they fetch record prices).

Because the supply of land is fixed, in a growing economy, it becomes more costly, squeezing corporate profits and money available for wages. Hence the inexorable rise in the cost of housing as a proportion of incomes. Eventually, prices simply can't go higher because property is priced out of the reach of most people.

By looking at data spanning 300 years (see box, left), my research suggests this cycle operates on an 18-year basis, having about 14 years of stable or rising property prices, followed by four years of recession. The last recession was in 1992, with house prices stabilising around 1993. That suggests that 2007 will be the final growth year for this cycle before the four-year downturn begins again.

The fact that this cycle is now a global, rather than local phenomenon, is clearly shown by changes in the distribution of global income. According to the IMF, the percentage of GDP going to workers' incomes in the G7 countries has fallen

from 68% to 61% over the past 20 years. What caused this earnings squeeze? The arrival of millions of Asian workers into the global labour force; as the supply of employees rose, so wages fell.

So who captured the difference? Economists say the gains have gone to the 'profits' of 'capital'. But man-made equipment – the classical definition of capital – is reproducible on demand. In other words, as more people want to buy more consumer goods, supply rises to match and prices are driven down by competition. For example, it is much cheaper to buy a car these days than 30 years ago, even though they and the machines used to make them are far more sophisticated. So why should the rate of return to capital (by this definition) rise? It did not. The gains were pocketed by the owners of land and natural resources. To see this, compare the rise in land-related assets to share-price growth in the UK. Over the past decade, land prices have risen nearly fivefold, while the FTSE 100 has gained around 40%. But wages have barely kept up with inflation.

Can we escape from boom and bust?

This global shift to land rents as a proportion of GDP is being seriously misdiagnosed. The IMF sees a rise in land values as added wealth. It is not. It is debt. In Britain, people are now locked into a £1.3 trillion debt pile. When we pay for land, we merely transfer income from one person to another: we do not add anything to the nation's wealth. Yet the Treasury claims land values ought to be included when we measure total saving.

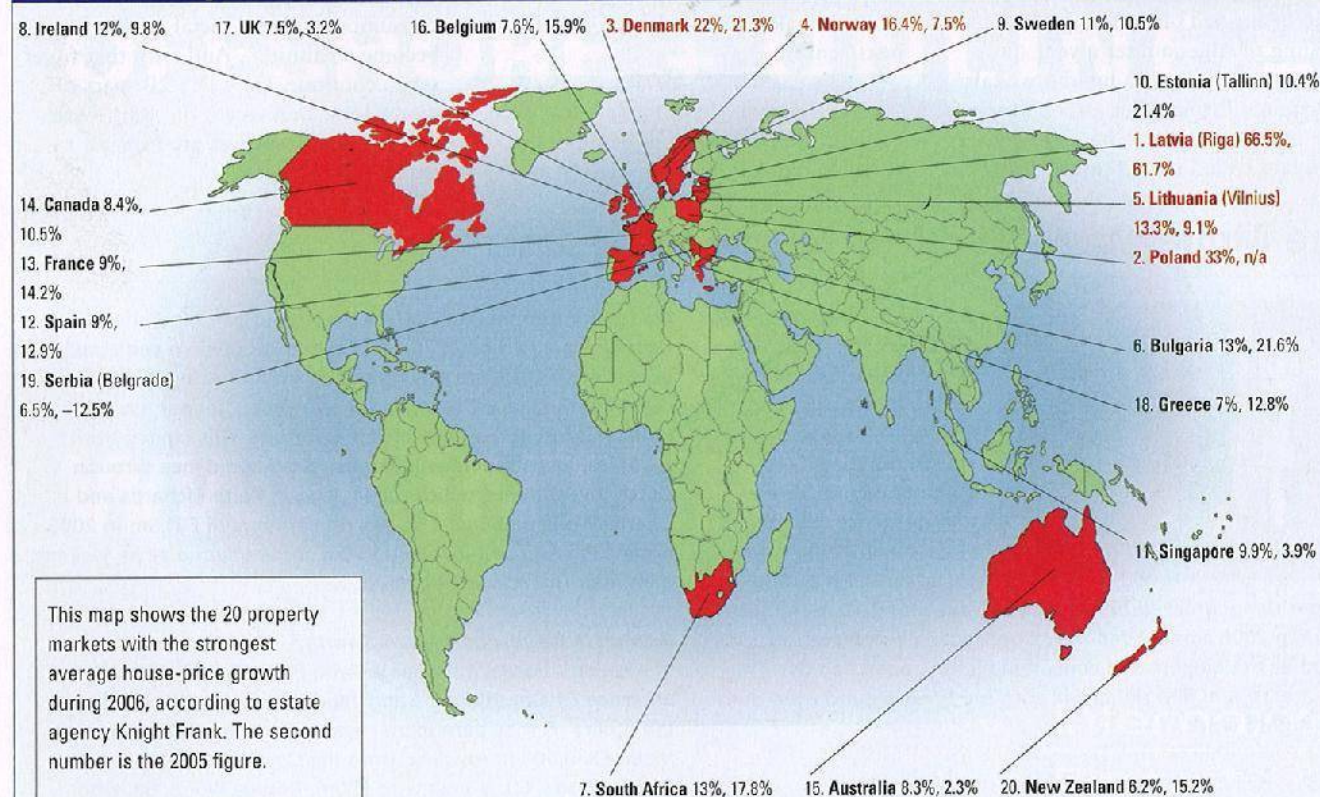
But a debt is a debt: one person's rise in housing 'wealth' is a lifelong noose around another's neck. That's why we should worry about falling global savings and investment in industrial countries. The historic rise in house prices will not stop debts from crushing consumption as world property markets stall in the months ahead. And as spending dries up, company profits will be hit, leading to rising unemployment, more repossessions and further falls in property prices.

Is there nothing that government can do about these cyclical busts in housing? There is: it can transfer the tax penalties on wages and savings onto rents. That would reduce the incentive to speculate in land and encourage capital formation and value-adding enterprise. But as we saw from the way Gordon Brown brushed aside the recent Lyons report (which he commissioned), there is no prospect of a reform of property taxation. And the Treasury continues to claim that the housing market will grow to 2010 – when Gordon Brown is likely to lead Labour into the next election.

But the reality is that by then the extent of the economic downturn caused by a falling housing market will have become apparent. Mr Brown should enjoy his time as prime minister while he can – the electorate is unlikely to feel warmly towards him while in the midst of a 1990s-style slump.

The paperback of Fred Harrison's *Boom Bust: House Prices and the Depression of 2010* is out this month (£14.95)

The MoneyWeek map: world property-price hot-spots



From Industrial Revolution to dotcom bubble...

Beginning with the 1932 recession and working backwards, this table shows British recessions according to the 18-year business-cycle theory. The dates match historical records of mass unemployment and financial crises over the past 230 or so years.

Primary recession	Mid-cycle recession	Primary recession	Mid-cycle recession
1776	1785	1902	1911
1794	1803	1920	1929
1812	1821	1938	1947
1830	1839	1956	1965
1848	1857	1974	1983
1866	1875	1992	2001
1884	1893	2010?	