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The Real Estate Bubble

By Fred E. Foldvary

A soap bubble is a ball made of a thin film of soap dissolved in water. Soap bubbles are ephemeral, lasting a short time before bursting. There are also bubbles in the economy, classes of assets whose prices inflate like air in an expanding balloon and then collapse.

The expansion of asset-price bubbles is unsustainable, as the prices rise above what is warranted by normal returns and demands. The asset prices crash. A recent bubble was the technology boom of the late 1990s, when Internet and other stocks rose to levels that could not be justified from the likely profits of the firms.

The most important bubble in the economy is that of real estate. There has been a real estate cycle with a duration of 18 years since the early 1800s. Real estate booms have often become a bubble. It happened during the 1920s in the US, especially in Florida. It happened in Japan during the 1980s. And it is happening again now in the US.

The last bottom of the real estate cycle in the US was in 1990, when there was a recession. Real estate prices have been rising since then, and were not at all deterred by the downturn of 2001. Real estate speculation has carried real estate prices in some parts of the US, such as California, to heights that cannot be sustained when interest rates rise as the Federal Reserve reverses its low-interest policy. Another crash is coming.

Henry George, the American economist and social reformer of the latter 1800s, originated one of the first theories of business cycles. The basic cause, he said, was land speculation. During an economic boom, at first, a growing demand for real estate is met by reducing vacancies. But then new real estate is constructed, and rent and land values rise. Speculators notice this and buy land expecting to sell at higher prices later. This speculative demand, added to the demand for use, carries land prices so high that investments in enterprise become unprofitable. Land becomes priced for expected future uses, rather than present-day uses.

The fall in new investments then reduces demands for labor and goods, which then reduces other demands, and the whole economy falls into a recession and then a depression. Faced with rising vacancies, real estate prices collapse, bankruptcies rise, loans default, banks fail, and then the cycle begins anew. This theory of the business cycle was original with George and not part of the previous classical school thought. Georgist theory, which I coined as 'geoclassical' for emphasizing land, was a major advance in classical thought.

Even though a third of investment is related to real estate, the real estate cycle is ignored in neoclassical business-cycle theory. Mainstream economic doctrine tells us that unexpected shocks create the fluctuations in the economy. But the regularity of the major business cycle cannot be explained by random shocks. Neoclassical economic fails to explain the trade cycle.

The Austrian school of economic thought has its own theory of the business cycle, which does pay attention to real estate. In the Austrian theory, an injection of money into the banking system artificially reduces interest rates, as indeed has been happening in the US in recent years with the Fed increasing the money supply by 25 percent since 2001. With rates so low, borrowing for long-term slow-maturing investments - such as real estate construction and purchase - becomes profitable.

The money expansion is unsustainable; monetary inflation causes price inflation. As prices and interest rates rise, many of these projects become unprofitable. Austrian economists call them 'malinvestments,' investments that looked promising when interest rates and other prices were lower, but are not profitable when the price distortion caused by the money expansion reverses. The reduction and abandonment of investment projects leads to a depression.

The Austrian and the Georgist explanations are complementary. The Austrian half emphasizes the role of money and interest rates, and the geoclassical half emphasizes the importance of land and the role of land speculation. A geo-Austrian synthesis creates a powerful business-cycle theory that is consistent with history and goes a long way in explaining major business cycles.

The article 'This Inflated House' by Mark Thornton in the August 2004 Free Market journal, published by the Ludwig von Mises Institute, illustrates the Austrian-school attention to real estate. Thornton notes the widespread practice of extracting equity from real estate as owners have refinanced at lower interest rates. As recognized by the Austrian school, monetary inflation often does not at first lead to rising prices in consumer goods. The injection of money often first goes into investments, commodities, and land purchases.

As Thornton explains, 'the cause of higher home prices is that the Federal Reserve has kept interest rates, and thus mortgage rates, at historically low rates so that people find it easier to finance homes.' Real estate is bought mostly with borrowed money, and lower interest rates keep the financing cost, the monthly payments, low, even as real estate prices rise. Banking practices contribute to the bubble as they make interest-only loans with no money down. Lending standards typically relax as the bubble approaches its peak.

But the collateral of land value is an illusion. Land has no cost of production, and its price can fall to zero. But why should the banker worry? The bank deposits are insured by the federal government! If the bank fails, the government will bail out the depositors. This encourages more risky loans, which provide temporary profits and perhaps more stock options and bonuses for the banking executives.

Also, home loans can be sold in the secondary market facilitated by agencies which were established by the federal government. As Thornton tells it, 'The Federal Reserve and the Mac-May family (Freddie, Fannie, Sallie, etc.) have conspired to create a housing bubble in the US.' It's not a secret conspiracy but simply all these agencies breathing together to blow up the housing balloon that eventually has to burst.

Thornton says that it 'is difficult to predict how long bubbles will last,' but the geoclassical half of the geo-Austrian theory does provide an indication. Historically, the

real-estate cycle has had a duration of 18 years, aside from the interruption of World War II. That puts the next real estate bottom around 2008. If past patterns continue, and so far they are right on schedule, we can expect the next recession to take place towards the end of this decade. With all the distortions caused by monetary policy and real-estate speculation and lax bank lending, the recession could be a major crash and the worst depression since the 1930s, an 'economic nightmare,' as Thornton calls it. And that nightmare does not even take into account the threat of terrorist attacks or the effects of continuing war and a possible oil crisis.

What is clear is that the tragedy and madness of the business cycle is not a natural outcome of a nonexistent free market, but caused by foolish government policy. Two remedies are essential: free banking and the public collection of land rent.

- Free-market banking would eliminate the monopolization of money and manipulation of interest rates by central banks such as the Federal Reserve, and leave money expansion to a competitive market of private banks.

- The elimination of taxes on income, sales, and produced wealth, replaced by tapping land rent for public revenue, would take the profit out of market-hampering land speculation fueled by tax-funded public works along with monetary inflation.

Both reforms are necessary in order to completely eliminate the business cycle and the agony of business failures and idled workers.

But both reforms are ignored and disparaged by mainstream economics, so they are not enacted or even talked about. At least those who understand geo-Austrian theory will be warned in advance and can arrange their affairs to minimize the losses that others will suffer from.

-- Fred Foldvary