The state's complicity in the real estate crash

The government causes real estate boom-bust, argues **Fred Foldvary**. He sees three strands to the problem.

THE GLOBAL real estate boom that has taken place during the past decade has in 2007 been decelerating and will most likely have turned into a global real and financial crash in 2008. The news media and financial press have focused on the sub-prime mortgage losses and have pointed the finger of blame at mortgage lenders and brokers. But the sub-prime mortgage problem is only the tip of the iceberg. Submerged beneath the financial surface is the bulk of the iceberg – inflated prices of real estate. Our economic vessels are on course to collide with these real estate icebergs and then sink. As with the *Titanic*, there are not enough economic lifeboats to save us all.

The cause of the real-estate boom-bust cycle is government intervention, with three strands. First is monetary intervention, the manipulation of money and interest rates by the monetary authority. Second is the government-sponsored secondary mortgage market. The third intervention is the fiscal folly of taxing labour to subsidise landownership.

In order to understand the problem of monetary intervention, we need to analyse the effect of money on interest rates. The rate of interest originates in what economists call 'time preference,' the tendency of most folks to prefer to have goods sooner rather than later. Since we don't live forever and the future is uncertain, most people prefer to have things such as a car and a house earlier in life rather than waiting until one has enough savings to make the full purchase.

This time preference endows present-day goods with more value to us than future goods. We are willing to pay more to have things now rather than later. So future goods have a discount relative to present-day goods. The rate at which future goods get discounted becomes the natural rate of interest. Interest is the premium we pay to shift purchases from the future to the present.

This natural rate of interest, if not interfered with, plays a vital role in the economy. The natural interest rate makes borrowing equal to savings. If more people want to save, the interest rate falls so that the extra savings is loaned out. Borrowing is either for consumption (such as a vacation) or for economic investment, such as a house or machine. After netting out savings used for consumer loans, the rest of savings is borrowed for economic investments. Therefore, net savings equal investment. But this is so, only because the interest adjusts to make it so, to equalise both savings and borrowings and net savings and investment.

With this equilibration or equalising, the interest rate also allocates output between consumption and investment. This is the vital job of the interest rate: to ensure that income gets spent on consumption and investment. If folks save more, they consume less, so the interest falls, and the reduced consumption is offset by increased spending for economic investment. All is balanced and in harmony when the natural rate of interest is free to do its job.

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But in today's economies, the interest rate is not able to do its job. The natural rate of interest has been shackled. The money supply is not set by the market, but by a monetary authority, the central bank. While we have regulated markets for most goods, when it comes to money, we practice central planning. The central bankers decide by how much the money supply shall increase, and in so doing, they manipulate the interest rates.

In the United States, for example, the Federal Reserve expands the money supply by buying treasury bonds. They finance the bonds by increasing the reserves of the banks, the money the banks hold in their accounts with the Federal Reserve. To loan out this newly created money, the banks lower their interest rates on loans. Indeed, the Federal Reserve sets a target for the interest rate. If the market rate should rise above their target, they increase the money supply some more so that the banks will lower the rate to meet the target.

The Fed-targeted market rate of interest is now not equal to the natural rate, what the interest would have been without this manipulation. Indeed, there is no way to know what the natural rate would be, since pure supply and demand are not operating. The supply of money is set by the monetary authority at the level that meets the targeted interest rate.

Typically, when the economy is depressed, as it was in the early 1990s and in 2001 in the US, the Fed targets a low interest rate, below the long-run average. In 2003 it went as low as one percent. At such low rates, funds are borrowed for investments that would not be made at higher rates. Funds are borrowed especially for interest-rate sensitive projects of long duration, such as real estate construction. Funds are also borrowed to purchase long-lived assets such as real estate and the associated durable goods such as furniture.

Since these investments would not have been made at higher interest rates, this induced investment is an economic distortion. Like an athlete on drugs, the economy appears to be stimulated, but when the drug wears out, the economic body will suffer disease. Since planned consumption has not fallen, consumption clashes with new investment, and prices rise. But prices don't all rise at the same rate. Prices rise fastest and earliest where the money is being loaned out, a large part of which is for real estate purchases.

Thus is born the real estate boom. It is an artificial boom, juiced by cheap loans. If the natural rate of interest had been allowed to do its job, the boom would not have been sparked.

As the boom progresses, the monetary authority has to reverse course. The rapid expansion of money will cause inflation to rise, so the central bank then decelerates the expansion of money. It raises the interest rate

target. This reduces investment, and many investments made at lower interest rates cease to be profitable. The distortions caused by the previous low interest rate become manifest.

The distortions would not be so devastating if they were confined to industries such as real estate construction and sales. But the second intervention has now spread the distortion throughout the financial system. That intervention is the government-sponsored secondary mortgage market.

In the United States, the federal government has sponsored several enterprises, such as Fannie Mae and Freddie Mac, that have facilitated the secondary market in mortgages. Without this market, banks that originate real estate loans would hold them until the loan is paid off. If the borrower defaulted, only that bank would be affected.

But with the secondary market, banks can sell their mortgages to Fannie Mae and Freddie Mac, and then make a new loan. This greatly expands the ability of the financial system to make real estate loans. Fannie and Freddie themselves sell bonds to finance their loan purchases. With implicit guarantees from the federal government, Fannie and Freddie can issue bonds at lower rates. Fannie and Freddie also assemble mortgag
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of the expansion, and the secondary mortgage market makes bankers and mortgage brokers loosen lending standards to keep rolling over loans that get sold.

Eventually, land prices rise so high that entrepreneurs who seek sites for investment decide that the real estate and interest-rate costs are too high. As expected profits fall, investment slows down and then stops growing. Investment drives the business cycle, and when investment falls, workers in those fields lose their jobs, and their demands for goods fall, and the whole economy then tumbles into recession. Foreclosures rise even more, and the financial system crashes as banks and other financial institutions become insolvent.

The engine of this perverse cycle is real estate speculation, and the only way to stop it from happening is to take the steam out of it by tapping the rent and land value for public revenue. If most of the rent is tapped for public revenue, there is no profit in speculating on land. Real estate would only be held for actual use or to rent to others for use, not for land-value gains. The land value will be small and not rise if most of the rent is collected for public revenue.

The secondary mortgage market would not be so perverse if most of real estate mortgages were made to purchase buildings rather than land. However, to eliminate distortions in the mortgage market, government guarantees should be phased out. Folks will find real estate much more affordable if they only need to borrow to buy the building and not also for a high land price.

The monetary intervention can be remedied by shifting from central banking to free-market banking, where the money supply is determined by the public demand to hold money rather than by a monetary authority. The supply of governmental currency would be frozen and would serve as a money base like gold did in the old days. Private bank notes would be convertible into government currency, preventing inflation.

The interest rate would then be able to do its job, to equilibrate savings and investment. There would be no more manipulation of interest rates to either stimulate or put a brake on the economy. Without the real estate cycle, there would be no business cycle, and the economy would not recede, and thus not need any monetary stimulus. With no more inflation, the economy would be free to grow as fast as folks want. And with no tax on wages or investment, growth could well be dazzling, limited only by the supply of labour as wages rise and poverty becomes extirpated - pulled out by the roots.

Since such policy changes are not forthcoming, we are unfortunately riding the economic river to a financial waterfall, a recession and depression. The timing of the real estate cycle has been quite accurately predicted by those familiar with the past pattern. Real estate construction and prices have peaked consistently shortly before the major depressions, with an average period of 18 years. The last real estate recession was in 1990 in the US, so adding 18 years puts the next recession at 2008. Of course sometimes the interval is a bit more or less than 18 years. But it is striking that in 2007 real estate prices in the US were already falling, and the mortgage problem got ugly.

This time around, the real estate boom has been global. The global economy has linked together the economies of the world like never before. While real estate markets still have local variances, the financial markets have tied economies together, and real estate has boomed world-wide with few exceptions. Moreover, fiscal policy is fundamentally similar world-wide, as real estate is explicitly or implicitly subsidised. Such policies stem from quite similar political structures, including rent seeking by special interests.

As the US enters a recession, having been the world's biggest importer, other economies will recede also as sales fall and as their real estate markets also peak out – if they have not already done so. The bigger the boom, the greater the fall, and as this has been the biggest global real estate boom in history, the consequent economic fall will be proportionate.

Crises have one consolation. They provide an opportunity for reflection and a climate for major shifts in policy. Perhaps this time policy makers will see the fundamental causes of the boom-bust cycle – and popular opinion will open to a big shift in monetary and tax policies. Reformers need to be ready to step in and offer the twin remedies – free banking and land-value taxation. L&L

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good idea bad idea

THIS ISSUE: TAX IN THE UK

GOOD IDEA ?

Acording to the UK Pre-Budget Report published in October, "from 1 November 2009, the Government proposes to replace Air Passenger Duty with a duty payable per plane rather than per passenger". Responding to 'Charging for Landing' in our last issue, **L&L** reader Conal Boyle, from Port Talbot in Wales is enthusiastic about the proposal. He writes – "If it's done the right way, this could be a form of land value taxation. Should reformers get involved in these discussions? I hope we can take this forward."

BAD IDEA ?

The new Scottish Nationalist government has set off down the road of institutionalising modern-day landed privilege. Its 'new' fiscal ethos was set out by Finance Minister John Swinney in his first budget, presented to the Parliament in November. The Nationalists will introduce a new additional tax on earned income, penalising effort, and will abolish Council Tax – the tax on unearned income – the only periodic public charge on publicly created location values. Oh dear Mr Swinney – don't you know the way of the 21st century is to "pay for what you take, not what you make"?

What do you think? What good ideas are you hearing aired in public debate – and what bad ones?
Let us know.
e ideas@LandandLiberty.net

Mr Greenspan's

Alan Greenspan was chairman of the US Federal F
1987 until last year. **Michael Hudson** considers the

IN 1966 I was designated to fire Alan Greenspan. I was Chase Manhattan Bank's balance-of-payments economist at the time, and was writing a study of the balance of payments of the US petroleum industry. Chase and the Socony Oil Company each had paid $10,000 to finance the study, and Socony had insisted on bringing in Mr Greenspan. My boss in the Economic Research Department, John Deaver, worried that Greenspan was so eager to get business by giving the client what it wanted, that few people had much confidence in his statistics.

Greenspan was supposed to be producing statistics on US oil company capital investment. What he was actually doing was coming up with rough approximations of US figures – basing them on total worldwide investment. He told his statistical assistants to assume proportionality. One of them – Lucille Wu – told me "it's all implicit". By 'implicit' she meant they were to assume that European and Near Eastern depreciation rates and other tax laws were identical to US laws. But this was obviously not the case.

One day Mr Deaver and I were invited up to David Rockefeller's dining room. Mr Rockefeller – Chase's President – told me to inform Mr Greenspan that unless he could provide specifically US figures, and/or be forthright about his assumptions, we would have to leave his contribution out of the study. (I remember Socony's representative was a friend of his, and I think they made sure he got paid as their favorite business lobbyist *du jour*.)

Mr Greenspan was an economic lobbyist for the rich – for large corporations and for Wall Street. That is the job of a Federal Reserve chairman these days. Like a good criminal defense lawyer or the 'expert witnesses' they hire, a good lobbyist makes a cover story believable. Mr Greenspan crafted a myth that many people wanted to believe. The myth was that people (just about everyone) could get rich by going into debt, to buy property whose

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