FROM THE SUBPRIME TO THE TERRIGENOUS RECESSION BEGINS AT HOME

by Gavin R. Putland

Most of the world thinks the current recession was somehow caused by the banking system, but the underlying cause was property bubbles bursting. This is leading-edge study put together by Proz Oz's very own research officer, and has monumental importance.

The American word "**subprime**" refers to the credit-worthiness of borrowers. But that wasn't supposed to matter, because if the borrowers defaulted the lenders could simply sell the collateral to repay the loans. The scheme came unstuck because the collateral was residential property, which was overvalued due to a speculative **bubble**. When the bubble popped, borrowers owed more than the collateral was worth, so that lenders couldn't collect and therefore couldn't re-lend — for housing or anything else. Thus the financial system communicated the housing crash to the rest of the U.S. economy.

What is commonly called a "property" bubble or "housing" bubble is actually a **land** bubble. A building is worth no more than the cost of producing an equivalent building, and loses value due to deterioration and obsolescence. But *land* does not have a production cost, and its **locational value** tends to increase due to improvements in location-dependent services. Moreover, from the viewpoint of private entities, the overall supply of land is fixed, as is the supply that can be legally used for any particular purpose, and the supply within acceptable distance of any particular services, infrastructure, or markets. Yet access to suitably located land is essential to economic participation. So land values are competed upward until they absorb the economy's capacity to pay. In a growing economy, one should therefore expect land values to rise. But rational expectations periodically give way to belief in the greater fool: rising prices attract buyers who expect to sell at still higher prices, and that expectation becomes the sole support for current prices. Banks create credit against speculatively inflated prices and, in so doing, facilitate further inflation.

Eventually the illusion becomes unsustainable: the bubble bursts. At first, the "burst" is manifested as a fall in *turnover* while prices flatten out, as prospective sellers refuse to take losses. This in itself can be enough to cause a recession, not only because builders and developers slow down while waiting for unsold stock to clear, but also because slower sales cause a credit contraction by frustrating the sellers' plans to repay loans. If sellers cannot wait for the market to meet their expectations, prices are forced down, leaving other borrowers with negative equity, in which case the credit crunch and recession are obviously worse.

The word "*subprime*" is therefore a distraction. Yes, loose lending helped to pump up the U.S. housing bubble; but rising collateral values came first, and loose lending was the response. Moreover, not all of the loose lending was to subprime borrowers (to say nothing of those "subprime" borrowers who met all the criteria of higher-rated borrowers, except the unwritten one concerning skin colour).

Describing the present global disaster as a *financial* crisis is a further distraction. Yes, British and European banks were exposed to repackaged U.S. subprime loans. But more importantly, they were exposed to their respective *domestic* property markets. As the following survey shows, most of the current recessions in European and Asian countries were preceded by bursting *domestic* property bubbles.

Strictly speaking, the mechanism by which a collapse in the property market spreads to the wider economy does not depend on the reason why the market collapses, provided that the collapse comes as a *surprise* to market participants. Hence, when assessing the correlation between falling property values and recessions, it is not necessary to establish in every case (although I shall venture an *opinion* in each case) that the fall in property values represents a bursting bubble. But when property values rise rapidly and then fall, a bursting bubble is the simplest explanation and satisfies the criterion of surprise. Moreover, a genuine bubble tends to involve high turnover and high leverage, which amplify the effects of the surprise.

President Obama's much-reported statement that "the crisis began in the U.S." was ambiguous as to whether the beginning was causal or merely chronological. He is generally assumed to have meant the former. But whatever he meant, I argue for the latter. If the bursting of the U.S. housing bubble caused the *U.S.* recession — as seems to be acknowledged by all — and if other countries had similar problems with their domestic property markets before they too fell into recession, the claim that the latter recessions were fully imported from the USA, although convenient for certain political and pecuniary interests, strains credulity.

1. Parallel recessions

Sorry to be a toxic bore, but this section makes repetitive reading. That's the point. Readers who wish to be spared the details may skip to the next section or the summary.

Ed: I've snipped this long set of data and their explanations as to how they were sourced, but it's all laid out in http://lvrg.org.au/blog/2009/06/from-subprime-to-terrigenous-recession.html Call me partisan, but I think this is Nobel Prize standard work! Look, the "dismal science" of economics, being mired in neoclassical nonsense, is today so discredited that the Nobel is handed out to mathematical modelers and glorified social workers!

Definitions of symbols

T (for Turnover) means the fall from the peak in property turnover or related loans (direct figures on turnover being hard to find).

t means a reported or apparent glut of property for sale, suggesting that sales have slowed (another proxy for the elusive figures on turnover — not because the proxies are any easier to find, but because any alternative is better than none).

V (for Value) means the fall from the peak in property prices, in real terms.

R means the start of the official Recession.

r means one quarter of negative growth to date, perhaps indicating the onset of recession.

Group 1: Parallel recessions

The following table is in chronological order, sorted first by the fall in property values (V), then by the fall in turnover (T or t), then by the onset of recession (R or r).

Year	2005				2006				2007				2008				2009
Quarter	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1
USA			T		V							R					
Denmark					t		V					R					
Ireland							T		V				R				
Greece									V								r
Latvia									T	V			R				
S. Korea										tV						r	
Hungary										V				R			
UK									T		V				R		
New Zealand										T	V		R				
France											V			R			
Lithuania										T	V				R		
Estonia					T							V	R				
Finland										t		V			R		
S. Africa												V				R	
Luxembourg							t						V		R		
Australia											T		V			r	
Spain											T		V		R		
Sweden												T	V	R			
Hong Kong												T	V	R			
Iceland												T	V		R		
Singapore											T			VR			
Canada													T	V		r	
Slovenia														V		r	
Belgium														V		R	
Ukraine															V	R	
Czech Rep.													T		V	R	
Norway							t							T	V	R	
Slovakia														T	V		r
Russia															TVR		
Bulgaria														T		V	R
Malta															T	r	
Italy													TR		V		

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Year	2005				2006				2007				2008				2009
Quarter	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1
USA			T		V							R					
Denmark					t		V					R					
Ireland							T		V				R				
Greece									V								r
Latvia									T	V			R				
S. Korea										tV						r	
Hungary										V				R			
UK									T		V				R		
New Zealand										T	V		R				
France											V			R			
Lithuania										T	V				R		
Estonia					T							V	R				
Finland										t		V			R		
S. Africa												V				R	
Luxembourg							t						V		R		
Australia											T		V			r	
Spain											T		V		R		
Sweden												T	V	R			
Hong Kong												T	V	R			
Iceland												T	V		R		
Singapore**											T			VR			
Canada													T	V		r	
Slovenia														V		r	
Belgium														V		R	
Ukraine															V	R	
Czech Rep.													T		V	R	
Norway							t							T	V	R	
Slovakia														T	V		r
Russia															TVR		
Bulgaria														T		V	R
Malta															T	r	

Group 2: Recessions out of sequence

Year	2005				2006				2007				2008				2009
Quarter	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1
Taiwan**															TVR		
Italy													TR		V		

Group 3: Recessions without domestic property bubbles

Year	2005				2006				2007				2008				2009
Quarter	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1
Germany														R			
Japan														R			
Netherlands														R			
Mexico															R		
Portugal															R		
Switzerland															R		
Austria																R	

CONCLUSIONS

With the aid of the tables in the summary, one can discern the following patterns:

1. **A downturn in the property market, especially in turnover (sales) of properties, is a *leading* indicator of recession**, with a lead time of up to 9 quarters for turnover, or up to 8 quarters for values. Of all the countries in which a conspicuous fall in turnover was documented, there was no case in which the onset of recession preceded the fall in turnover, and only one case (Taiwan) in which the onset of recession seems to have been in the same quarter as the fall in turnover; and in the one case (Italy) in which recession preceded the downturn in property values, it did not precede the downturn in turnover.

2. **In the property market, a fall in turnover is a *leading* indicator of a fall in prices**, and the lead time is usually one to two quarters. In no case is there persuasive evidence of the fall in prices coming first, although there are three cases (Taiwan, Russia, South Korea) in which the two falls may have been almost simultaneous, and one case (Norway) in which the sources disagree.

3. **Recessions are mostly home-grown.** In the seven countries that entered recession without any resemblance of a bursting domestic property bubble, and in Taiwan, where the onset of recession was almost simultaneous with the property downturn, the recession came comparatively late, leaving plenty of time for the domestic economy to be affected by recessions in other countries, or bursting property bubbles in other countries. Such cases, however, were in the minority; in most countries the recession was preceded by a downturn in the domestic property market.

Concerning the last point, I do not deny that recessions in themselves are somewhat contagious; when people and firms in one country fall on lean times, they tend to import less, in which case they directly affect the GDPs of other countries. Neither do I deny that, due to the partial globalization of the financial industry, devalued collateral (chiefly property) in one country can affect the availability of credit in other countries. I do not even deny that a recession following a domestic property crash may occasionally have an external proximate cause; there is evidence of that in Ukraine and Russia. But clearly the first country to suffer a property crash and recession cannot blame the rest of the world. And because economic interactions are made easier by geographic and jurisdictional proximity, one would expect the economic health of one country to be more exposed to its domestic property market than to external events. The above tables support that expectation.

If, as I contend, recessions come mostly from domestic property markets, then the real significance of globalization lies in international arbitrage by property investors, which causes property bubbles and bursts to form global waves: **recessions are global chiefly because property bubbles are global.**

In the event of any dispute about the data on which these conclusions are based, it will be pertinent to note the use of conservative words such as indicator, usually, minority, and most. In view of the large amount of data and the eclectic range of sources, it is highly likely that there are a few errors in the data, but highly unlikely that there are enough errors to invalidate conclusions expressed in such qualified language.

POLICY IMPLICATIONS

To the extent that recessions are caused by bursting property bubbles, they can be prevented by preventing property bubbles. In particular, they can be prevented by policies that *stabilize the growth of land values around the long-term trend.* For this purpose it does not matter if the long-term trend becomes faster, as long as wild fluctuations around that trend are eliminated.

Wild swings in land values occur because of **contradictory price signals**. When a bubble is inflating, high prices by themselves deter buyers; but *rising* prices attract buyers by (seemingly) promising "capital gains", negating the correction that should be provided by high prices. After the bubble bursts, low prices by themselves attract buyers, but *falling* prices deter buyers by threatening "capital losses", negating the correction that should be provided by low prices. So the market overshoots in both directions. To prevent this, one must attenuate or counteract the signal sent by the *rate of change* of prices.

One solution is to reduce taxes on productive activities and increase taxes on unearned increases in land values. As noted on the home page, this policy would *increase* the long-term rate of growth in land values by enabling and encouraging governments to do things that increase land values — such as investing in infrastructure. This of course would be highly beneficial to property owners. But the same policy would reduce the attractiveness of "capital gains" (which would be taxed more) relative to income from assets (which would be taxed less), and thereby attenuate the effect of the rate of change of prices, as required.

The stabilization of growth in land values would be particularly effective if the taxation of unearned "capital gains" were accomplished by means of a periodic tax (i.e. a "holding tax") proportional to the increase in the land value since a certain reference date. Then rising prices would mean rising holding costs, which would deter purchases and encourage sales, while falling prices would mean falling holding costs, which would encourage purchases and deter sales. Thus the signal sent by the holding tax, like that sent by the actual prices, and unlike that sent by the rate of change of prices, would be in such a direction as to stabilize the market.

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