The Depression of 2026

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Now that the US economy is recovering from the Depression of 2008, people are wondering when will be the next great economic crash. The business cycle in the USA has had a period of 18 years, so the most likely year for the next great recession is 2026. The Depression of 2026 will have the same causes as the other depressions since the early 1800s (see this article).

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Nobody paid attention during the 1990s when those familiar with the real estate cycle predicted the Depression of 2008 (including myself, in 1997). Almost all economists, financial analysts, journalists, pundits, bloggers, and armchair cynics will also scoff at this prediction of a severe recession and depression in 2026. They will say there is no way to accurately predict such an event so far in advance. But the cycle exists precisely because people don't believe it.

There has been one fundamental cause of the boom and bust cycle: massive subsidies to land values. Since these subsidies are a governmental intervention into the market, the cause of the cycle is not "business," hence the term ìbusiness cycleî is misleading. It is a cycle of economic distortions caused by government policies.

The monetary subsidy to real estate consists of cheap credit. In the US, the Federal Reserve manipulates interest rates by expanding the money supply. An injection of money increases the money reserves of the banks, which then lower their interest rates to loan out the extra money. Cheap credit fueled the real estate bubble that peaked in 2006, and super-low interest rates today are sowing the seeds of the next bubble. Similar money creation occurs by other central banks.

An artificial expansion of money and credit eventually causes price inflation, and one of its problems is that prices rise unevenly. Prices rise soonest and fastest where the money is being loaned out, and much of it goes to finance real estate purchases and construction. An example of relative price distortion is the increase in the purchase price of real estate relative to rentals. When the central bank reduces its expansion of money, interest rates rise, and the investments caused by cheap credit come to a halt, generating bank and other business failures.

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The other branch of government subsidies to land values is fiscal—government's taxing and spending. The biggest subsidy is the generation of land rent by government's public goods. Better transit, security, schools, parks, streets and highways make locations more attractive and productive, generating higher rent and land value. If the payments for these works come from the landowners, the payments reduce the rise of land values. But the financing of the public goods has mostly come from taxes on labor, enterprise, and goods.

In the USA, landowners get special tax breaks. When a homeowner sells the house, much of the asset value gain is exempt from the capital gains tax. Owners of real estate can deduce mortgage interest and property taxes from taxable income. Those owning real estate other than their residence are able to deduct depreciation even if the building is not losing value, and they can sell their property tax free if they buy a similar property as an "exchange." Land speculation can thus become tax-free.

The reason why land is the most important element in the economic-distortion cycle is that much of the gains from economic expansion is captured by greater land rent. Then when speculators observe rising prices for real estate, they jump in, and increase the demand, accelerating the rise in prices. Land values then rise above the prices which those who actually want to use land can afford. High prices for land and high interest rates choke the expansion. As investment falls and workers in real estate lose their jobs, the economy falls into a recession.

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In 2012, the US economy is still depressed, but recovering. The stock market has already been recovering, anticipating economic expansion. The economic recovery is slow because government has propped up land values and minimum wages, and also because of expected tax increases in 2013, higher oil costs, and the costs imposed by financial restrictions and medical insurance mandates. Elements boosting the economy are continued technological progress in electronics and biological applications, as well as the expansion of natural gas and oil extraction.

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Shocks from outside the US economy could alter the cycle timing. The European sovereign debt crisis could end in massive defaults, but the European authorities are well aware of the dangers. They have not cured the problem, but have treated the effects with more debt, organized cancellations of some debt, and counter-productive austerity measures. Countries such as Greece could solve the debt problem with high growth by replacing their value-added taxes with land-value taxes, but Europeans would much rather depress their living standards than eliminate their land-value subsidies. There has also been the continuing threat of a war on Iranís nuclear program, as its national slogan ìDeath to America!î is taken seriously.

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Americans still have time to prevent the next great boom and bust, but they are culturally bound to the status quo, as are almost all economists, so the warnings will go unheeded as they did during the 1990s and 2000s. We are now far upstream, but heading down into the river of no return to the real estate and financial waterfall of 2024-2026.

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