The Welsh Economic Experiment Could Go Very Wrong

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The idea that all of **economics** comes down to land prices seems like an arcane one. Especially with the online world increasingly dominating the bricks and mortar of retail.

But it isn't. Land is special. It's different to the other factors of production in several important ways that you need to understand. And two recent developments make that painfully obvious.

Akhil Patel from *Cycles, Trends and Forecasts* sent over an email pointing out the first one. (I strongly suspect his speech at Friday's conference will be on this general issue, which I'm looking forward to immensely.)

Welsh secretary Alun Cairns told the Tory party conference the following:

> *No other policy will have such an immediate impact on growing the economy in south Wales and the south west of England than our decision to abolish the tolls on the Severn crossings.*
>
> *After 50 years of having to pay to enter Wales, I'm grateful to my Cabinet colleagues, particularly Chris Grayling who understood the significance of this policy.*
>
> *The announcement has been one of my proudest moments as secretary of state. 25 million vehicles cross the bridges every year, with a cost of up to £20 a time.*
>
> *Anyone living and working in south Wales, knows how important this.*
>
> *Just think – no tolls, no booths, no charges, no long queues to get into Wales.*
>
> *This decision will immediately boost the economy of south Wales by £100m a year.*
>
> *And we all have something to offer that benefits the whole of the UK.*

Sounds great, right? A win-win solution.

Unfortunately, things aren't quite as they seem. None other than Winston Churchill explained why in 1909. It's his example that says it best:

> *Some years ago in London there was a toll bar on a bridge across the Thames, and all the working people who lived on the south side of the river had to pay a daily toll of one penny for going and returning from their work.*
>
> *The spectacle of these poor people thus mulcted of so large a proportion of their earnings offended the public con-science, and agitation was set on foot, municipal authorities were roused, and at the cost of the taxpayers, the bridge was freed and the toll removed.*
>
> *All those people who used the bridge were saved sixpence a week, but within a very short time rents on the south side of the river were found to have risen about sixpence a week, or the amount of the toll which had been remitted!*

And that's the way the cookie crumbles. Economics is full of these examples. Where people mess with the price mechanism, they get beaten up.

Here's another example of the same phenomenon from Churchill, applied to charitable giving:

> *And a friend of mine was telling me the other day that, in the parish of Southwark, about 350 pounds a year was given away in doles of bread by charitable people in connection with one of the churches.*
>
> *As a consequence of this charity, the competition for small houses and single-room tenements is so great that rents are considerably higher in the parish!*

Here's the key point Churchill's examples illustrate:

> *All goes back to the land, and the land owner is able to absorb to himself a share of almost every public and every private benefit, however important or however pitiful those benefits may be.*

You can read Churchill's full speech **here**.

What is it about land that allows it to capture the gains?

We'll have to wait for Akhil's speech to find out. But some of the reasons are clear.

The supply of land is restricted, so demand is the key. The inelasticity of supply means changes in demand turn into price changes accrued to the landowners. The economics of skyscrapers is fascinating because of this.

Not only is the supply of land restricted, but you can't move land around. Land in Liverpool can't move down to London where it can get a higher price. Liverpudlian labour and capital can.

The government has found ways to fiddle with these truths. It made them worse, of course.

Zoning laws, height restrictions and restrictions on the use of land are examples of how the government affects the supply of land. While they do so, the returns to landowners will always be elevated artificially. And that can lead to housing bubbles.

But all this also leads to predictable booms. If returns flow to land, then it's not difficult to figure out where's best to invest.

According to Churchill and Cairns, south Wales looks promising. But Akhil lays out somewhere even better here.

The black swan turns pale

For a few months we've been following the story of Australia's housing bubble with new interest. It's the potential crisis on no European's screen. Which is concerning given the level of funding which Europe supplies to some of the world's largest banks Down Under.

The issue in Australia is surprisingly similar to the sub-prime story in the US. And everyone agrees it's all about land prices at the core.

Which is odd given the amount of land Australia has. But even that is up for debate if you read the papers.

Let's turn to a more interesting angle in this *Capital %26 Conflict*.

How big is the Australian housing bubble? Capital Economics calculated that, based on a median house price to income ratio, Australian houses are about 38% overvalued. Which happens to be far worse than the US's 30% in 2006.

ABC News reassured its readers that this time is different and Australia is special:

> *However, he noted that this measure does not take into account the long-term lower level of interest rates and therefore the bigger amount people can comfortably borrow and the lower rental returns investors demand.*

This is morbidly hilarious. Rising interest rates happen, which increases the risk, not decreases it. Something that will only temporarily be affordable is not affordable and won't benefit the buyer in the end.

Not only that, but rising rates are precisely what popped the sub-prime bubble, so it should be obvious that low rates are dangerous.

The latest development is a remarkable survey from Finder.com.au on just this issue. Australian Broker reports:

> *A staggering 57% of mortgage holders could not handle a $100 increase in their* [monthly] *loan repayments, according to new research by Finder.com.au.*
>
> *This additional $100 is equivalent to an interest rate rise of just 0.45% based on the national average mortgage of $360,600. This means the average standard variable rate of 4.83% would only have to rise to 5.28% to put more than half of mortgage holders in stress.*

Not only are Australians walking a tightrope on their repayments, but 39% of mortgages are interest only. A hit to house prices could spell disaster.

Surprisingly, it's the wealthy that are in trouble. Martin North of Digital Finance Analytics tracks mortgage stress by suburb. And it's the famously wealthy ones that are showing signs of distress.

Never forget how small a problem the US's sub-prime bubble looked in 2007. Australia's house price bubble is brewing trouble for you.

Until next time,

Nick Hubble
Capital %26 Conflict

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