The Cantillon Effect

Tall buildings and what they forecast.

With Phil Anderson.

Sometime in the very early 1800s, a Manhattan carpenter named Lozier came to the somewhat startling conclusion that the city in which he lived was dangerously lopsided and had too many taller buildings on its lower end. If any more structures went up, he warned the city, the island would sink into the Hudson River. To head off this expected calamity, Lozier suggested to the city's mayor that a chunk of Manhattan's northern end be hacked off, towed down the Hudson, and then attached to the southern tip. This, Lozier explained, would redistribute the island's weight and ensure no further sinking.

Impressed with the scheme and with Lozier's ingenuity, New York's mayor suggested Lozier commence at once, handing over to him from the City Treasury a good deal of cash to do so. To help him, Lozier advertised for workers. Some 500 showed up one morning, shivering in the cold waiting for 'the boss' to show up. As the reader might already have guessed however, our carpenter Lozier was long gone; taking with him the city's money intended to finance the project.

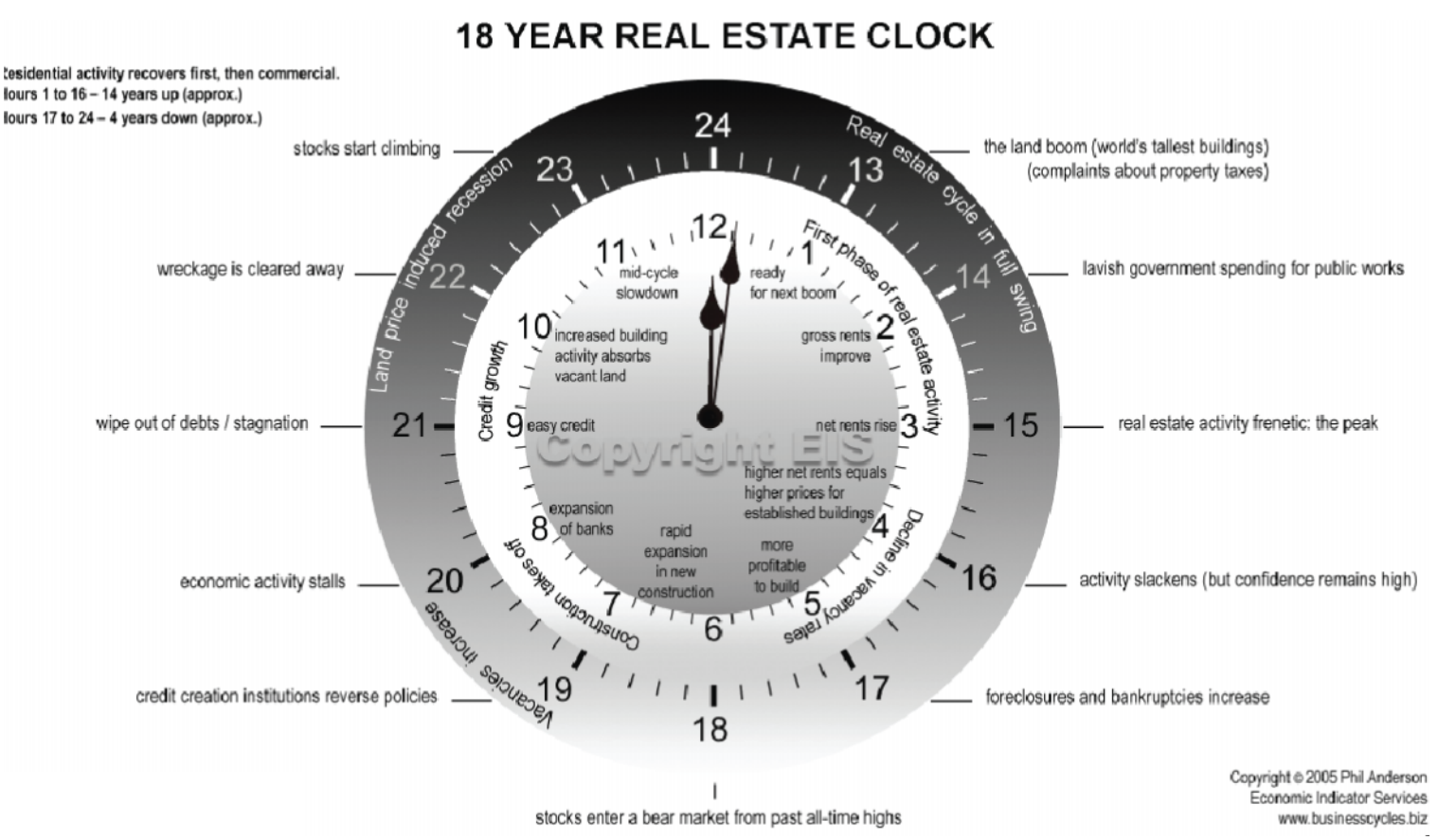
Over the years, New York City has had its fair share of real estate swindles. Another was thought to be in progress when a 50 metre high 'superstructure' was started on a six and a half metre plot of Broadway land in the spring of 1887. The owner, a Manhattan realtor named John L. Stearns, actually owned the neighbouring plot as well, off lower Broadway in New Street. The front plot, however, facing Broadway, had become so hemmed in that Stearns found it practically unsaleable except at a give-away price.

Frustrated, Stearns approached Bradford Lee Gilbert, a nearby architect for a possible way out. The solution, Bradford recalled in his reminiscences, was to build an iron bridge truss, but stand it on its end; a solution that took him a full six months to conceive and design he said later. In this way, the real structure of the building would start several stories above the curb and help produce the best design to maximize occupancy and rentals. The world's first 'skyscraper', as the invention was later called, built of skeletal steel was born.

So ingenious was the invention, utilizing the land space as never before, that the design enabled its owner to reap $90,000 a year more in rentals than would otherwise have been possible. A mania for tall buildings quickly developed; a phenomenon that continues to this day. Since then, the opening of successively taller, then tallest buildings, has proceeded in waves: the most remembered being The Empire State Building which opened for business in May of 1931 to great fanfare, but practically empty.

I've given a name to this phenomenon - The Cantillon Effect: so named after Richard Cantillon (1680 - 1734), an Irish banker of the early 1700's, generally credited today as the first economist to suggest that a change in the supply of money and credit will affect the economy by changing prices. Cantillon recognised that an increase in the availability of credit would result in economic expansion, but that ultimately this would be overdone as prices rose and imports increased. His work pre-dates Adam Smith and was just as important, if not more so.

For maximum forecasting ability, however, the Cantillon effect should only be interpreted in conjunction with the 18-year real estate cycle, at the end of which is when the Cantillon effect will usually be at its most obvious, with easy credit conditions on display and when competition for the world's tallest is sure to be at its height: the taller the building on the drawing board, the more available and easier to procure is the bank created credit.



As it happens, the world's tallest buildings have had a distinct and consistent habit of being completed right at the top of the real estate cycle, (since Gilbert's first tower, there has not been an exception to this occurrence at each real estate peak), producing for us - at least so far - the most reliable indicator of an approaching real estate cycle top.

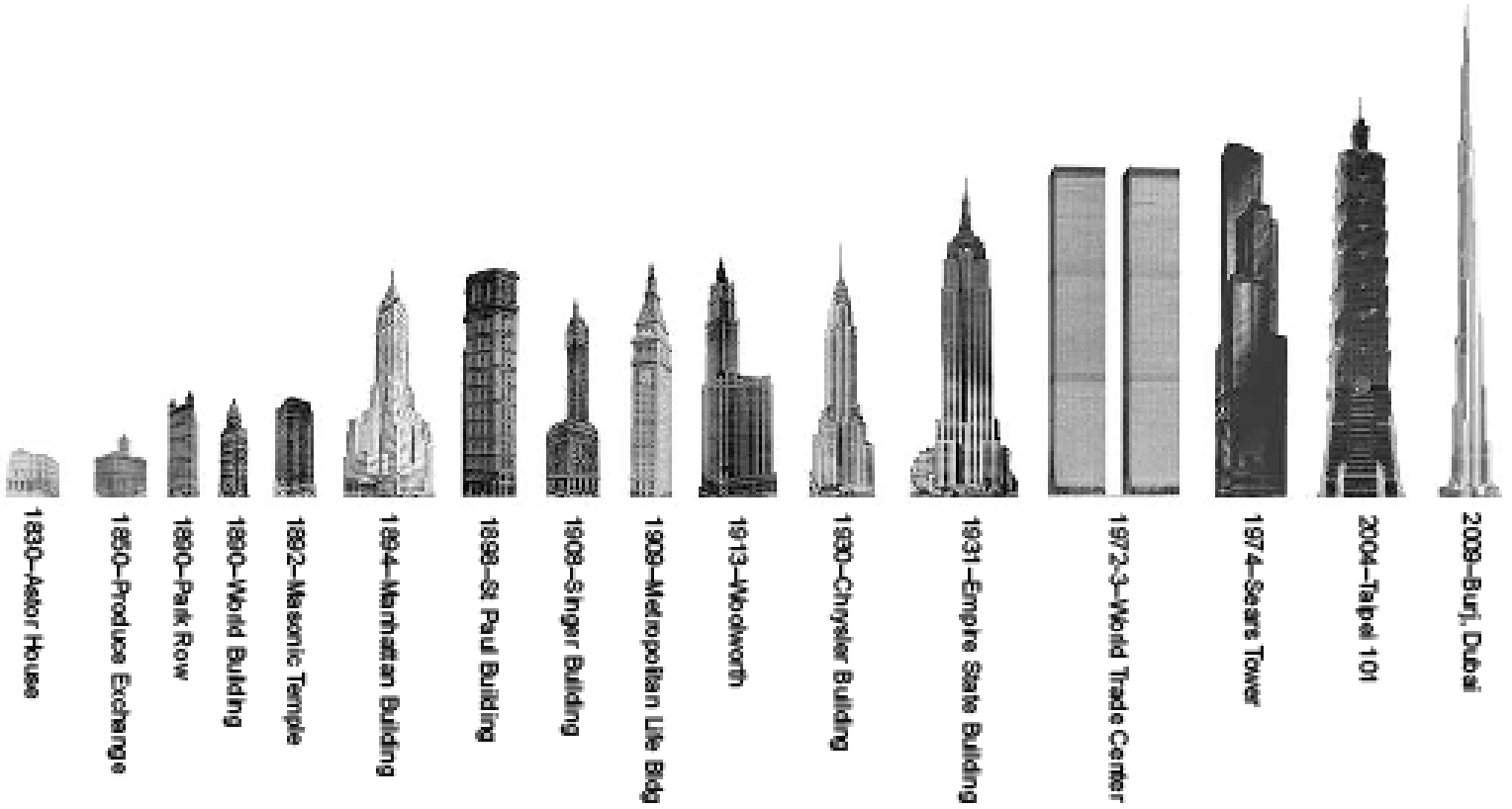
This is hardly surprising: as any decent architect could tell you, though rarely these days it seems, an economist. Tall buildings are just built spaces to make the land pay. As a general rule, skyscrapers are a speculative project, built mostly by developers with other people's money. Such buildings are going to be built only when credit conditions are easing or at their easiest, the time when developers are most flush with funds: hence the link with credit, and to Richard Cantillon.

So what will happen as this latest real estate cycle approaches its low point in 2010? Already, the confluence of tallest buildings into the end of yet another 18-year real estate cycle (the previous cycle low in the US was in 1992) has repeated, just like every other since 1837. It can also be seen that the geographic location that supports the tallest, usually experiences the severest slump in the years after the general downturn elsewhere. This does not augur well for Dubai. (In Shanghai, the 101-story Shanghai Tower is due to open shortly, being built by Minoru Mori and his associated company. Whilst he is a rich man, a lot of debt - US$ 7.2 billion worth - is financing his ambition. China though, has a tonne of reserves to recover reasonably well from the present world-wide downturn.)

As for what is happening in Dubai, we know that development in recent years was proceeding at break-neck speed and long term it is hard to be too bearish on the whole scenario, but the city will see a few bumps in the road shortly. Whilst information is not easy to come by about what is happening there, (the required information with which to make a judgement is now classified a state secret) there is no doubt a decent

amount of debt and leverage was used. The builders of Dubai are likely to need a hefty state bail-out. Lower oil prices, should this eventuate, could easily create a panic in this location later in the year.

The world's tallest always open in recession and are never fully occupied.



About Phil Anderson

(Adapted from an article first printed in MoneyWeek, UK, February 8th, 2008)

Phil Anderson is Managing Director of Economic Indicator Service Ltd, an economic forecasting service based in London. Phil uses Market Analyst to help with forecasting and trading decisions. His book 'The Secret Life of Real Estate' was published in the UK in 2008. The web site can be found at http://www.businesscycles.biz