by Steve Hanke

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The great 18-year real estate cycle

On January 3rd, US Federal Reserve Chairman Ben S. Bernanke delivered a major speech at the annual meeting of the American Economic Association. In his formal paper, "Monetary Policy and the Housing Bubble," Chairman Bernanke argues that the Fed's monetary policy was not responsible for the U.S. housing bubble. He claims that faulty regulation was the primary culprit.

Chairman Bernanke's claim is a great canard. The Fed is a serial bubble blower. Let's first consider the Fed-generated demand bubbles. The easiest way to do this is to measure the trend rate of growth in nominal final sales to U.S. purchasers and then examine the deviations from that trend. As the accompanying chart shows, nominal final sales grew at a 5.4% annual rate from the first quarter of 1987 through the third quarter of 2009. This reflects a combination of real

sales growth of 3% and inflation of 2.4%.

The nominal final sales measure of aggregate demand contains three significant deviations from the trend (demand bubbles). The first followed the October 1987 stock market crash. The second followed the Asian financial crisis and the collapse of the Russian ruble and Long-Term Capital Management in 1998. The last jump in nominal final sales was set off by the Fed's liquidity injection to fend off a false deflation scare in 2002.

The Fed's zigzag pattern is clear: an overreaction to a so-called crisis, resulting in the excessive injection of liquidity (a sales boom), followed by a draining of liquidity and a recession (a sales slump).

The most recent aggregate demand bubble wasn't the only one that the Fed was pumping up. As the accompanying chart of price indexes shows, the Fed's favorite inflation target – consumer prices, less those for food and energy – was increasing at a regular, modest rate. Over the 2003-2009 period, this metric increased by 14.3%.

The Fed's inflation target metric signaled "no problems." But abrupt shifts in major relative prices were underfoot. Housing prices measured by the Case-Shiller index were surging, increasing by 44.7% from the first quarter in 2003 until their peak in the first quarter of 2006. Share prices were also on a tear.

The most dramatic price increases were in the commodities. Measured by the Commodity Research Bureau's spot index, commodity prices increased by 92.2% from the first quarter of 2003 until their peak in the second quarter of 2008.

The Fed should dust off the works of economists from the Austrian school, particularly Prof. Friedrich Hayek's. The main lesson from the Austrians was their extreme skepticism about the exclusive reliance on one magic index – the price level – to guide central bank policy.

Indeed, Hayek stressed that changes in general price indexes don't contain much useful information. He demonstrated that it was the divergent movements of different market prices during the business cycle that counted. It's time for the Fed to dump inflation targeting.

Chairman Bernanke's denial of the Fed's culpability raises an interesting question: how can the Fed make fantastic claims without being brought to account?

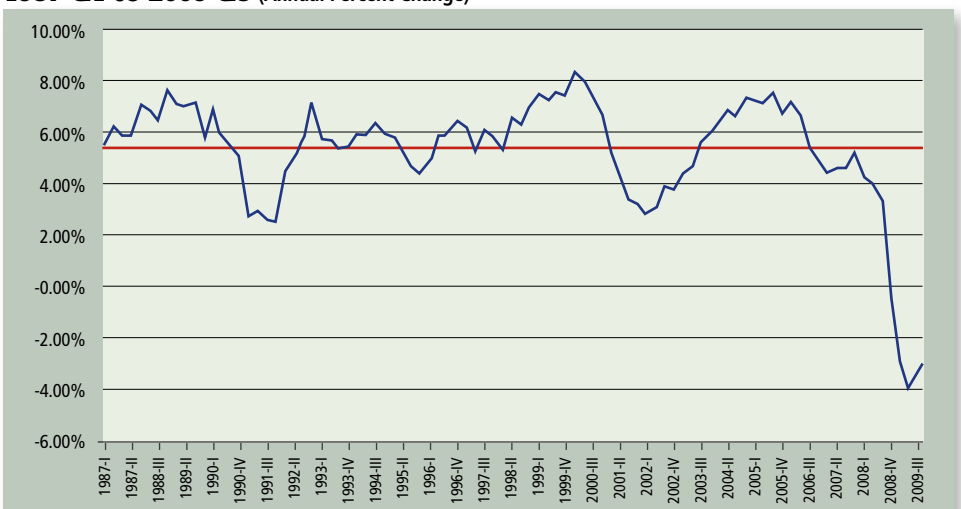
In a 1975 book of essays in honor of Prof. Milton Friedman, *Capitalism and Freedom: Problems and Prospects*, Prof. Gordon Tullock wrote:

"…it should be pointed out that a very large part of the information available on most government issues originates within the government. On several occasions in my hearing (I don't know whether it is in his writing or not but I have heard him say this a number of times) Milton Friedman has pointed out that one of the basic reasons for the good press the Federal Reserve Board has had for many years has been that the Federal Reserve Board is the source of 98 percent of all writing on the Federal Reserve Board. Most government agencies have this characteristic…"

Does the mighty Fed really control the information flow and ultimately the press? Prof. Larry White subjected this question to what the Fed must have thought was the indignity of factual verification. His findings support Friedman's assertion.

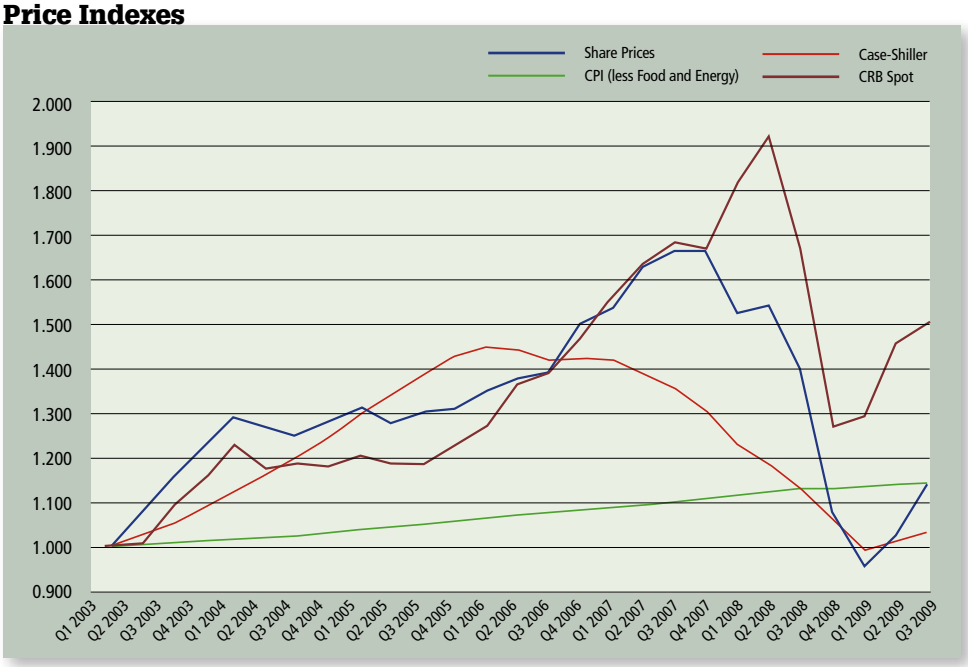
In 2002, 74% of the articles on monetary policy published by U.S. economists in U.S.-edited journals appeared in journals published by the Fed, or were authored (or co-authored) by Fed staff economists.

Final sales to domestic purchaser from 1987 Q1 to 2009 Q3 (Annual Percent Change)



FSDP = GDP + Import - Export - Inventory
Source: Bureau of Economic Analysis, US Department of Commerce and Author's Calculations

Price Indexes



Source: International Monetary Fund, International Financial Statistics, Federal Reserve Bank of St. Louis; Standard and Poor's; Bloomberg and Author's calculations

The Great 18-Year Real Estate Cycle

Peaks in Land Value Cycle	Interval (years)	Peaks in Construction Cycle	Interval (years)	Peaks in Business Cycle	Interval (years)
1818	-	-	-	1819	-
1836	18	1836	-	1837	18
1854	18	1856	20	1857	20
1872	18	1871	15	1873	16
1890	18	1892	21	1893	20
1907	17	1909	17	1918	25
1925	18	1925	16	1929	11
1973	48	1972	47	1973	44
1979	6	1978	6	1980	7
1989	10	1986	8	1990	10
2006	17	2006	20	December 2007	18

Source: Fred E. Foldvary. The Depression of 2008. Berkeley: The Gutenberg Press, 2007.

The Fed's capacity to write and re-write history dominates the information flow. It's no wonder the Fed's canards give it few worries.

Speaking of economic history, one thing that the purveyors of monetary policy (and all prudent investors) should become well versed in is a piece of business-cycle history that has apparently passed them by – namely the little-known, but essential, 18-year real estate cycle.

This cycle goes hand-in-hand with Austrian business cycle theory in which booms and bubbles are created when central banks set short-term interest rates too low, allowing credit to expand artificially.

As Prof. Mason Gaffney characterizes it: "Bank credit swells and shrinks in synch with the land cycle. The two interact in a positive feedback process: swelling bank credit raises land prices; buyers need more credit to purchase the land; the appreciated land then serves as collateral for more bank loans, and so on."

Land prices eventually peak and then construction activity peaks. This is followed by a peak in the general economy. In short, land prices are a leading indicator of both construction activity and general economic activity.

The accompanying table tells this story. It also shows that, with the exception of World War II, the peak of most real estate cycles is roughly every 18 years.

These data talk, and the most interesting thing they say is that every 18 years we can expect the culmination of a credit-fueled real estate and ensuing business cycle. This, of course, doesn't imply that all recessions are preceded by a real estate cycle. It only says that all real estate cycles have spawned economic downturns.

This knowledge has allowed for some prescient forecasts. The prize in that department goes to Prof. Fred Foldvary who wrote in 1997: "the next major bust, 18 years after the 1990 downturn, will be around 2008, if there is no major interruption such as a global war." GA

For a full treatment of the 18-year real estate cycle, I recommend the following items:

- Fred E. Foldvary. "The Business Cycle: A Georgist-Austrian Synthesis." American Journal of Economics and Sociology Vol. 56, No. 4, 1997: 521-41.
- Mason Gaffney. After the Crash: Designing a Depression-Free Economy. Ed. Clifford W. Cobb. Chichester, U.K.: Wiley-Blackwell, 2009.
- Phillip J. Anderson. The Secret Life of Real Estate and Banking. London: Shepheard- Walwyn, 2009.

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