

The economics of the property boom-bust cycle

Economic situations vary and there will always be factors unique to a given boom-bust cycle. There are however a range of broad principles that can often be observed over the course of the property cycle. The assumption is made that the economy starts from a stable equilibrium with limited infrastructure, which will of course not be true of all cycles. The boom-bust cycle can be split into five sections:

1. Start of the boom
2. Middle of the boom
3. Towards the end of the boom
4. At the peak
5. The crash

The boom-bust property cycle is directly related to:

- The general economy, because property is bought with money;
- Land values, because property is built on land.

1. Start of the boom

Assuming that the economy starts from a stable equilibrium, there are no rapid increases or decreases in prices, supply equals demand and price stability prevails. Population growth over time bolsters demand from businesses and individuals for commercial and residential property. There exists a disequilibrium in the market and either supply or prices (or both) need to change to restore equilibrium.

If supply increased to meet demand, prices would remain stable. Property density would increase (e.g. redevelopment of existing sites into more units); undeveloped areas would become developed; and infrastructure would increase to cope.

This does not necessarily happen. Landowners know that if they do not increase property supply, then prices must adjust in order to restore market equilibrium. That is, property prices are gradually bid up by the increased demand.

As a result, developments outside of prime central locations will occur, feeding through to an increase in infrastructure around the city centre. This in turn pushes up the value of undeveloped land in the city centre even further.

With undeveloped land values bid up, brownfield redevelopments become more attractive. Existing property is 'over-enhanced', for example by replacing an existing building with another of higher specification (more units).

As the limited supply of land drives price growth, it becomes just a matter of time before property speculators (novice investors) start entering the game.

2. Middle of the boom

Novice investors are mere speculators who believe property values can only continue to rise. They will therefore pay inflated prices for existing buildings, or buy new build property from developers also at inflated prices.

As prices rise, speculators spend more in order to gain a higher profit. Consumption in the economy falls as consumers use more income for property investment. The feel-good factor of boom time masks this fact and consumers often go a step further – making unsecured borrowings to finance further expenditure.

A paradoxical consumer position emerges: savings are increased in order to finance property investment, while consumption also increases as it is financed by unsecured borrowing.

3. Towards the end of the boom

With consumption fuelled by over-borrowing, the economy experiences a trade deficit. Domestic output also falls as money is withdrawn from the economy through consumer savings for property investment. That is, domestic output is unable to meet consumer demand and so imports increase to satisfy excess demand, and exports fall as more production is required for domestic consumption.

The resulting trade deficit must be financed and this is achieved through attracting inward investment into the domestic economy from abroad. Government gilt rates increase in order to attract foreign investors. This ultimately leads to rising interest rates.

4. At the peak

Investments are being made based on historical returns – speculators do not adjust their expectations to reflect the fundamental economics. Consumption continues to be fuelled by unsecured finance and second-charge loans. Lenders lend at higher valuations which are only the result of speculative excesses.

Investment, consumption, lending and borrowing are all in excess. Interest rates rise to cope with the trade deficit and consumer price inflation.

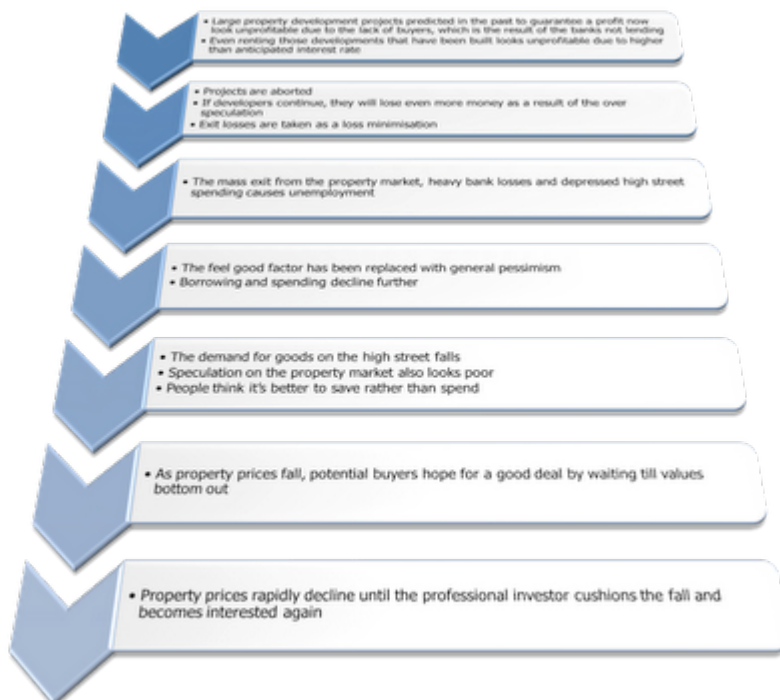
5. The crash

Higher interest rates curb consumer expenditure and help to bring inflation under control. Projected cashflows and present values of uncompleted capital intensive development projects fall. Investment returns look less attractive. The property development market slows...

...and so begins a chain reaction of events...



...the chain continues:



And so the market bottoms out and is ripe with opportunity for the professional investor.