

**NEW ECONOMIC
THINKING^{AND}
REAL ESTATE**

— **Danny Myers** —



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New Economic Thinking and Real Estate

Danny Myers

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New Economic Thinking and Real Estate

Foreword

A new form of economic thinking began to emerge in 2008, prompted by the unforeseen financial crisis that had stumbled banks across America and Europe. This catastrophic event also served to accelerate the ongoing academic debate about the relevance of some aspects of the mainstream economics curriculum, which had been simmering across Europe since the turn of the century. As Professor of Economics Diane Coyle (2012) perceptively observed: it was patently obvious that a chasm existed between ‘the interesting questions of real-world problems and the workhorse economics being taught to students’. In other words, the financial crisis had highlighted a tension that existed between those who taught traditional, orthodox, neo-classical economics, and those making the case for a modern, heterodox, new economics.

No longer were the scientific methods offered by econometric (mathematical) approaches, or the precision of marginal returns, or economic models based on historical data, held up as sacrosanct. The modern challenge for economists was to make sure that their work is set in a real-world context; that the data and logic used confirms the current circumstances; and lastly, but by no means least important, that the growing scale and complexity of financial markets and products is acknowledged as a key part of economic analysis. As students of this text will discover, rather surprisingly, much of this appears to be in sharp contrast to the established approaches taught by many mainstream economists.

New economic thinking benefits from this debate as it seeks to establish the virtues of a modern approach to economic analysis. In a good number of chapters, this simply involves reiterating basic economic principles; improving the practical grasp of managing and using data; and recognising the importance of the financial sector to the broader economy. In short, what is identified is a selective approach, and content that blends with the times and resonates with the current graduate community as they search for jobs in difficult times.

Another unique feature of this text is its emphasis on the importance of real estate. Far too often, property is overlooked by mainstream texts but, given that many of the risks that banks accept when they provide loans are secured by property (be it residential or commercial), it can no longer be left out of the subject. In fact, real estate assets are too often the ‘window dressing’ and the ‘noise’ that confuses the analysis of so many locked into the mind-set of neo-classicism.

New economic thinking, therefore, brings into sharp focus the importance of property, finance and data handling as central tenets to comprehending today's economy. Furthermore, to enhance the approach several links to the internet are included as hyperlinks in the eBook and webnotes in the paperback.

The picture we end up presenting is not particularly neat and tidy with answers to closed questions based on tried and tested theory. Instead, we present a view that is slightly more complex in order to develop insight into the practical tools available to economists and enable answers to the open-ended questions that will inevitably arise during your professional career. This is not stated to provide some kind of excuse not to study economics, but to highlight why those who seek to *understand* the world of real estate need to embrace the language and methodology of 21st century economics.

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Introduction: Setting the Scene

This book is designed to provide an introduction to the role of the economy in understanding real estate. To make it topical, the Great Recession that ran across much of Europe from 2008 to 2014 is used to provide the story line, and a defining set of data is outlined in Table I.1, below. This recessionary saga presents a fascinating set of events that not only allows a broad review of modern economics, but also captures the state of play within the real estate profession. Ironically, the financial crisis that triggered the period of Great Recession took everyone by surprise, and there was no consensus about the solutions. Consequently, the debate over the options ranged far and wide; For example, should a government respond by reducing the national deficit or increasing it? Would lower rates of interest stimulate economic recovery or suppress it? Should welfare benefits be maintained or cut? Does economic inequality damage or encourage economic growth? Should depositors in failed banks be protected or face big losses?

Obviously, these policy options will make more sense once you have completed your studies – but do not expect to be given definite answers. Economics is clearly not that kind of subject, and the supporters of the new approach are keen to dispel the myth that economics is a science analogous to physics; hence, it should not be expected to produce universal, timeless, truths. Indeed, it is important to introduce economics as a social science that deals with human behaviour. As a consequence, at best it can be expected to provide guidelines, ideas, models and predictions – but not hard and fast rules.

The text was primarily conceived for those studying surveying or real estate management, as the RICS regard comprehension of business economics as an essential prerequisite for anyone graduating into a profession relating to property. However, a parallel market also exists among those studying finance and business. In fact, anyone interested in the economics profession's response to the challenges presented by the marked reductions to the pace of economic growth; the systemic

Table 1.1 Gross Domestic Product, European Union (28 countries). Millions of Euro

2008	2009	2010	2011	2012	2013	2014
12,325,878	11,781,797	12,030,439	12,240,116	12,179,168	12,199,435	12,365,418

Note: Data expressed in constant 2005 prices.
Source: OECD Statistics, December, 2015.

financial failures that haunted economies worldwide; and a desire to acknowledge and comprehend the multitude of real estate questions that arise from its use as an asset for investment, security for loans, development and ownership, should find the content informative.

New economic thinking is pertinent for three reasons. Firstly, it introduces some of the academic debate that occurred following the credit crises that prevailed in most high income countries following the collapse of Lehman Brothers in September 2008 – the now-notorious Wall Street investment bank. Secondly, the text highlights the uncontested ideas that have endured the crisis and continue to be central to economic discourse. In this sense, it cherry-picks, from the 250-year history of economic ideas, the tools and concepts that have survived the test of time. Thirdly, it places a strong focus on the relationships that exist between real estate markets and the broader economy.

This third feature is most important, as ‘property’ or ‘real estate’ is rarely addressed by mainstream texts. For example, if you look up ‘real estate’ in the index of an introductory economics textbook (such as Mankiw (2014), or Samuelson and Nordhaus (2010)), you will find real exchange rates, real GDP, real interest rates, real variables, and even reality versus perception – but no real estate. Under ‘housing’, you might find references to the consumer price index (CPI), to rent control and, possibly, even business cycles and forecasting – but certainly nothing on commercial property. Yet, each and every year, commercial and retail developments are, in value terms, the biggest sectors within real estate. Similarly, macroeconomics data miners, working for agencies forecasting economic activity, are also prone generally to overlook the broad range of real estate activity, apart from the occasional reference to housing. However, as we highlight in this text, *all* real estate is of central importance to understanding and forecasting fluctuations in the general levels of economic activity.

Recognising which property to proceed with for development, occupation or investment purposes is based on good timing and an ability to interpret economic activity. In fact, the principal reason for showing an interest in a property will depend upon the precise market it is being traded in and, inevitably, these are dynamic markets in which economic conditions (rates of return, finance costs and values, etc.) frequently fluctuate. Thus, compiling valuation and investment reports should not be regarded as crude mathematical processes that can be learnt by rote; professional surveyors also need to be able to draw upon market information and economic data to form an overall evaluation.

Studying this text, therefore, should help you to develop an intuitive judgement of property markets and enable you to provide sound advice to clients with financial interest in property assets. It will provide confidence in reading economic indicators and identifying trends, and give the ability to understand the role of

property in an economic context. Such skills should avoid the embarrassment of the next generation of economists, financiers, surveyors and estate managers having to spectate during subsequent recessions like innocent bystanders. As the high-powered American Financial Crisis Inquiry Commission (FCIC), which Congress set up in 2009 to examine the causes of the financial and economic crisis in the United States, concluded, 'the crisis was avoidable'.

To be precise, the FCIC (2011) clearly confirmed that the mess left by the crisis was the result of: 'a series of ill-advised and poorly executed decisions, inactions and serious misjudgements'. Warning signs were ignored and misunderstandings prevailed. This text sets out to clarify these findings and, more importantly, to prepare the property world to be sharper next time round. As the commission wisely stated, 'The greatest tragedy would be to accept the refrain that no one could have seen this coming and thus nothing could have been done. If we accept this notion, it will happen again' (FCIC, 2011: xxviii).

So do not be fooled; economic cycles will continue to fluctuate between good and bad times, and an upheaval on the scale of 2008 could even be repeated. However, by rehearsing some of the economic logic – the tell-tell signs – that formed the backdrop to this almighty crash, we could benefit from the lessons learnt, and stand a far better chance to stay ahead of the market in the future.

The storyline

The crisis that began in the American housing market during 2007 rapidly impacted on the economies and financial systems of Europe and beyond from 2008 onwards. The data (see Table I.1) detailing the impact reveals a sorrowful tale. Total economic activity across the 28 EU countries had contracted between 2008 and 2013 by €126 billion. In 2014, there were some signs of recovery, and the EU countries as group made €40 billion more than they had in 2008. Regardless of the sluggish recovery that had begun, recessionary problems rumbled on in Greece, Holland, Italy, Portugal, and Spain throughout 2014/15.

From 2009 to 2012, the global financial system slid further into disrepute, business communities became disorganised, and neighbourhoods were destroyed. The repercussions of the economic downturn were all encapsulating. They were certainly far wider and deeper than anything that went before, and the economy is predicted to remain below par in certain parts of Europe until 2016. With the Great Depression of the 1930s, recovery took four years; in some cases, however, it looks as though the Great Recession could take twice as long to return to the pre-recession level of 2008.

This period of economic decline and instability, contrasts sharply with the relative calm steady economic growth that had prevailed since 1995. Furthermore, a recovery from this low point would require a different regulatory approach to the risks involved in funding the large amounts of loans awarded by the world's banks and financial institutions for commercial property development, residential mortgages and so on.

In a nutshell, what had happened in the run-up to the financial crisis was that the relatively free flow of finance from banks to property owners had led to what commentators called a 'credit bubble' which, in turn, fuelled a bubble in property

prices. Typically, the term ‘economic bubble’ – like an actual bubble – is used to capture the price of something rising continually upwards, becoming more and more fragile the higher it gets. They tend to be driven by herd-like behaviour, where people share a common interest in a specific type of commodity and cause its price to rise far beyond any intrinsic value the commodity in question might actually have.

In effect, the term ‘bubble’ is used to capture the idea of a speculative asset being constantly transacted and bid up in price – inflating, and inflating, until it eventually bursts. Famous bubbles include the price of black tulips, which had been the subject of a bubble in Holland in the 17th century; the value of British South Sea stock, whose bubble inflated and burst in 1720; and the more recent dotcom bubble in internet company shares that burst in March 2000, causing more than \$7 trillion dollars to be wiped off the market value.

The Great Recession bubble, however, represents the biggest of them all. House prices and mortgage-backed securities (credit allowances given on residential and commercial property) both inflated at unbelievable rates from 2002 to 2007, a good deal further and faster than any forecaster could imagine. In fact, the two bubbles ran in tandem, as house prices and mortgage-related credit (in the form of various mortgage-backed securities) followed one another in an upwards spiral (the consequences of this residential investment frenzy were amplified by the global reach of these bubbles, as they were experienced more or less simultaneously across many countries, the prime examples being the USA, Australia, Ireland, South Africa, Spain and the UK).

The bottom line was that for many years, and certainly since the beginning of the ‘noughties’, the risk of mortgage default had diminished to the tiniest amount and, backed by ever-spiralling house prices, money was lent (mortgaged) and re-lent (re-mortgaged) to millions of people, including those on exceptionally low incomes – the phrases ‘sub-prime’, ‘junk’ and ‘toxic lending’ were coined in retrospect. For nearly a decade, the financial world had progressed securely and happily, until the inevitable happened – the bubble burst and the excessive concentrations of mortgage-related risk were splattered across the financial counters at banks across the world. This financial earthquake was difficult to foresee, and is still rather difficult to account for, but more will be explained in Part B. The point is that a housing bubble had begun to leak here and there in 2007, and eventually burst across the world economies in 2008 – not with a pop but an almighty crash – as property (unlike black tulips) affects everybody.

The world began to experience the worst recession since the 1930s – but this one would prove to be more protracted and difficult to resolve. Economists had not seen it coming and were dumbfounded and undermined in suggesting solutions. Thousands of customers of all major banks and related organisations had simultaneously defaulted on loans, to the tune of several trillion, and this had led to the bursting of another bubble, in which the people struggling to pay debts sold property assets which were rapidly falling in price. This incredible breakdown in the financial system had serious worldwide implications for employment, productivity, welfare, prices and the importance of real estate as an asset class. As the press coverage at the time portrayed it: the credit crisis had sucked the life out of the economy. It sent shockwaves across each economic system, and there were relatively few markets across the globe that were not affected.

The key lesson that can be learnt from the global crisis of 2008 is that no economy can live beyond its means in perpetuity. In other words, unless the assets of a business, a bank or a household are sufficient to cover the liabilities of that business, bank or household, in time the balance sheet will go out of kilter – become imbalanced, turn insolvent, end up bankrupt – *kaput* – whatever you want to call it. The double whammy that was dealt to the financial system and the economy in 2008 was caused by two bubbles bursting more or less simultaneously. This raises the question: why did no one see this coming? Some preliminary answers to the house price bubble are outlined below, while questions relating to the bubble in mortgage backed securities will be put on hold until we examine financial systems in Part B.

Hindsight is a wonderful thing

The Halifax price index, shown in Figure I.1, has been calculated for over 30 years, and it provides evidence of two housing bubbles. The first, relatively small, bubble commenced in 1986 and burst in 1989, leaving a significant number of people in a position of negative equity (where a mortgage is greater than the value of the related house). The second bubble, which is central to the story being relayed, commenced in 2000 and burst in 2007. In fact, during this period, house prices actually soared rapidly, by an astounding 130% in real terms (that is, relative to inflation) before crashing down.

This is all so easy to see and comment on in hindsight, but few managed to call it as it happened. In their defence, the low mortgage interest rates made house

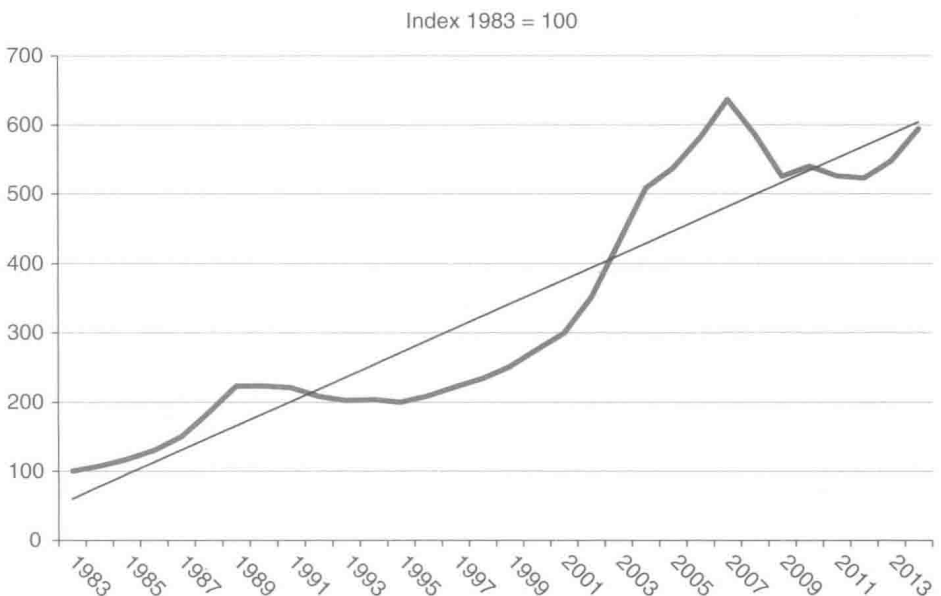


Figure I.1 UK house prices, 1983 to 2014.

Source: Adapted from Halifax house price index, 2015.

price rises seem perfectly logical at the time. Furthermore, the Halifax is only one of several house price indices, and the others were not going up as quickly (the discrepancies between data measuring the same phenomenon will be dealt with in Chapter 8, where we review various statistical indicators used to monitor economic activity).

The more reliable data to forecast from looks at trends in housing construction – namely, housing starts, and these are portrayed in Figure I.2. From these data, it is clear that housing is a boom-and-bust industry and, more specifically, a decline in residential investment is often one of the first indicators to reveal that a recession is about to occur. In fact, the data suggests that housing starts began to decline from 2004 onwards, whereas industrial production did not begin its nose-dive until 2008. The logic behind this data set is that builders usually commence with the construction of residential property when they are confident that it can be quickly sold on completion. If the economic climate changes, they might delay progressing the project until conditions become more favourable; no one wants to incur the cost of construction until they are confident that sales will follow on pretty quickly after completion. Consequently, during a recession, it might be possible to count a large number of foundations, but any other signs of activity to complete the work are non-existent. As a result, housing starts will increase in number when the economy is on the up, and slow considerably when the economy is on the way down.

Comparing the data in Figures I.1 and I.2 highlights an important contrast. Housing starts data demonstrates more volatility (in the sense that it is more sensitive to changes in circumstances), whereas house price data is less responsive to changes in economic conditions (in the sense that they tend to be ‘sticky downwards’). Thus, whenever an economy experiences a decline in demand, the volume of sales adjusts more sharply than the prices. Furthermore, with a decline

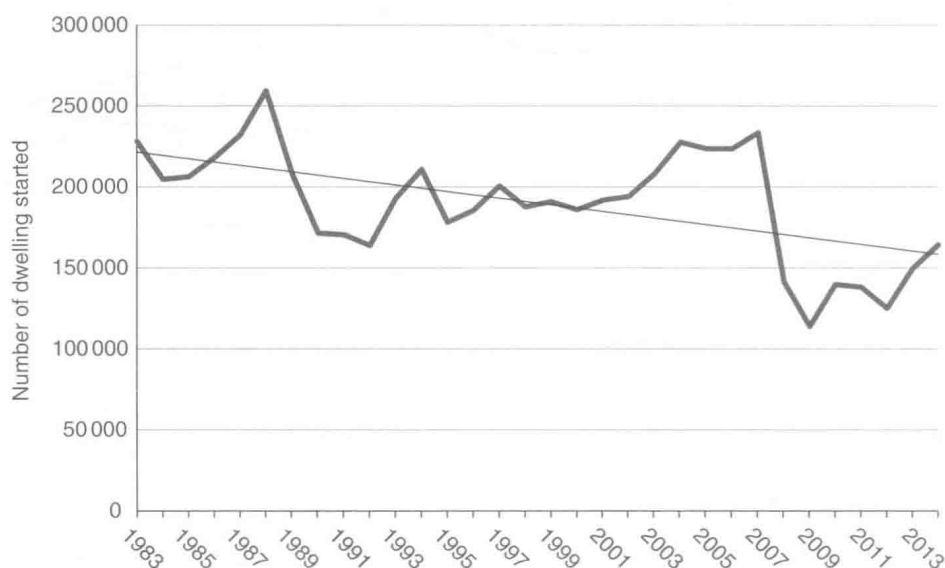


Figure I.2 UK housing starts 1983 to 2014.

Source: Adapted from Housing Statistics, Live Table 211, 2015.

in sales volume comes a decline in jobs in construction, finance, surveying and real estate agencies. Hence, when demand reduced as it did in 2008, it was quickly followed by a marked decline in the number of starts. In short, housing starts provide a better forecasting indicator than house prices.

The writing on the wall

By now the message should be clear. This book is designed to help students develop an intuitive ability to interpret economic indicators and acquire the confidence to assess property markets. As such, it is divided into three parts, namely:

- A Resource choices
- B Financial systems
- C Measuring and forecasting

Part A: Resource choices

This part deals with many of the traditional basic microeconomic principles, outlining the ways that resources tend to be allocated in private property markets. As budding economists might expect, a significant part of the exposition here is concerned with the determinants of supply and demand. However, we also emphasise that markets evolve and, to a large extent, are culturally derived. We therefore seek to explain, as plainly as possible, the position of man-made markets that deal with property in today's dominantly capitalist world.

In many introductory texts, two model systems of resource allocation are rehearsed – the centrally planned and the free market economy. These economic models are simplified representations of two different systems, but neither extreme exists in a pure form. In practice, modern economic systems are far more complex. We propose, therefore, to cut to the chase and emphasise that free private market decisions exist alongside centralised legislation and control. In some ways, this approach suggests that the typical textbook world of 'free markets' is a myth.

The intention of Part A, therefore, is to demonstrate how investors in property continually face choices that are constrained and refined by government and other cultural interventions. Resource choice is often compromised by social and political controls that limit what market participants can or cannot do. If people cannot do the things that they find most profitable, they lose the incentive to invest and innovate. To use examples presented by Ha-Joon Chang (2011) in his critique of capitalism: if the government seeks to keep privately rented accommodation at an affordable level and put a cap on rents, landlords lose the incentive to maintain their properties or build new ones. Or, if the government restricts the kinds of financial products that can be sold, two contracting parties that may both have benefited from innovative transactions that fulfil their idiosyncratic needs cannot reap the potential gains of free contract. Thus, we present a case that those interested in property and finance are less 'free to choose' than conventional mainstream economic titles might suggest.

Part B: Financial Systems

Part B seeks to emphasise the importance of the financial sector to make sense of the broader macroeconomic scene. In an introductory text comprising eight main chapters, having three of them allocated to central banks, monetary policy, financial products and the performance of related markets, etc. may seem imbalanced. However, the received wisdom is that the financial crisis of 2008 and the subsequent Great Recession raised serious questions about neoclassical economics, and financial systems are a central part of the story.

An important section of Part B reviews the recently conceived flow of funds model as a means of understanding the determinants of economic growth and the likelihood of entering into future debt-fuelled recessions. As such, it introduces the relationships between the real economy and the financial system – or, to be more precise, the relationship between the stock of financial assets and real sector assets (actual economic output).

This relatively new approach goes some way to explaining why so few surveyors and traditionally trained economists could manage to forecast, or even to anticipate, the recession of 2008 as, in their day, no distinction was drawn between the financial sector and the real economy. It is only since the emergence of the Great Recession that explicit modelling of the financial sector alongside the real economy has gained credence as an important aspect of macroeconomic analysis that needs to be studied by budding economists and surveyors. To paraphrase the Harvard economist Benjamin Friedman (2009: 42): ‘an important question – which few seemed interested in addressing before the onset of the 2008 credit crisis – is what fraction of an economy’s total returns are absorbed up front by the financial industry and the real estate sector.

The new paradigm puts investment – particularly for commercial and residential real estate – at the centre of the analysis. It focuses on the debt and cash flow, emphasising how ‘risks’ and ‘uncertainty’ tend to make economic systems unstable and difficult to forecast. This fresh approach rejects the static equilibrium methodology of mainstream economics as irrelevant in analysing property assets, and plays up the importance of understanding how investment is financed and debts managed to determine the state of the macroeconomy.

Part C: Measuring and Forecasting

Without doubt, being able to manage, use and interpret data is a vital skill for surveyors (and economists) to develop. The appraisals that clients request need to demonstrate an economic awareness. There is an expected level of detail relating to: the relative costs and benefits arising from the proposed investment; the implications of the interest rates paid on borrowed funds; the relevant tax measures; the prevailing market conditions; the legislative constraints imposed by planning policy and building regulations; and the end user requirements.

As such, there are many indicators of economic change to explore, ranging from the formal to the ridiculously informal: from levels of business investment, the availability of credit and the number of cranes that can be counted on the skyline, to the sales of men’s underpants [1] and the membership numbers of the National