LAND PRICE

Threat to Forecasters

by Fred Harrison

BANK OF ENGLAND economists now admit that they do not know when Britain will emerge from the slump of '92. The Treasury computer model of the economy - and City and university economists who search the plethora of data churned out by official agencies - failed to forecast the slump; many of them sent out false signals of "green shoots" appearing on the horizon; and they now admit that their theories failed the people who are losing their jobs by the tens of thousands each month.

It need not have been so. *Land & Liberty* warned of the global crash in its Jan.-Feb. 1988 issue, where I wrote: "I confidently predict that the next major economic recession - the one that will cause widespread unemployment and business closures - will occur in 1992."

Over the last four years, *L&L* and *Economic Intelligence* published analyses based on the land-price data which is the core of an effective forecasting model. Economists would not listen, and now the banks are collapsing (the USA) or are teetering on the edge of doing so (Japan): all because they financed speculation in land.

NOW COMES a second agency willing to claim that land values are a key indicator of what is happening in the economy. Hillier Parker, a major British real estate agency, has published the first of its reports on what it calls "Residual Land Values".

Their "residual land value" is no more than the price of land in the marketplace. "Residual land values are theoretical in that they are calculated by taking the capital value of a potential development and then subtracting the total development cost," reports Hillier Parker. "The results make possible an objective comparison of land values for different property types across the country and over time."

Hillier Parker's theoretical approach to logging land values is understandable, because - with a few exceptions - government agencies do not publish authoritative data derived from direct monitoring of market prices.

Based on Hillier Parker's scrutiny of what has gone wrong with the UK economy, the report claims:

◆ The index is "the most sensitive indicator of the property market to date" - on, for example, the viability of construction;

◆ Land values reveal when pressure is building, which might help developers and banks to avoid excesses;

◆ Had the series existed a few years ago, "it would have acted as an early warning of the recession to come".

THIS LAST claim, which empirical analysis over the last four years in *Economic Intelligence* has proved to be correct, undermines the integrity of existing macro-economic forecasting models.

Forecasters pay no heed to trends in the land market, and have paid the price in the collapse of their credibility - which exposes a yawning gap in the theory that is supposed to guide policy-making.

Hillier Parker concentrate their calculations on the non-residential sector (the Department of Environment publishes good data on housing land prices).

The results illustrate lessons which are well established among a small group of land economists around the world. For example, the selling price of land is subject to more volatile movement than rents. Hillier Parker discovered that "residual land values are a useful indicator for predicting rental movements. The residual peaks up to two years ahead of the rental value. The residual values also fall by a greater amount than the rent."

In all five sectors analysed by Hillier Parker, "residuals peaked significantly earlier than rents...The time between the peaks of the residual and the rent is consistent at between 18 months and two years except for Central London Offices where the difference is reduced to six months".

In the industrial sector, for example, manufacturers who wanted to expand production facilities were confronted by a sudden upsurge in the price of access to land in 1987. This triggered a crazy bout of speculation in industrial land which took prices to unaffordable heights. The collapse came in late 1989, leaving in its wake the heightened expectations of landlords who demanded rents which were also higher than many tenants could afford.

Unfortunately, Hillier Parker offer no theoretical insights into the mechanisms which transmit the impact of the land-price boom/slump into the rest of the economy. This is understandable, for they represent land-owning interests that would find themselves in the "hot seat" for generating the instability that leads to massive waste of capital (look at all the idle office buildings), and heart-rending levels of unemployment.

But this split loyalty to commercial interests should not create dilemmas for university forecasters, and least of all for a popularly-elected government. For apart from landowners, the property sector is also made up of the construction industry, which relies on land as an input in the value-creation process rather than a commodity in which to speculate.

The British construction sector represents 6% of gross domestic product. According to Department of Environment figures, the latest drop in orders (19% between the first and second quarters of this year) will feed through the economy to knock another 1% off GDP.

The government, therefore, if it wishes to be kept properly informed of trends in the economy, appears to have a special responsibility for incorporating land market trends in its forecasting model. That, however, means rewriting the equations after relearning how the industrial economy - given the present tax-and-tenure distortions to the land market - really works.