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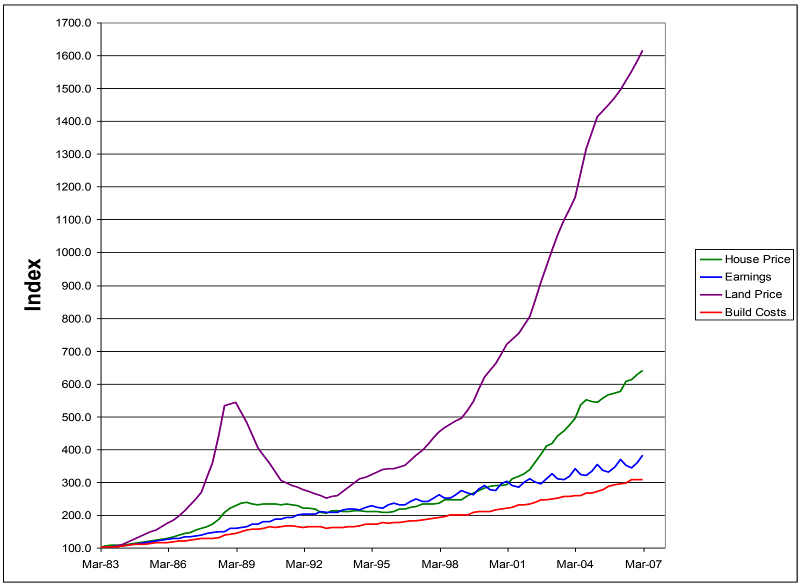
Boom/Bust: Why did Gordon Brown refuse to listen?

FRED HARRISON writes: According to the experts, Britain is not heading for a housing crash. The Royal Institution of Chartered Surveyors (RICS) - the professional body representing the property industry—assures us there will not be a housing meltdown. But crash the housing market will, as prices peak this winter. That outcome is written into the DNA of the economy. When 20% or more of house prices are wiped out over the next two years, the RICS will rationalise how it misled people into believing that buying a house today will not land them in negative equity.

Under the prevailing rules of the economic game, there was nothing that the Bank of England could have done about it in 1997, when Gordon Brown handed monetary policy to it. And there is nothing that the Prime Minister can do to stop the recession that follows a housing boom.

In 2005, when my *Boom Bust: House Prices Banking and the Depression of 2010* was published, the property professionals predicted that price rises over the next two years would be weak. I said they would take-off into double digits. I was correct.

I also predicted that the UK market would begin to seize up at the end of 2007, as the ratio of house prices to earnings hit 6.5. That ratio was achieved this summer. But the price take-off cannot be attributed to either wages (the Treasury's scapegoat), or the costs of construction. The graph above shows the trend in prices since 1983. The cost of land, which rewards speculation and determines the fate of the construction industry, goes wild over the cycle before the Big Crash.

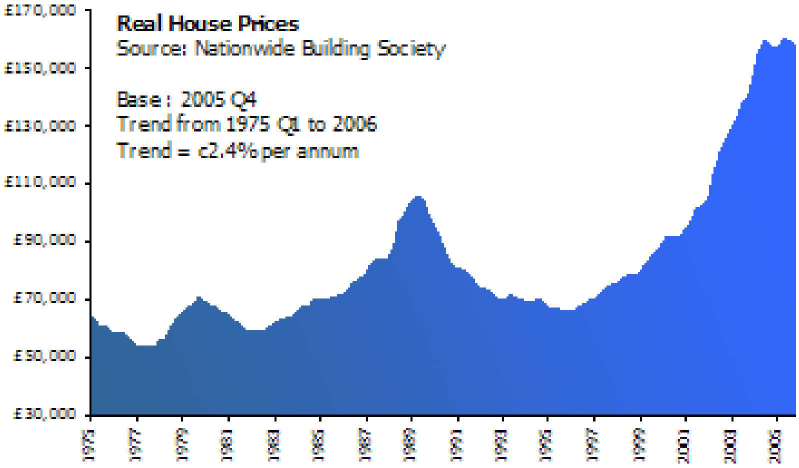


THE big question now: what happens over the next three years? In his last budget as Chancellor of the Exchequer, in March, Brown persisted with the Treasury fiction that instability in the housing market had been eliminated. Brown repeated his mantra phrase:

"By holding firm to our commitment to maintain discipline in public sector pay, we will not only secure our 2% inflation target but create the conditions for maintaining the low interest and mortgage rates that since 1997 have been half the 11 per cent average of the previous twenty years. *And we will never return to the old boom and bust*".

We've had the boom – *now for the bust!* But the Prime Minister fervently believes this will not happen. Otherwise he would have called a snap election. By deciding not to hold that election, he will lead Labour into the next recession.

WHEN Labour came to power



in 1997, we anticipated the trends in house prices. The historical evidence was assessed by the Treasury for Brown's benefit, and on more than one occasion he informed the House of Commons that recessions were linked to housing booms.

That evidence was reviewed in *Boom Bust*. I showed that the business cycle operates on an average of 18 years. In the middle of that cycle there is a 14-year cycle in the housing market. The UK evidence (graph above) shows changes in house prices over the last two cycles. They peaked in the early 1970s, crashed, recovered and headed for the peak in 1989; crashed again, leading to the 1992 recession. We are in the endgame of the current cycle, with house prices peaking this winter; with a recession in 2010.

The US evidence matches the UK's. The price of houses in the median range bottomed in 1992. This meant that prices would peak in 2006, with a sustained slide and a recession. Prices *did* peak in 2006, and the IMF is signalling the prospect of a recession.

Without a theory, the patterns of the past cannot be taken for granted. Economics is the study of social behaviour. We cannot forecast outcomes with the same precision available to natural scientists. But, with the business cycle, I have shown that the data has been consistent for three centuries. And in *Boom Bust* I offered, for the first time, a theoretical explanation.

So Gordon Brown could only claim to have upset past trends if he put in place structural reforms with the power to change the course of history. The actions he took were cosmetic. Making the Bank of England independent of the Treasury was irrelevant. The US central bank has been independent for a very long time – and that did not protect American home owners from the cyclical booms and busts.

THE downturn in British house prices next year will be led by panic in the buy-to-let sector. Already, 40% has been wiped off the prices being asked for some new investment properties. Large numbers of apartments stand idle. As it dawns on the speculators that prices are heading south, they will flood the market.

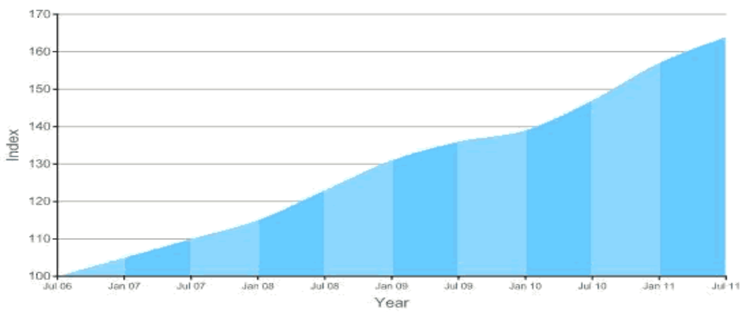
The insights that Economic Indicator Services (EIS) use have long been available to the Treasury. In 1983 I wrote *The Power in the Land* to compare Britain with the US, Japan and Australia. This comparative analysis showed that the disease that afflicts the housing market was not peculiar to Britain.

I submitted briefing papers to the Treasury, hoping to ward off the crash in house prices that would begin in 1987. The Tory government declined to take preventive action. The outcome was the recession of 1992. I then alerted Tony Blair's government when New Labour was elected in 1997. Again - the Treasury refused to adopt counter-cyclical policies.

Britain will now follow the US housing market, with the slide into the recession that cannot be avoided.

And yet, according to the official spin, *EIS is wrong: land values, for example (see graph below), are predicted by the Valuation Office to remain buoyant through to 2011.*

History will once again prove EIS correct. Meanwhile, the unfolding events will test the nerves of investors. Who will be the next victim of the misdiagnosis that led to the run on Northern Rock?



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