Property development—drawing on the experience of the seventies

*Remarks made by the **Governor** at the annual luncheon of the British Property Federation on 11 May.*

Mistakes of the seventies

Even before the 1970s, inflationary expectations were beginning to infiltrate into investment thinking. The warning notes had become a distinct and very audible theme by the time I entered upon my responsibilities as Governor almost a decade ago. I do not intend to detain you with any extended account of the secondary banking crisis which thereafter came upon us. But property figured centrally in that crisis, and what we have had to do to bring inflation under control has had major repercussions on property values since then. My world and yours have thus been closely intertwined and I thought that a number of reflexions from my side as to how these interconnexions have worked in the past, and might work in the future, would be of interest to you.

Let me take you back for a brief look at the economic conjuncture at that time. After a period of slack activity and rising unemployment economic policy was increasingly being directed towards expansion. Finance was readily available, but investment by the industrial sector was slow to pick up. There was no other area of economic activity which seemed to offer as good a prospective rate of return to the entrepreneur as property development. The consequence, particularly because of the restrictions that had gone before, was that far too much was undertaken all at once. This was given particular encouragement at that time of generally rising inflation by the widely held belief that real property was the inflation hedge par excellence, a belief which seemed to command a blind adherence in some quarters.

A great deal of the financing was done by fringe financial institutions because the banking system proper—which traditionally had reservations on prudential grounds about becoming too heavily involved in development projects—had further been restrained from this type of lending by credit restrictions. The fringe obtained their finance, often for projects at the speculative end of the market, from the wholesale money markets which were then expanding rapidly.

With the clarity of hindsight— so often a 20/20 vision—the mistakes are obvious enough. Property values, even in a time of inflation, do not always rise smoothly and inexorably on a gradient leading to the right-hand corner of the graph. Money is not always and in all circumstances purchasable at a price, if the depositor suddenly loses his confidence in the taker. And short-term money-market funds are not the appropriate base for developments whose characteristic is often a relatively long time between conception and completion. There were lessons too about bringing fringe institutions within the supervisory framework and about the methods of supervision of the banking system proper. But that—although it has occupied some of our energies domestically and internationally—is another story.

It was to this inflationary and unstable situation that the first oil shock made its own special and unwelcome contribution—inflationary as to prices and deflationary as to activity.

A particular irony was that in many instances what had been seen as the best hedge against inflation furnished some of its most conspicuous victims. The experience of that period forced both the previous and the present governments to give increasing priority to defeating inflation and, as means to that end, to restoring and maintaining conditions of monetary stability.

I believe that you will share my conviction that if we are to enjoy a sustained period of non-inflationary growth we need a stable monetary environment. That has certainly been the Bank's objective under successive governments, and it explains the role given to monetary policy.

I am not open to a siren voice which would say—as once was fashionable—that inflation is good for property, at least as long as it remains moderate. The history I have recited contains the moral. Once inflation is entrenched in attitudes and expectations it displays a restless wish to break out and accelerate to ever higher levels. Its containment and defeat require unremitting efforts until the disease is finally driven out of the system. I do not believe that property markets can flourish long under conditions of inflation.

The return of positive real interest rates

Let me turn to where we now are. With the decline in inflation we are in a position where monetary policy, as expressed in the present target range for the relevant aggregates, will exercise a continuing downward pressure on inflation while at the same time allowing room for a measure of real growth. And indeed there are already signs that a recovery has begun. While there are exceptions, a number of other industrial countries seem to be similarly placed.

I want to consider with you some of the ways in which things may be different for you in such an environment.

Lower inflation has already brought lower interest rates. For the investor in property, as for development and investment decisions of all kinds, the important question is how much further interest rates will fall. Progress will depend heavily on the degree of assurance that inflation is securely under control. It is a sign of how deeply entrenched inflationary expectations had become in all our countries and how difficult it is to eradicate them that despite falls in the actual rates of inflation that have already occurred, nominal interest rates have remained stubbornly high. Reducing interest rates depends not only on the current rate of inflation at any time but also on the degree of public conviction that the stance of anti-inflationary policy will remain resolute.

No-one can claim to forecast these things. But it would, I suggest, be prudent to plan on the assumption that real interest rates will remain at least moderately positive. That would indeed be the desirable outcome. At times in the post-war period, real interest rates were zero or even negative. Positive real interest rates and low rates of inflation create a different environment for forward planning in the property business.

Restoration of rationality to investment and financing decisions

Given its relative security, property was traditionally seen as in a category similar to fixed interest investments. When inflation took off in the early 1970s, property acquired a speculative attraction.

The calculation is radically different for the developer and the investor alike in an environment of low inflation and moderately positive real interest rates. Property is recognised again as a relatively illiquid asset. The fundamentals again become important. The choices made by developers within property, and for investors as between property and other assets, have to be based on a longer view of competing real costs and real returns. The greater competition and selectivity to which this gives rise is in my view healthy.

The fluctuations in the property market over these years have inevitably caused changes in the sources of finance for the financing of property development. Leaving aside their lending against residential property, the banks have been much more cautious in terms of both the size and the quality of their exposure in the commercial property market. The long-term financial institutions have resumed their role as major investors in property. Property is being financed on a longer-term basis, which is as it should be.

What I am suggesting is that the disinflationary process is helping to restore rationality to investment and financing decisions. This is a result to be expected and greatly welcomed. For the dangers and disadvantages of inflation are precisely that it represents a very great source of insecurity, uncertainty and inefficiency. Nothing works as it should; what should be rational is made random; and planning for the future is frustrated.

The challenge ahead

You will know better than I what kinds of adjustment and flexibility this environment will call for on your side. I observe with interest, Mr President, that your Federation is undertaking a critical investigation into building costs and performance. As I understand it, this stems in part from your concern and recognition that, while individual specialisms have their own distinctive contribution to make, there may be scope for more effective teamwork and combined commitment, especially in work on larger projects.

No doubt there is need for similar teamwork in developing new projects and enterprise in many other areas of activity. The creation of business that will flourish in new areas of manufacturing and services often requires not only the provision of risk finance—vital though that is—but also the marriage of money, management and technological skill in teams set up to create and expand small businesses. More generally, it may also be that the proliferation of smaller units in manufacturing, whether as off-shoots from large firms or the creation of small new ones, will modify the requirements for factory and office accommodation; and create a need, for instance, for continued development of science and industrial parks and shorter leases, perhaps, for small businesses.

We in the City have been concerned with the application of information technology to office working methods. Something of a revolution may be in prospect. It seems reasonable to suppose that requirements for conventional offices may be reduced in some areas. But new technology will bring the development of new services and probably better working conditions—both factors tending to increase demand—very possibly more widely dispersed geographically.

Banking services throughout the country are also being affected by the new technology. The move towards electronic instead of paper transfer of funds will make it possible for banks to offer payments facilities at the places where people do their shopping, and to deal with their banking business at home. This too may have consequences for some of you.

But all these special instances, Mr President, I leave confidently in the hands of your members. I feel sure that the spirit of enterprise and the keenness to get things done that has long characterised your business will continue to do so; and I hope that you will be accompanied in this by your customers, who in fact comprise most of the rest of our economy. Without vigour and adaptability we will not be able to take advantage of the possibilities of the phase of change that lies ahead.