Concord Pacific Place on the North Shore of False Creek, Vancouver, July 2004 (Elvin Wyly).

The City as a Real Estate Growth Machine
Geography 350, *Introduction to Urban Geography*
Elvin Wyly

Harvey Molotch and the Growth Machine

In 1976, a delightful and fascinating article appeared in the *American Journal of Sociology*; Harvey Molotch's article offered a deceptively simple definition: "The City as a Growth Machine: Toward a Political Economy of Place."[1] For Molotch, "A city and, more generally, any locality, is conceived as the areal expression of the interests of some land-based elite. Such an elite is seen to profit through the intensification of the land use of the area in which its members hold a common interest. An elite competes with other land-based elites in an effort to have growth-inducing resources within its own area as opposed to that of another."[2] Molotch understood cities as interest-group mosaics: land-use patterns, he suggested, actually provided a map to the political and economic interests at work in a particular place. Business and property owners, and other elites who have interests in various land parcels, are always working to

[1] Harvey Molotch (1976). "The City as a Growth Machine: Toward a Political Economy of Place." *American Journal of Sociology* 82(2), 309-332.
[2] Molotch, "Growth Machine," p. 309.

enhance their individual *and collective* assets, as *communities* of land-based elites. "Each unit of a community strives, at the expense of the others, to enhance the land-use potential of the parcels with which it is associated ..." as, for example, "hotel owners on the north side of a city may compete with those on the south to get a conventional center built nearby...."[3] But Molotch was quick to point out that "Each member of a community is simultaneously the member of a number of others; hence, communities exist in a nested fashion (e.g., neighborhood within city within region)" and thus "subunits which are competitive with one another at one level (e.g., in an interblock dispute over where the bus stop should go) will be in coalition at a higher level (e.g., in an intercity rivalry over where the new port should go)."[4]

Molotch's great insight was to explain the strange bedfellows of politics in these coalitions, on certain issues and at a particular scale. Dominant interest groups -- wealthy corporate leaders, large bankers and insurers, large property owners, labor-union leaders, construction companies, newspapers and media companies, and local politicians across the entire ideological spectrum -- disagree on so many issues. But all of these warring interests suddenly and quite literally find common ground when it comes to the fortunes of their locality. All agree on the need to sustain growth, and to compete against other cities for new investment, plant relocations, or new residents. The essence of the city, for Molotch, is the growth machine: a pro-growth coalition of otherwise disparate and fighting interest groups who can mobilize around the shared drive for urban competition.

Molotch's "Growth Machine": local elites who might disagree on almost everything else will unite behind one shared motivation: the pursuit of local growth.

Molotch's article became deeply influential among sociologists who studied city politics, and also among political scientists who took an urban approach. The work became even more influential when Molotch co-authored *Urban Fortunes: The Political Economy of Place* with John Logan. But Molotch's original analysis placed great emphasis on 'smokestack-chasing' -- the practice by which cities compete for new industries and factory facilities.[5] Others who were inspired by Molotch's work, and by the Logan-Molotch work, continued this emphasis on the production side. Generations of students have paid careful attention to the dynamic coalitions of local elites who would compete with other cities to chase down a big industrial company and drag it home -- what one economic development expert has called "the great buffalo hunt."

[3] Molotch, "Growth Machine," p. 311.
[4] Molotch, "Growth Machine, p. 311.
[5] Indeed, much of the subtlety of Molotch's framework became apparent when he began to consider challenges to growth-machine politics. The intense smokestack-chasing efforts of many cities in the 1960s and 1970s provided vivid illustrations of the environmental consequences of industrialized urban growth, and played an important role in the rise of environmental activism and 'slow-growth' movements.

Real Estate and the Growth Machine

In recent years, it has become clear that we need to pay closer attention to some of the explicitly land-based aspects of the city as a growth machine. Although growth coalitions still compete intensely to attract all kinds of companies, the relative decline of heavy manufacturing and the rise of many postindustrial economic and social patterns has changed the relations between production and consumption. Under certain conditions, some cities are showing signs of becoming a particular type of growth machine: *a real-estate growth machine*. Molotch, to be sure, considered the importance of construction companies, commercial office-building owners, apartment-building owners, and real-estate brokers in his model of the growth machine. But now these coalitions seem to be changing, and in some cities, more and more households, firms, and investors are viewing the urban environment as a vehicle for capital accumulation through real estate. One hint appeared not long ago in the *National Post*:

> "The subject of houses was never out of her mind for more than a few minutes. She was a beautiful wife and mother, this neighbour I once knew, but what I remember most is her loving and always hopeful study of the market in residential real estate. Long before it was fashionable, she embodied the ethos of the housing market. Her family income was modest, but she wasn't going to let that limit their accommodation. She made it her business to know where the good houses were, which of them might be bargains, and which Toronto neighbourhoods were graduating from 'pleasant' to 'desirable.' When she moved, she carefully traded up, figuring out precisely how much investment in renovation would be needed to produce how much profit. She was the homeownership queen, the mortgage maven, and she always knew, within about 50¢, the amount of equity her family held in their current house. Eventually they moved to Vancouver, and one afternoon I visited her there. She was living high on a hill overlooking the harbour. She had about as good a view as anyone in Canada. It was perfect. But as she sat sipping wine on a wide, handsome deck, I imagined she was slowly, quietly putting together the pieces of yet another move on the real estate board."[6]

Canadian home prices have increased by fifty percent over the last decade, more than twice the pace of the TSX Composite. The total value of residential real estate transactions in Canada in the first five months of 2005 approached $38 billion, and most market indicators showed continued health through 2006 and 2007. Resale activity in July 2007 set a fourth consecutive monthly record.[7] Canadians have outstanding balances of more than $65 billion in home-equity lines of credit, and $277 billion in mortgages.[8]

What are the urban geographies of these enormous flows of capital and commitment?

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[6] Robert Fulford (2005). "Canada's Urban Gold Rush." *National Post*, October 1, A1, A8.
[7] Carla Wilson (2007). "Housing Market Remains Very Hot." *Times-Colonist* (Victoria), August 16, B2.
[8] Fulford, "Gold Rush," p. A8.

The Role of Urban Real Estate Markets

In an insightful chapter titled "Cities as Real Estate," John Miron suggests that "to understand cities is, in part, to know how land and buildings acquire monetary value and how this value influences what gets built, where, and why. The motivations of individuals, firms, and governments are central to this understanding."[9] There are compelling reasons to consider these motivations. Statistics Canada's National Balance Sheet measurements estimate the market value of residential structures at $1.80 trillion, and nonresidential structures an additional $1.59 trillion. Considering all structures and the value of land ($2.0 trillion), real estate amounts to $5.39 trillion. All assets -- including everything from savings and checking accounts, machinery and equipment, life insurance and pension funds, and all sorts of stock and bond investments -- add up to $22.9 trillion. Real estate thus accounts for about one-quarter (23.4 percent) of all assets in Canada.[10]

Real estate accounts for about one quarter of all assets in Canada.

But what does real estate do *in the city*? In the most abstract, theoretical terms, we can distinguish three essential functions of the urban real estate market.

The functions of urban real estate markets:

1. Provision of facilities to serve human needs -- such as buildings for companies and workers, houses and apartments for residents.

2. Allocation of land and location among competing uses.

3. Provision of opportunities for savings and investment.

1. First, it provides the facilities that serve the needs of the city's people -- commercial and office buildings for the city's companies and workers, residential houses and apartments for residents, etc.

2. Second, the real estate market helps to allocate land and location among competing uses: should a centrally-located plot of land be used for a community garden? A luxurious mansion? Low-income housing? An upscale apartment tower? A parking lot? In market economies, the answers to these questions are usually determined by ability to pay: real estate markets set prices for various locations,

[9] John Miron (2000). "Cities as Real Estate." In Trudi Bunting and Pierre Filion, editors, *Canadian Cities in Transition*. Don Mills, ON: Oxford University Press, pp. 154-172, quote from p. 154.
[10] Based on Miron, "Cities," updated with Statistics Canada (2011). *National Balance Sheet Accounts, Second Quarter 2011*. Ottawa: Statistics Canada, Table 65.

helping to screen among various competing potential land uses.

3. Third, urban real estate markets provide a setting for investment, and for a long-term store of value.

The spatial form of the city we see is, in large part, determined by the relations among these three functions, and the tensions involved in defining, protecting, or regulating real estate market processes. Here, we explore neoclassical economic approaches to understanding the urban land market, before considering a suite of alternative interpretations offered by urban political economy analysts. Then we turn our attention to contemporary examples of 'global' urban real estate markets.

Models of Urban Land Use

"Architect Frank Lloyd Wright predicted in the 1950s that the shape of cities would be decided by the winner of a race between the car and the elevator. 'Anyone who bets on the elevator is crazy,' he said.

China may prove him wrong. Some 350 million Chinese -- more than today's entire U.S. population -- will move to China's cities in the next 15 years, says consultant McKinsey & Co., and government measures to limit urban sprawl and protect farmland mean developers have to built up rather than out. McKinsey estimates as many as 50,000 skyscrapers will be built in China during that time, the equivalent of 10 Manhattans."[11]

Von Thünen's concept of ***location rent:***

1. Land uses determine land values, through farmers' competitive bidding.

2. Land values allocate land uses according to ability to pay.

3. For each land use, the competitive bidding process and different abilities to pay will trace out a curve that declines from a central market; the land uses with the steepest curves will capture the central locations.

Conventional accounts of urban real estate are based heavily on agricultural land use theory, first developed by Johann Heinrich Von Thünen. A German farmer in the early nineteenth century, Von Thünen became concerned with ways of improving the cost accounting used on his estate. He devised a way of understanding the relations among commodity prices, transportation costs, and farm-to-market distance in deciding the optimal use of a particular parcel of land. His concept of "location rent" defined the amount a farmer would be able to pay for a particular location and still make a reasonable profit; location rents decline for farms located farther from a market, and the rate of this decline is set by transport costs, tracing out a curve representing the location rents offered by farmers at different locations. Different crops have

[11] Jason Clenfield (2010). "Hyundai, Hitachi Vying to be Top Dog: Rising Giants Target Rising Elevator Demand." *National Post*, June 1, FP1, FP12.

different market prices, and hence different location rents; moreover, some crops are more expensive to transport than others, and so there are variations in the *rate of decline in location rent* as we go farther away from a central market. High-value crops that can be sold for a high price at the market, but that are difficult and costly to transport, will have the steepest curves. In the agricultural land market, then,

> "(1) land uses determine land values, through competitive bidding among farmers;
>
> (2) land values distribute land uses, according to their ability to pay;
>
> (3) the steeper curves capture the central locations."[12]

William Alonso reworked Von Thünen's agricultural theories to understand the structure of the ***city****:*

"if the curves of the business firms are steeper than those of residences, and the residential curves steeper than the agricultural, there will be business at the center of the city, surrounded by residences, and these will be surrounded by agriculture."

Von Thünen's concept of location rent became influential in agricultural economics, but seemed to have little applicability to urban questions. That began to change in the late 1950s, when analysts were studying new sources of information that revealed fine-grained patterns of land use, land value, and population and housing density inside cities. An urban economist named William Alonso adapted and refined the agricultural land use models, and formalized a modeling approach that became highly influential in economics, regional science, urban geography, and in city and regional planning.[13] Another analyst, Richard Muth, was working along the same lines, and sometimes the general approach is referred to as the "Alonso-Muth" model.[14]

Alonso begins with a series of simplifying assumptions that will help us to see general, organized patterns amidst the complexity of the urban world. First, Alonso assumes a city located on a flat, featureless plain -- such that transportation has the same cost and difficulty in all directions. All the city's employment is assumed to be at the center, in the "central business district" or CBD. People in the city ar all assumed to be economically rational -- competing to maximize their economic benefits and their satisfaction, while minimizing cost and effort. It is further assumed that there are no government restrictions on the use of land. Given these assumptions, Alonso

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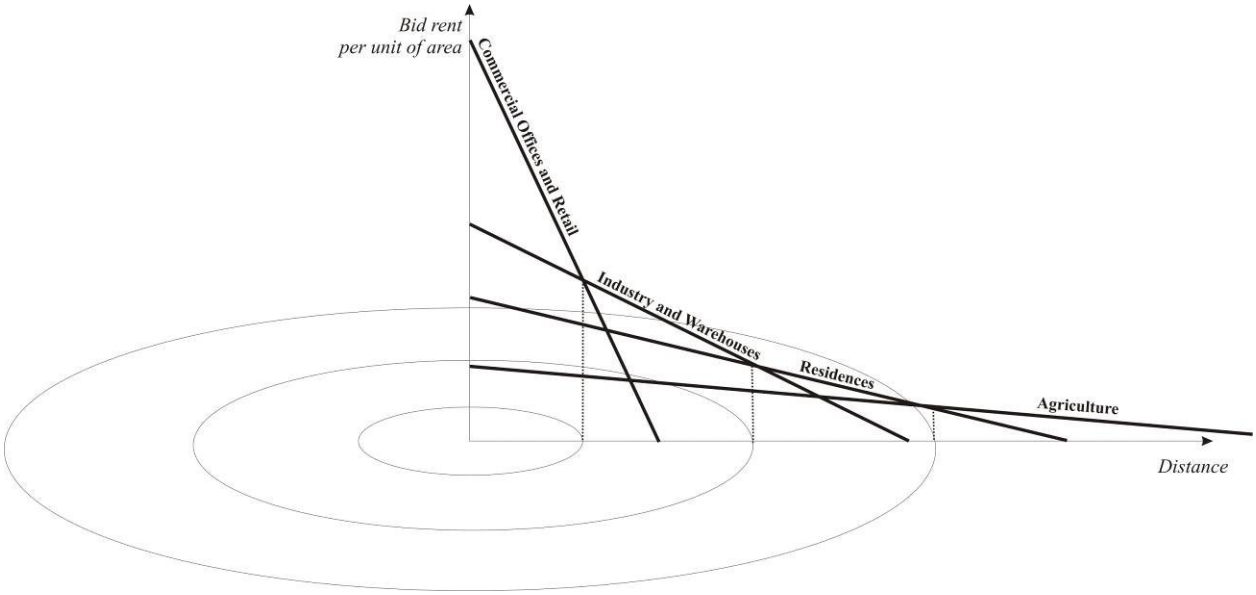
[12] William Alonso (1960). "A Theory of the Urban Land Market." *Papers and Proceedings of the Regional Science Association* 6, 149-157.
[13] William Alonso (1964). *Location and Land Use*. Cambridge, MA: Harvard University Press.
[14] Richard Muth (1969). *Cities and Housing*. Chicago: University of Chicago Press.

examined how different actors would compete for various locations. As in the case of Von Thünen's farmers, the key was competitive bidding:

> "For all types of land use, the most central sites will be the most attractive. Because of the geometry of the city there are relatively few central sites in relation to the total space available. As a result, competition for central sites will be intense, and the prices offered for them will be higher than those offered for less central sites. Different types of land users will place different financial evaluations on the utility of centrality, depending on their particular schedule of expected income and expenditures. It is logical, for example, to expect some offices, banks, hotels, and other establishments to be able and willing to outbid households for central sites because the extra income accruing to a central location through increased trade is likely to outweigh the savings in commuting costs obtained at the same site by a household..."[15]



The Classical, Mono-centric Alonso Bid-Rent Model. *Source:* Graphic by Elvin Wyly, based on William Alonso (1964). *Location and Land Use*. Cambridge, MA: Harvard University Press .

In more formal terms, "if the curves of the business firms are steeper than those of residences, and the residential curves steeper than the agricultural, there will be business at the center of the city, surrounded by residences, and these will be surrounded by agriculture."[16]

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[15] This is Knox and McCarthy's synthesis and review of Alonso's work. Paul Knox and Linda McCarthy (2005). *Urbanization*. Upper Saddle River, NJ: Prentice-Hall, quote from p. 134. Alonso summarized the contrasts between the agricultural and urban land use models this way: "The household differs from the farmer and the urban firm in that satisfaction rather than profits is the relevant criterion of optimal location. A consumer, given his income and his pattern of tastes, will seek to balance the costs and bother of commuting against the advantages of cheaper land with increasing distance from the center of the city and the satisfaction of more space for living. When the individual consumer faces a given pattern of land costs, his equilibrium location and the size of his site will be in terms of the marginal changes of these variables." Alonso, "A Theory," p. 154.

[16] Alonso, "A Theory," p. 156.

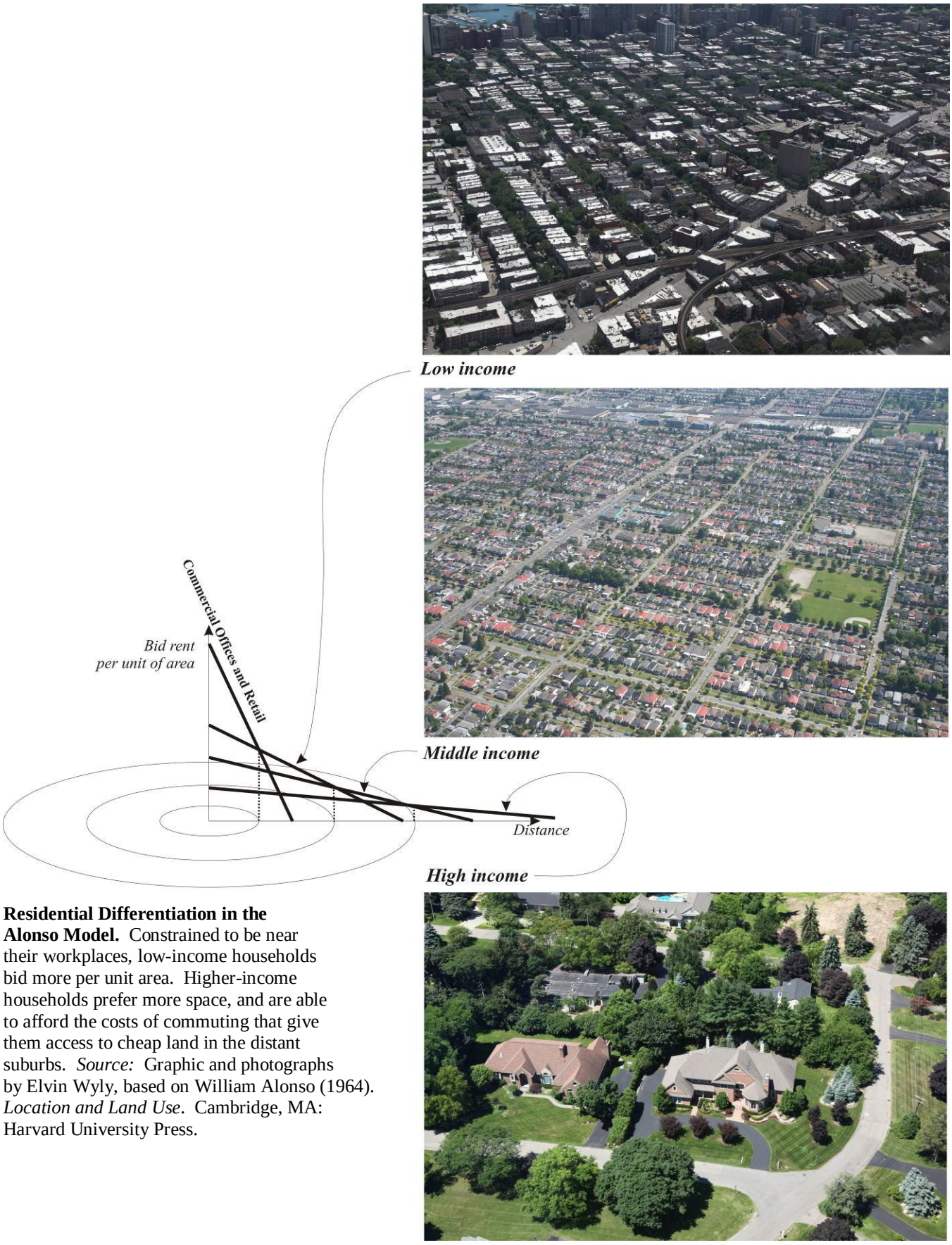
But Alonso also examined the behaviors of *different kinds of households*. Higher-income households can always outbid lower-income households at any location. But middle-income and higher-income households typically prefer large, detached houses on their own private lots -- and they are able to afford the costs of commuting and private automobile ownership. Middle- and higher-income households, then, are willing and able to choose locations farther away from the CBD to gain access to large, spacious parcels of land. There are systematic differences, then, in the bid-rent curves of different income groups:

> "...given two individuals of similar tastes, both of whom prefer living at low densities, if their incomes differ, the bid rent curves of the wealthier will be flatter that those of the man of lower income. Therefore, the poor will tend to central locations on expensive land and the rich to cheaper land on the periphery. The reason for this is not that the poor have greater purchasing power, but rather that they have steeper bid rent curves. This stems from the fact that, at any given location, the poor can buy less land than the rich, and since only a small quantity of land is involved, changes in its price are not as important for the poor as the costs and inconvenience of commuting. The rich, on the other hand, buy greater quantities of land, and are consequently affected by changes in its price to a greater degree."[17]

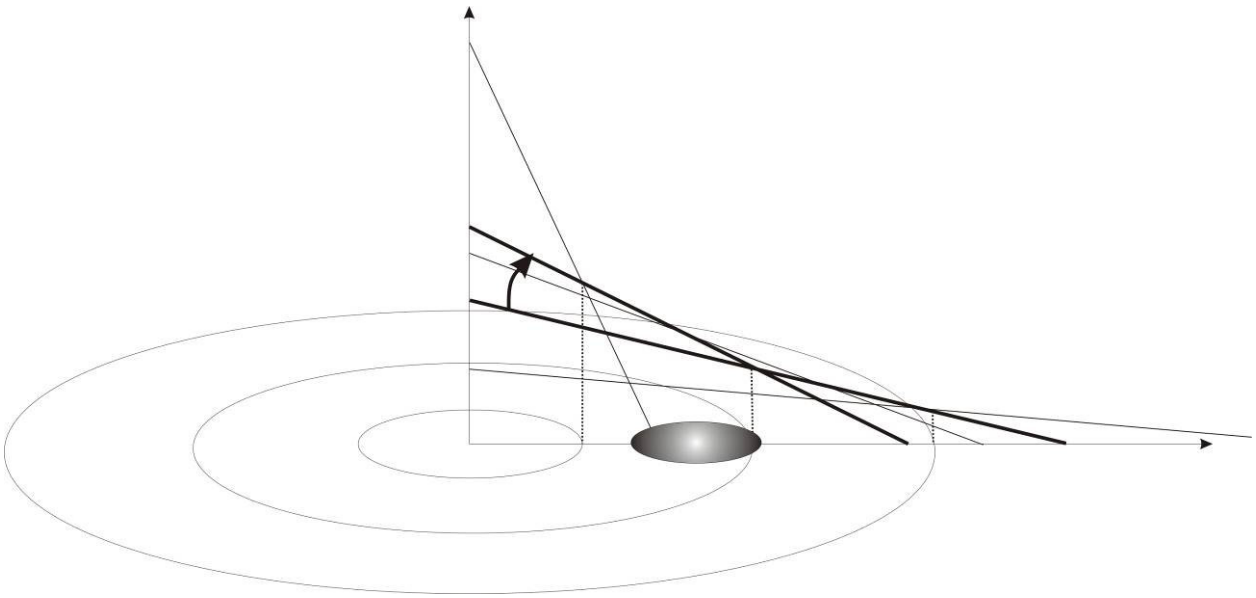
Alonso's model provided a compelling explanation of the paradox of poor people living on the most expensive urban land: by forcing the poor to live in tiny, run-down housing, slum landlords can maximize the return ***per unit of area.***

This formulation became the key to explaining the paradox of so many large cities: poor people living in centrally-located land -- land that by any expectation should be among the most valuable in the metropolis. The key issue here is to appreciate that all the bid-rent curves represent economic demand *per unit of area,* and so one way for poor people to live on expensive land involves over-crowding. Alonso's model thus became a highly influential way to account for the serious problems of concentrated inner-city poverty and 'slum' housing in many cities. The model became the foundation for urban planning principles, as well as general models of urban land use and urban transportation.

[17] Alonso, "A Theory, p. 156.



Residential Differentiation in the Alonso Model. Constrained to be near their workplaces, low-income households bid more per unit area. Higher-income households prefer more space, and are able to afford the costs of commuting that give them access to cheap land in the distant suburbs. *Source:* Graphic and photographs by Elvin Wyly, based on William Alonso (1964). *Location and Land Use*. Cambridge, MA: Harvard University Press.



Changes in Bid-Rent Patterns. If middle- or high-income households change their preferences and favor more central locations, their bid-rent curves will become steeper. Low-income residences will facing increasing competition and pressures for displacement from centrally-located residential areas. *Source:* Graphic by Elvin Wyly, based on William Alonso (1964). *Location and Land Use*. Cambridge, MA: Harvard University Press .

Alonso at Main and Hastings

It's worth taking a closer look at the Alonso paradox in local context. Vancouver has the highest housing prices in Canada, and my friend Jim Frankish once offered a humorous take on the model when he quipped that if you're looking for an affordable, middle-class house in this area, "it's beyond Hope." (Hope is more than 150 kilometers east of Vancouver on the Trans-Canada Highway.) After years of cheerleading the steady rise of house prices, the local press has begun highlighting the negative consequences. *Vancouver* magazine carried a front-page article on "why we're losing our best young people" because young professionals are forced to move away when they realize that Vancouver's high prices and crushing mortgage debt burdens will make it impossible for young families to buy homes.[18] The author profiled a struggling middle-income couple in their mid-thirties, unable to afford a home:

> "Tina and James are part of what, real-estate-wise, might be called Generation Fucked. As the city becomes a global 'lifestyle destination,' tens of thousands of middle-class households are getting a hard lesson in diminished expectations. Unless the members of Gen F want to raise their children in a one-bedroom condo, their salaries will qualify them to be no more than permanent renters in Vancouver. This is a well-known phenomenon in cities like Paris and New York, but it's a recent development here, taking an entire cohort in their 20s, 30s, and 40s by surprise."[19]

[18] Tyee Bridge (2011). "Going, Going, Gone." *Vancouver*, November, 68-78.
[19] Bridge, "Going," p. 70.

Note the implicit comparison between raising children in one-bedroom condos -- bad -- and the preferred alternative that is now so difficult for young people to attain. Traditionally, for most Canadians, this preferred alternative has been the detached single-family house with its own private yard. But is this the preference for all Vancouverites? Sustained high levels of immigration to Vancouver have deepened and refined a planning tradition of experimentation and creativity in urban design. Compared to the development industry in other cities, the industry here is far more willing to defy the old North American assumptions -- so long as the

100 Block of East Hastings, April 2008 (Elvin Wyly). Old inner-city housing can be big business.

overall real estate growth machine continues running at a healthy speed. This has meant that Vancouver is one of only a few cities in North American that has successfully defied the assumption that middle-class and wealthy homebuyers always prefer suburban single-family homes. Vancouver's development industry and local planning institutions have demonstrated the viability of high-density living for upper-middle-class and wealthy households, and there is also a growing emphasis on attracting families with children. There are now more than 9 thousand

married-couple families, and more than 4,500 children in the downtown core's new condominiums.[20] This suggests that Alonso's bid-rent curves may be changing.

Many of the region's poorest residents would agree with the upwardly mobile young professionals: something does seem to be changing in Vancouver's poorest neighborhood, the Downtown Eastside.

If you're in severe poverty in BC and you're able to qualify for social assistance, the maximum shelter rate is $325 per month. If you're able to qualify and you make it to the top of a waiting list that now has 13,400 names on it, you may get into BC Housing or one of the other social housing and "non-market" options in the Downtown Eastside.[21] There are 6,274 of these units in the neighborhood. If you have special needs -- a mental illness, addiction, the need to escape domestic violence -- you may qualify to get on the waiting list for one of the 844 community care facilities or group residences (CCGRs). But if you're just poor and you can't qualify for anything else, then one of your last housing options before homelessness might be one of the 3,827 single-room occupancy (SRO) units in the Downtown Eastside. These are typically 10' x 10' or 10' x 12', with a small sink; a shared bathroom is down the hall. The SROs are in a set of clusters of aging hotels built in the first decade of the twentieth century, and the rooms are often extremely dirty, dilapidated, and infested with rats or bedbugs. Yet these buildings remain lucrative, and Alonso helps us to understand why. One of the hotels shown in the image above is owned by a family widely described as a slum landlord, or "slumlord." The family also owns three other hotels in the area.[22] While the provincial welfare shelter allowance is meant to cover the full cost of recipients' housing expenses, these landlords (along with many others) have been able to increase many of their rents above $425 per month. If the landlords are able to get an overall average of $400 per month for each of the hotel's 171 units, that yields a monthly cash flow of $68,400. That's a revenue stream of $820,800 annually, and if total expenses can be kept down to $300,000, that's a net flow of $520,000.[23]

This makes it possible to calculate a very rough estimate of the value of this property to an investor. If the discount rate is 5 percent -- the annual rate of return that an investor will expect for putting money into this project -- then a net ongoing annual cash flow of $520,000 has a present value projected out to infinity of $10.4 million ($520,000 / 0.05 = $10,400,000). The tax-assessed value of the hotel, which was built in 1908, and the land is $7.32 million. It is not uncommon for property tax assessments to lag behind market values, and so it may be possible that the $10.4 million provides a more realistic estimate for this property. But it is also possible that investors demand a higher rate of return than 5 percent. A 7 percent discount rate would translate a $520,000 annual cash flow into a market price of $7.43 million. Historically, a discount rate of 6 or 7 percent was common in the rental real estate market; but the massive turbulence in world financial markets in the last few years has made many investors happy to

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[20] Derived from figures reported in City of Vancouver Economic Development (2009). *Bizmap Market Area Profile: Downtown Vancouver (DVBIA).* Vancouver: City of Vancouver, p. 4.
[21] Waiting list as of May, 2008. See Seth Klein and Lorraine Capas (2011). *Unpacking the Housing Numbers: How Much New Social Housing is BC Building?* Vancouver: Canadian Centre for Policy Alternatives, p. 2.
[22] Jean Swanson and Wendy Pedersen (2009). *Still Losing Hotel Rooms.* Vancouver: Carnegie Community Action Project. See also Sean Condon (2008). "A City Soft on Slumlords." *The Tyee*, November 10.
[23] These figures do not consider an additional stream of revenues (and expenses): the pub, with a capacity of 280 seats.

park their money for much lower rates so long as the principal is safe. There's a good chance that today's rental discount rate is significantly lower than 5 percent.[24]

Now compare the monthly yield per square foot at this SRO -- $10.94 per month for every square foot of the 50' x 125' parcel -- with what we might find at the very top of the region's housing market. There's a beautiful house with a 180-degree views of the city from West Vancouver, one of Canada's wealthiest neighborhoods and along the coast of the North Shore mountains. The house is in the legendary British Properties, and it has 3 bedrooms, 2.5 baths, and 2 fireplaces. The rent is $4,600 per month. If we ignore the value of the private lot, the house's 3,419 square feet each generate a monthly return of $1.34.[25] If the yard is indeed regarded as important enough to count as an attraction to potential renters, then the per-square-foot return nosedives; assuming a quarter-acre lot (10,890 square feet), this suburban bastion of Anglophile luxury yields a rental income of just 42 cents per month per square foot. This is only 3.8 cents on the dollar compared to the East Hastings property. Alonso reminds us: distance -- moving out from the urban core to the suburbs -- buys a lot of cheap space, encouraging large houses on large lots. Accessibility has a high price for people who prefer or who need to be close in, even if that need results from the location of crucial social services, or from the history of city-building that resulted in the central locations of the SRO hotels. This is the Alonso paradox: the poorest people living on the most expensive land.[26] On a per square foot basis, Vancouver's poorest neighborhood yields at least 8 times more ground rent than the region's wealthiest suburbs. Even if we adjust for the fact that valuable land encourages builders to construct vertical imitations of yet more land -- the nine stories of the hotel, each with more square feet of revenue-producing living space -- the per-square foot monthly return is still more than the wealthy suburb ($2.11 vs. $1.34 for the British Properties house, and $0.42 if the beautiful lot is also counted).

On a per-square foot basis, land in one of Canada's poorest neighborhood yields much more economic rent than land in suburban West Vancouver, one of Canada's richest neighborhoods.

Yet Alonso also reminds us that the bid-rent curves can change. The Downtown Eastside now has 17,700 market rental and owner-occupied units, outnumbering the non-market housing

[24] It is also possible that our estimate of the landlord's expenses is too low. Unfortunately, it is very difficult to obtain reliable information on these costs. We can look to a housing studies classic for a very rough estimate, based on a detailed survey of landlords in New York City in the late 1960s. Vancouver's expenses are likely to be much lower than those in New York. But if the expenses are towards the top end of the New York survey results, this would mean expenses of 66.7 percent, a net revenue stream of about $273,000, and a valuation (assuming a 5 percent discount rate) of $5.46 million. Expenses at the lower range of the New York results (53 percent) would yield an annual net rental income of about $386,000 and a valuation of $7.71 million. See George Sternlieb (1972). *The Urban Housing Dilemma*. New York: Housing and Development Administration, City of New York, p. 596.

[25] This also assumes no operating expenses or other deductions that reduce net rental income. This exclusion builds in a conservative bias for our comparison -- giving full credit to the slumlords for the higher cost of doing business in the inner city.

[26] This scenario is based on information in City of Vancouver (2010). *2009 Survey of Low-Income Housing in the Downtown Core*. Vancouver: City of Vancouver, Housing Policy Community Services Group. See also Miron, "Cities."

supply. In recent years, the number of new social housing units built or converted to make up for lost and closed units is only one-third the rate of new market condo construction. The community has become an epicenter of controversies over gentrification.

The Beasley, downtown Vancouver, September 2010 (Elvin Wyly).

Limitations and Alternatives

This approach has been subjected to a number of criticisms. Several issues have been raised as limited, 'internal' critiques that do not challenge the essence of the model (only its details). Most of those who borrowed Alonso's models used only the mono-centric version (even though his 1964 book also included a detailed discussion of multiple centers). In the 1970s and 1980s, analysts sought to refine the polycentric model specification to account for the development of economically autonomous suburbs and "edge cities." Similarly, the energy crisis of the 1970s initiated broad interest in the effect of transport costs on urban land market structure. A broad stream of urban modeling emerged in these years to predict the long-term effects on cities, but

within a few years petroleum costs began to fall once again.[27] Another criticism of the models comes from John Miron's work; as he points out, the model is useful, but presumes the existence of a supply of developed land or housing. Much of Miron's work is concerned with analyzing the decisions and constraints faced by developers and investors who are involved in creating that supply of useable urban land.

More fundamental critiques began with David Harvey's landmark 1973 book, *Social Justice and the City*. Harvey reviewed the urban economic models that were becoming dominant at this point in time, and emphasized how they provided accurate *descriptions* of shocking inequalities in the city -- but they really didn't explain much. Harvey emphasized that the models explained how the preferences of the rich established the constraints for the poor, and so any shift in the elite preference curve would force all other lower classes to adjust their own residential locations. "If congestion costs increase ... for example, and the rich decide that the time and frustration are not worth it, then they can with ease alter their bid rent function and move back into the centre of the city."[28] Harvey aimed his critique at Richard Muth, an economist who was working on models quite similar to Alonso:

> "Let us go back to Muth's (1969) presentation of the Von Thünen theory. After an analytic presentation of the theory, Muth seeks to evaluate the empirical relevance of the theory by testing it against the existing structure of residential land use in Chicago. His tests indicate that the theory is broadly correct, with, however, certain deviations explicable by such things as racial discrimination in the housing market. We may thus infer that the theory is a true theory. This trust, arrived at by classical positivist means, can be used to help us identify the problem. What for Muth was a successful test of a social theory becomes for us an indicator of what the problem is. The theory predicts that poor groups must, of necessity, live where they can least afford to live.
>
> Our objective is to eliminate ghettos. Therefore, the only valid policy with respect to this objective is to eliminate the conditions which give rise to the truth of the theory. In other words, we wish the Von Thünen theory of the urban land market to become not true. The simplest approach here is to eliminate those mechanisms which serve to generate the theory. The mechanism in this case is very simple -- competitive bidding for the use of the land."[29]

Harvey's analysis went far beyond critique. In dozens of articles and books from the 1970s through the 1990s, he developed a comprehensive alternative theory of the urban real estate market as a key feature of advanced capitalism. The key point for Harvey is the inescapable contradictions between two of the three main functions of real estate markets that began our discussion -- the provision of spaces and places for economic and social needs, on the one hand,

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[27] Inflation-adjusted gasoline costs in the United States fell from the early 1980s to the lowest point ever recorded in 1998, before beginning a steady rise after 2001. Oil was trading at about $11 per barrel in 1998. In the summer of 2008, oil traded briefly above $160 per barrel. Dramatic increases in petroleum and gasoline costs in recent years have revived many of the old concerns about the costs of commuting, and the effects on households' ability to afford residences in suburbs that have been built at ever-greater distances from central job concentrations.
[28] David Harvey (1973). *Social Justice and the City*. London: Arnold, p. 135.
[29] Harvey, *Social Justice*, pp. 136-137.

versus the need for investment and capital accumulation on the other hand. The dynamic tension between the use value and exchange value of urban land is at the root of urban change -- and thus, urban inequality and political struggle. **Real estate functions as a sort of safety-valve for capital in times of crisis: as profit rates fall in the 'first circuit' of industrial production, capital must seek higher rates of return in the 'second circuit' (the built environment, fixed capital for production and consumption) or the 'third circuit' (science and technology, research and development, etc.).** For Harvey, then, real-estate building booms provide vivid warning signs of crisis in capital accumulation: falling rates of profit encourage massive capital switching, but then overinvestment and overbidding in the real estate market depresses profit rates here too.

Harvey's revolutionary challenge: the Von Thünen / Alonso theory is a true theory, in terms of explaining the situation. "The theory predicts that poor groups must, of necessity, live where they can least afford to live." But if we are to solve the problem, "the only valid policy is to eliminate the conditions which give rise to the truth of the theory. ***In other words, we wish the Von Thünen theory of the urban land market to become not true.*** *The simplest approach here is to eliminate ... competitive bidding for the use of land."*

Harvey's "capital-switching" theory: real-estate functions as a last-ditch source of profitability in economic cycles. As the rate of profit falls in the 'first circuit' of industrial production, capital seeks higher rates of return in speculative investments in the 'second circuit' of the built environment -- housing, office buildings, and land.

The Restless Urban Landscape

Changes in urban real estate markets in recent years have made this area of urban geography an exciting and vibrant literature. There has been a great deal of change, and because the restructuring of real estate markets is highly visible, and has so many serious material implications for so many different people, it attracts a lot of attention from urban geographers, housing economists, business-school analysts, and industry observers. Recent literature on the restructuring of urban housing markets is diverse, interdisciplinary, and sometimes contradictory, but one of the best ways of summarizing the main theme comes from Paul Knox's work on the "restless urban landscape." Knox argues that the built environment provides a useful mirror of underlying changes in economy, society, demography, and culture. A restless urban landscape results from turbulent transformations of the economy and culture of the society that produced the urban landscape.

Knox also believes that we can only get so far trying to analyze real estate markets as the product of one-dimensional, profit-maximizing consumers, investors, and developers (whether one chooses to use the framework of Alonso-Muth, or Harvey). Knox notes that "The restlessness of the

built environment has been complicated by the fact that some property owners do not behave 'rationally.' Rather than treating property purely as a financial asset, they may treat it in part as a source of social status, political influence, or 'pocket money,' thus failing to respond (or responding only belatedly) to changes in market conditions."[30] Anne Haila, a prominent analyst of urban real estate markets, suggests that we need to understand the multiplicity of actors and investors involved in the market -- and their varied intentions. Although many of these intentions may add up to a certain level of economic rationality, there are wide variations in the purposes of different kinds of intentions and time horizons:

> "A piece of land can be acquired and a building can be constructed for occupation (use) or for monetary return (exchange) or when sold (capital gain, defined as the difference between the purchase price and the resale price). An investor acquiring real property and developing it can be oriented towards satisfying a present need or receiving a short-term revenue (present), or can expect to receive benefit or revenue in the long term (future)."[31]

In other work, Knox has taken some of Haila's ideas even further, providing an extended argument that changes in urban real estate markets -- the shifting calculus of economic rationality combined with greater uncertainty in future demand and profitability in new kinds of industries -- provide a barometer of changes in capitalism itself.

Bubbles?

In recent years, urban real estate markets in the developed world have experienced three important changes. These changes have been important in many countries, but have been especially pronounced in the U.S. and Canada:

> 1. First, city and suburban real estate markets are now heavily *securitized*, meaning that individual financial obligations are packaged and sold as financial instruments and investments on stock and bond markets.
>
> 2. Second, securitization means that neighborhood housing markets are now more closely integrated with global capital-market processes.
>
> 3. Third, all of these shifts mean that the tensions between **use value** and **exchange value** are more tightly wound than ever before. Winners are winning more than they ever could have imagined. But losers are finding themselves increasingly pressured in ever more competitive housing markets.

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[30] Paul Knox (1993). *Urbanization*. Upper Saddle River, NJ: Prentice-Hall, p. 177.
[31] Anne Haila (1991). "Four Types of Investment in Land and Property." *International Journal of Urban and Regional Research* 15, p. 348.

In Canada, these trends have intersected in several growing concerns. Many analysts have noted that the increased integration of local housing markets into transnational flows has meant that housing is becoming an ever more important axis of social inequality. One recent study compared the total wealth of the poorest one-quarter of Canadian owners (owners with household incomes at the 25th percentile), with the richest renters (renters with incomes at the 75th percentile). The low-income owners had total assets of more than $143,000, not counting retirement pensions: just over $100,00 in housing wealth, and about $43,000 in other assets. For the higher-income renters, however, total assets were only $52,000.[32] In turn, the increasing role of home equity in patterns of inequality has generated two distinct controversies.

Changes in contemporary urban real estate markets:

1. City and suburban buildings are heavily securitized -- with individual transactions and obligations converted to tradable financial instruments.

2. Securitization has integrated local real estate with global financial investment markets -- increasing the availability of capital as well as its volatility.

3. The tensions between use value and exchange value have been worsened, magnifying inequality and political conflict.

1. First, rising prices have led to fears among those who are trying to buy their own home, but cannot afford to do so. In expensive metropolitan housing markets, middle-income families are faced with more difficult choices as Alonso-style bid-rent curves go higher 'up' and farther 'out' from the old city centre. My colleague Jim Frankish jokes that if you're middle-class in search of an affordable house in the Lower Mainland, it's beyond Hope.

2. Second, for those on the verge of buying a home, or who have recently juggled things to come up with the required downpayment, there is increasing anxiety about how high prices have gone. *Have we paid too much? Will house prices suddenly fall, leaving us owing more on the house than it could be sold for? Are we in a housing bubble?* The answers to these questions have enormous consequences for households. **Timing matters a great deal**, and it matters in different ways in different cities. After adjusting for inflation,[33] households "who bought houses in Vancouver or Calgary at the height of the boom in 1981-82 did

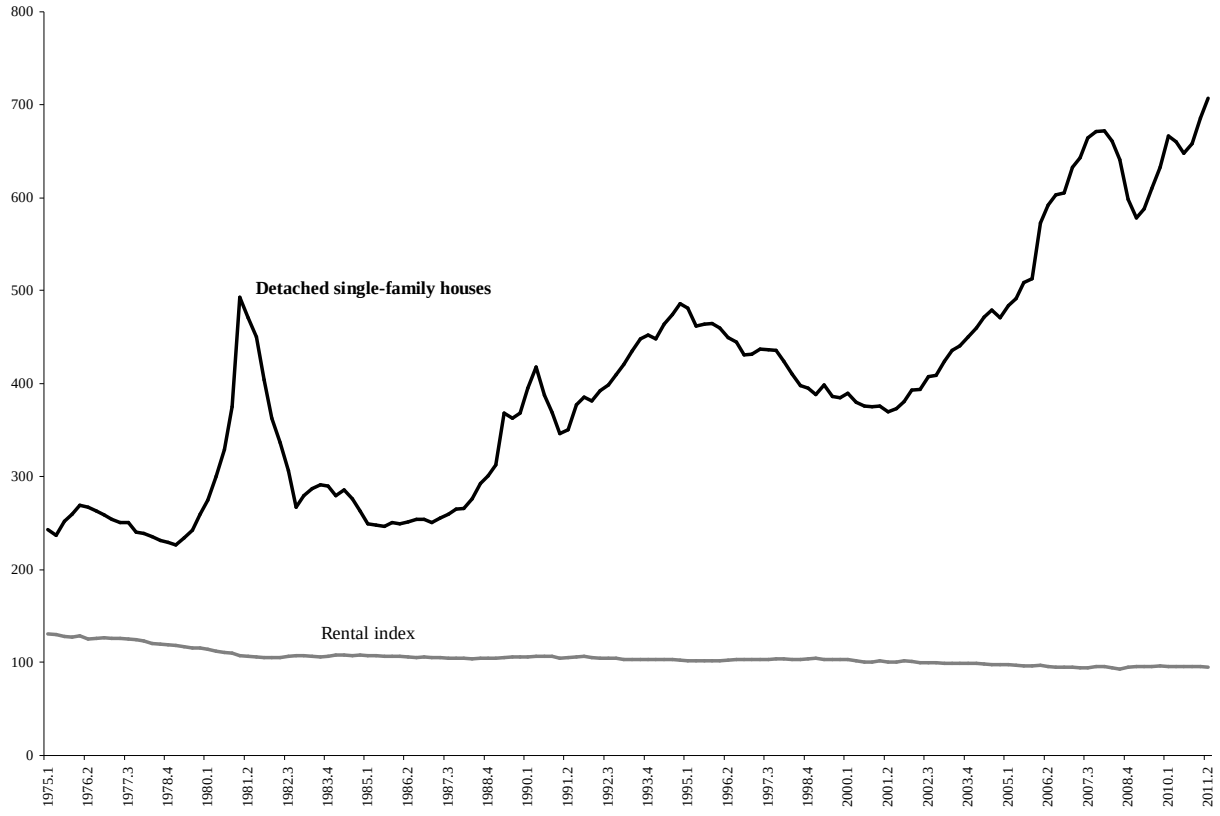
[32] Tsur Somerville, Li Qiang, and Pualina Teller (2007). *Are Renters Being Left Behind? Homeownership and Wealth Accumulation in Canadian Cities.* Discussion Paper 2007-01. Vancouver: Centre for Urban Economics and Real Estate, Sauder School of Business, University of British Columbia, p. 3.

[33] Housing economists usually refer to unadjusted house prices as "nominal" prices, and inflation-adjusted prices as "real."

> not see real house prices return to that level until 2005," while households "who purchased housing in Montreal or Toronto in 1989 would experience falling real house prices through 1997."[34]

In general, Tsur Somerville cautions against trying to make firm predictions about a housing bubble for Vancouver, but sees few signs that homes are overvalued at anything like the level they were in 1981 and 1982. Still, the inflation-adjusted trends suggest we may be getting close (see below).

Several considerations are important. First, 'bubbles' are extremely difficult to identify except in retrospect. Second, bubbles cannot be simply equated with rapid price increases: all else constant, when interest rates fall, prices will rise because a given household debt burden can finance a more expensive purchase. Third, bubbles are most pronounced when prices go well beyond what could be expected on the basis of underlying economic 'fundamentals' for an urban market – population or employment growth, inflation-adjusted growth in household incomes. Somerville sees no alarming signs of dramatic increases unjustified by economic fundamentals, but there are reasons to anticipate a slowdown in the rate of house-price appreciation.



Vancouver's Real Estate Boom: House prices and rental index rates are adjusted for inflation. *Data Source:* Tsuriel Somerville (2011). *UBC Center for Urban Economics and Real Estate Calculations of Royal LePage Survey of Canadian House Prices, and CMHC Data Via CanSim.* Vancouver: Centre for Urban Economics and Real Estate, University of British Columbia.

[34] Somerville et al., *Are Renters Being Left Behind?*, p. 5.

The U.S. Bubble and the Great Panic of 2007-2008

But anxieties have been more pronounced in the United States, and for good reason. Housing booms are nothing new, but certain aspects of urban housing markets seemed to display new types of behavior beginning with the short recession in 2001-2002. As the economy slid into recession and the stock markets declined, housing became an ever more popular investment vehicle. "Housing bubble" began to proliferate in financial headlines in 2002, and concerns intensified through 2003 and 2004.[35] When rising oil prices and healthy Gross Domestic Product (GDP) growth finally led the U.S. Federal Reserve Board to change course and hike the discount rate by a quarter-point at the end of June, 2004, the new alignments of capital and housing had become apparent nationwide. Particularly vivid instances of speculation appeared in New York, Chicago, Los Angeles, Miami, San Diego, and dozens of upscale resort communities. At the same time, however, massive shifts in fiscal policy and global financial and trade relations weakened the Fed's hand. Among other factors, the Chinese central bank's voracious appetite for U.S. Treasuries (a longtime tactic designed to maintain a low yuan and protect export market share) kept bond yields low and fed trillions of dollars in cheap credit to American homeowners. Mortgage rates refused to budge even as the Fed repeatedly raised short-term rates in 2004 and 2005, and in rare moments of clarity Alan Greenspan (Chairman of the Federal Reserve) admitted to almost complete confusion. He began to take notice of the new alignments of housing and capital that had been apparent as early as 2001 in New York.

By early 2005, Greenspan was assuring U.S. Senators that "the rapid rise in home prices over the past several years has provided households with considerable capital gains" and that dramatic innovations in housing finance "allowed greater access to that wealth"; but it was precisely those innovations that stood in the way of the Fed's tightened policy, and "For the moment, the broadly unanticipated behavior of world bond markets remains a conundrum."[36] A few more months of accelerated housing market

"Q: I have heard that the U.S. will bottom in February... House prices are as low as $25,000. I also heard about foreclosures. Do you think it wise to look there now?

A: Wow! In February, eh? First, the U.S. is a big place, markets that had the biggest price collapses -- Miami, Phoenix, Las Vegas and parts of California -- have bottomed right now. Second, every state is different for Canadians. In California you must declare your world income, in Florida your property taxes are more than double for a Floridian. Third, that $25,000 house (likely in Detroit) you can only visit with a gun in your pocket. Fourth, in my Real Estate Investment Course I tell my students that if they do not look at the property they want to buy for themselves, I am going to hit them with my laptop. Whether it is a foreclosure or not. But particularly if it is a foreclosure."

Ozzie Jurock (2010). "Real Estate Advice." *Westcoast Homes & Design*, Fall 2010. Vancouver: Pacific Newspaper Group, 82-83, quote from p. 83.

[35] In mid-2005, Robert Shiller tabulated counts of the phrase "housing bubble" in major world newspapers in the month of May, 2001 (zero), with the count jumping in the next two years to 18 and 20, and then to 35 (May, 2004) and 77 (May, 2005). Robert J. Schiller (2005), "Media Bubble?" *New York Times*, June 10.

[36] Alan Greenspan (2005), *Statement Before the Committee on Banking, Housing, and Urban Affairs*. U.S. Senate, February 16. Washington, DC: Board of Governors of the Federal Reserve System. Quotes from p. 2, 8.

inflation and falling mortgage rates alarmed the usually unruffled Chairman, who told Congress in June, 2005 that the stubborn behavior of bond investors "is clearly without recent precedent," and that exceptionally low rates "have been a major factor in the recent surge of homebuilding and home turnover, and especially in the steep climb in home prices."[37] Greenspan was exceedingly careful to dismiss the growing chorus of economists and journalists who saw the dot-com bubble inflating in the housing market. Curiously, the Chairman emphasized geography. A national bubble was unlikely, he said, but "there do appear to be, at a minimum, signs of froth in some local markets where home prices seem to have risen to unsustainable levels."[38] Greenspan offered a brief neoclassical economic explanation (transaction costs, local markets, un-movable commodities) to bolster the assurance that housing was relatively immune to speculative excess. But he quickly added that the increasing turnover in vacation properties and second homes was not bound by the same constraints, and he expressed worries about all of those wonderful market innovations he had once praised -- especially "exotic" forms of adjustable-rate and interest-only mortgages: "The apparent froth in housing markets may have spilled over into mortgage markets."[39]

These trends seem to provide strong evidence in support of Harvey's theories of capital-switching. The recession also turbocharged the market for existing homes, and pushed household debt to unprecedented levels. Mortgage debt mushroomed by $850 billion in only two years, and in 2001 the number of refinanced loans quadrupled to more than 11 million.[40] Millions of existing owners tapped the accumulated windfall created by several years of rapid appreciation, and took "cash-out" refinances to pay off credit card debt or to spend on current consumption. But low interest rates also allowed new buyers and trade-up households to bid home prices ever higher through the recession. Even more ominous were signs that irrational exuberance was beginning to infect housing markets. From the end of 1999 through the first quarter of 2001 total household wealth in equities and mutual funds dipped from $12.3 trillion to $8.7 trillion, while housing equity jumped from $5.4 trillion to $6.2 trillion.[41] Financial analysts who had spent the late nineties warning of a stock market bubble turned their attention to housing, and within a few years the quick-spec, same-day resale of homes was being called "an early-21st-century version of day trading. Buying stocks on margin has morphed into buying homes with no money down."[42] At present growth rates, the total U.S. mortgage balance will soon exceed $10 trillion. These figures cannot be dismissed as a product of general economic

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[37] Alan Greenspan (2005), *Testimony on Economic Outlook, Before the Joint Economic Committee*, U.S. Congress. June 9. Washington, DC: Board of Governors of the Federal Reserve System. Quote from p. 2.

[38] *Ibid.*, p. 2. Greenspan's June, 2005 testimony is particularly revealing; more than half of his prepared remarks focused on the housing bubble controversy, and he cited mortgage market innovations as both a cause of speculative behavior and a protection against macroeconomic shock if values were to decline.

[39] *Ibid.*, p. 2.

[40] Akash Deep and Dietrich Domanski (2002), "Housing Markets and Economic Growth: Lessons from the U.S. Refinancing Boom." *Bank for International Settlements Quarterly Review*, September, 37-45. "...instead of declining, as was the case in past recessions, household liabilities have risen to an all-time high of 106% relative to disposable income." (p. 38).

[41] Federal Reserve flow-of-funds data cited in Gerard Baker (2001), "The American Economy Remortgaged." *Financial Times*, August 17, 11.

[42] Motoko Rich and David Leonhardt (2005), "Trading Places: Real Estate Instead of Dot-Coms." *New York Times*, March 25, A1, C2, quote from A1.

growth: total mortgage debt at the end of 2003 stood at 65.3 percent of gross domestic product, up from 46.8 percent only a decade earlier.[43]

This upward trend continued far longer than most analysts continued. Moreover, a significant part of the boom in mortgage lending and credit began to involve "subprime" loans. "Subprime" does not refer to a below-prime interest rate mortgage, but rather the lending industry's judgment of the quality of the borrowers: subprime borrowers are mostly low-income people with poor credit histories and limited savings, who cannot afford to make a sizeable down payment. Subprime lending involves extending credit to these low-income, credit-blemished borrowers while charging higher interest rates to cover the greater risk of delinquency and default. For years, though, subprime lending caused great controversy: it allowed people to gain access to credit who would otherwise be excluded from the "prime" market, but unfortunately it also involved a wide range of deceptive, fraudulent practices that, paradoxically, made it possible for parts of the lending industry to earn large profits by making high-risk loans that were almost certain to fail. This abusive syndrome is known as **predatory lending**, and many experts had been asking, for many years, for changes in government regulations to outlaw some of the worst practices. Many conservative economists and policymakers rejected calls for regulation, however, on the grounds that the subprime market should be understood as an *innovation* -- new types of loan products, and the sharing of risks by investors buying and selling mortgages on the secondary market, were providing credit to more and more people, and the self-interest of investors carefully evaluating all the risks and rewards would provide the best kind of 'self-regulation' that would root out any improper lending practices. Among many other high-level officials in Washington, Alan Greenspan agreed with this free-market, deregulation approach, and thus there was very little regulation of the increasingly risky practices going on.

What explains the paradox of lenders eager to make loans that would never be repaid? The new industry structure had severed the connections that had once ensured that lenders made sure that a loan would be sustainable over the long term. Securitization -- that packaging of mortgages sold on Wall Street and other global financial markets -- meant that a local mortgage lender could make a loan to a local borrower, sell the obligation to an institution on Wall Street, and take the proceeds to make another round of loans. If a borrower fell behind on the payments, a lender could go back and offer another refinance deal -- and pack in another round of hidden fees that are charged against a borrower's home equity (the difference between the market value of a home and the total amount owed on the mortgage). As long as national house prices continued to increase each year, even when a borrower would fall behind and run out of home equity, the homeowner could be forced into a 'distress resale' that would fetch enough money to pay off the total mortgage -- avoiding all the legal costs of foreclosure, and avoiding any losses for the lender that made the loan, or the Wall Street institution that bought it. The only loser in this situation, of course, is the homeowner. And to make matters worse, subprime and predatory lenders had, for years, targeted African American and Hispanic/Latino households for the riskiest loan products -- stripping out home equity and worsening the risks of default, delinquency, and foreclosure in communities that had suffered for so many years from <u>exclusion</u> from mainstream credit markets.

[43] This figure has grown steadily since 1945 (when it stood at 10.0 percent), but was interrupted by the double-dip recession of 1980 and 1981-1982, and a very slight decline from 46.8 percent in 1993 to 46.6 percent the next year.

National house prices in the U.S. continued rising year after year until the middle of 2005. But the Wall Street machine that provided capital to make mortgage loans kept going, because for many years the packages of mortgages sold on world financial markets had been regarded as very safe -- and they had provided investors with yields that were substantially better than many alternative investments. So the lending institutions that had been making loans and quickly selling them to Wall Street kept going, and in many cases became even more aggressive in seeking out borrowers who could be put into creatively-packaged mortgages that could be sold on to investors. One notorious example was a lender that advertised what it called a NINJA loan: No Income, No Job or Assets.

The Great Panic of 2007-2008

Financial analysts joke that rising house prices forgive all sins -- because even the most unhealthy transactions can earn short-term profits while avoiding losses for lenders or investors. But as the national house price boom peaked, things changed very quickly. At the end of February, 2007, the global banking giant HSBC issued its first-ever profit warning to investors -- and noted that the losses were confined mainly to the bank's U.S. operations, and specifically, the operations of a subprime lender that HSBC had purchased several years earlier. Stock analysts and investors began to look closely at the details of many of the subprime loans, and they were shocked by what they found. In New York, the Dow Jones Industrial Average slid by 415 points in a single day, and the New York Times' breathless lead -- "Stock markets around the world plummeted yesterday in a wave of selling"[44] -- wound up serving as a vivid preview for all of the dramatic events of 2007 and 2008 that are now described on the front page of the *Wall Street Journal*, the most conservative major newspaper in America, as the worst financial crisis since the Great Depression.[45] First a wave of bankruptcies swept through the lightly-regulated non-bank mortgage companies that dominated the subprime and predatory business. Then, rising defaults and foreclosures worsened MBS losses, and threatened the off-balance sheet structured investment vehicles (SIVs) that Wall Street investment banks had devised to avoid regulation and disclosure of what had been such a lucrative new line of business. MBS and SIV losses undermined unregulated hedge funds, and began to trigger mounting losses in the equally unregulated and opaque web of insurance promises that banks and SIVs had purchased in the $60-trillion global credit default swaps (CDS) market. Banks, hedge funds, and other institutions reluctantly began writing down mortgage-related assets -- which for publicly traded companies involved a long, slow parade at each quarterly filing deadline that eventually reached some $500 billion by September, 2008. Thanks to the regulatory vacuum and the absence of disclosure requirements on SIVs, CDOs, CDSs, and all the other specialized acronyms of Wall Street's financial innovations, banks and institutional investors around the world began to hoard capital amidst contagious suspicion: no one could predict who would take the next writeoff, or even who would survive. Every financial transaction requires the acceptance of risk, and the spreading realization that new elements of the global financial system had been built on the foundation of sophisticated subprime risk models that earned top grades from bond-ratings agencies before imploding horrified bankers and investors. Risk was re-defined and re-learned

[44] Floyd Norris and Jeremy W. Peters (2007). "Slide on Wall Street Adds to Worries About Economy: Dow Tumbles 416 Points." *New York Times*, February 28, A1, C16.
[45] Richard Pérez-Peña (2008). "Amid Market Turmoil, Some Journalists Try to Tone Down Emotion." *New York Times*, September 22, C8.

as everyone tried to protect themselves from "a hideous STD -- a securitization transmitted disease."[46] Not knowing whom to trust, financial institutions began to refuse to lend, even as the Fed and other central banks flooded the markets with cash trying to reduce the short-term cost of funds. Arteries of the global credit blood supply were suddenly blocked, first in the summer and fall of 2007, again in March, 2008 with the demise of the ruthless investment bank Bear Stearns, and then again in episodes through the summer and fall of 2008. U.S. Federal Reserve Chair Ben Bernanke and Treasury Secretary Henry Paulson, who had both spent the spring of 2007 providing calm testimony that the problems were "contained" to the subprime market, were soon forced to spend hours in late-night conference calls and marathon weekend negotiations for increasingly urgent interventions that could be announced on Sunday afternoons to reassure investors at the opening of stock markets across Asia.

THE *WALL STREET JOURNAL* GUIDE TO THE END OF WALL STREET AS WE KNOW IT

by Dave Kansas

Everyone Began to Panic. *The Wall Street Journal* is regarded as the most conservative major newspaper in the United States. It came as no suprise when leftist and radical analysts began to speak of a crisis in capitalism when economic troubles surfaced in 2007 and 2008. What truly shocked was how 'crisis talk' became common among ever more staid and conservative analysts. As things got worse through 2008 and 2009, more and more conservative analysts and political officials began to use words and phrases that, only a few years earlier, could only be found in far-left radical newspapers or academic journals. The panic in the headlines seemed to reach its peak with the failure of Lehman Brothers, a 158-year old Wall Street investment bank that collapsed in the

[46] Richard Fisher (2008). "Dallas Fed's Fisher: Rate Cuts Won't Cure STD (Securitization Transmitted Disease)." *Wall Street Journal*, Real Time Economics blog, http://blogs.wsj.com/economics, September 26.

middle of September, 2008 -- a week "that would also mark the beginning of a brutal period that brought the viability of the entire global financial system into question." Title Source: Dave Kansas (2009). *Guide to the End of Wall Street As We Know It*. New York: Collins Business / The Wall Street Journal, quote from p. 91.

By the summer of 2008, the glaring contradictions of the Bush Administration's free-market ideology and its Chicago-School academic economic underpinnings were laid bare for all to see. Markets are always best left unregulated, and market prices always provide the most powerful and efficient signals and incentives that best allocate savings, credit, and investment -- except when those prices do absolutely none of those things, and when market prices in fact become the enemy threat requiring a military response. The deteriorating U.S. housing market had taken losses not only from subprime MBS, but also from securities backed by the "Alternative A" mortgages serving many middle- and high-income borrowers, and even some of the best, A-rated "prime" customers. Danger signs began to appear in the securities issued by the quasi-governmental-but-private mortgage companies Fannie Mae and Freddie Mac, the awkwardly named "government sponsored enterprises" (GSEs) that together owned or insured some $5.3 trillion in residential mortgage debt. Market rumors of troubles in the GSEs' capital base erased nearly half their stock prices on Friday, July 11, prompting long weekend sessions before Secretary Paulson appeared on the steps of the Treasury Building in Washington, DC to announce an unprecedented plan to inject billions into the companies through investments, loans, and preferred access to the Federal Reserve's discount lending window. Too many people and institutions around the world held instruments backed by the GSEs, threatening a global cascade of losses if they were to fail. Struggling to convince angry Senators in testimony a few days later, Secretary Paulson emphasized that the authority had to be unlimited, and only a blank check would work to correct the market prices that no seller wanted to admit as the true "value" of the mysterious securities: "If you've got a squirt gun in your pocket you may have to take it out. If you've got a bazooka, and people know you have it, then you may not have to take it out. By making it unspecified, it will greatly expand the likelihood it will not have to be used."[47]

Paulson got his blank-check bazooka, but within six weeks it became clear that the weapon was no match for the small-arms fire from a worldwide army of investors steeled by a market discipline that the Bush Administration had always regarded as infallible but unilateral doctrine in its crusade to spread the free-market gospel. On Sunday, September 7, the Administration seized both Fannie and Freddie, put them into a receivership status similar to bankruptcy, prepared to commit up to $100 billion to each company to restore capital reserves, and announced an unprecedented plan to buy shares of their MBSs on the open market in a bid to create a floor beneath the descending, fire-sale prices of securities that investors and institutions had no idea how to value. Since an investor's bid price for a mortgage-backed security must begin with an estimate of the net present value of a stream of future payments from various groups of homeowners in various risk classes or "tranches" -- many of whom are facing job losses, and some of whom were tricked into risky, expensive loans with complex, adjustable terms and all sorts of hidden expenses -- the MBS market had been in chaos for nearly a year. It was clear that nobody knew how to develop realistic assumptions of the scale of borrowers' distress, the prevalence of predatory practices, the precise timing of defaults and foreclosures, and the severity of loan losses as U.S. home prices (and thus potential foreclosure sale proceeds)

[47] Quoted in Stephen Labaton and David M. Herszhenhorn (2008). "Opposition, from Both Parties, Over Bailout Plan." *New York Times*, July 16, A1.

continued to fall. Rising house prices forgive all sins, because even the most abusive loans that are destined for quick delinquency and foreclosure generate lucrative up-front fees while "distress" resales cure lenders' and investors' losses while avoiding formal foreclosure proceedings. But house price declines, which spread throughout the U.S. after a peak in mid-2005, require full confession and contrition. And so even the largest nationalization in U.S. history was not enough to restore investors' faith. On Monday, September 15, the latest failure was Lehman Brothers Holdings, a firm founded by cotton brokers in 1850 that had survived the U.S. Civil War and the Depression only to be destroyed by subprime securitization when Bernanke and Paulson tried to say no, withholding federal guarantees that might lure a potential buyer. The next day, Paulson reversed course to nationalize the American International Group, the world's largest insurance company, with an $85 billion infusion for a 79.9 percent stake in the behemoth of the global credit default swaps business; an 80.0 percent stake would have triggered certain undesirable rules requiring the inclusion of AIG on the balance sheet of the U.S. government. The next day, Paulson, Bernanke, and other top officials reluctantly agreed that they needed to go to Congress for the last line of defense: authorization to buy up toxic MBSs of all financial institutions in order to clean up the balance sheets of banks and SPVs, and to use governmental power to define market prices in a market where fears of trading had destroyed all price signals -- using the unparalleled purchasing and borrowing power of the U.S. Treasury.

The three-page preliminary legislative proposal invested breathtaking governmental authority in a single individual. Section 8 specified that the Secretary's decisions "are non-reviewable and committed to agency discretion, and may not be reviewed by any court of law or any administrative agency," while Section 10 shyly confessed that the fine print on the statutory document authorizing the U.S. national debt "is amended by striking out the dollar limitation ... and inserting in lieu thereof $11,315,000,000,000."[48] The *Wall Street Journal* declared that the week marked "a decisive turn in the evolution of American capitalism,"[49] and after Bernanke and Paulson faced tough questions in testimony before Senate and House committees, President Bush delivered a prime-time television lecture on the housing, lending, and mortgage-backed securities practices that brought us to the point where "the market is not functioning properly."[50]

Conservatives were outraged at what could be the largest outright economic intervention in history (between $700 billion and $1 trillion of spending authority) led by the Bush White House. Republican Senators, House Members, and influential think-tank voices in the choir that normally praised Bush attacked the proposal as socialism, pure and simple. Congress had to postpone its election campaign preparation adjournment to struggle through tense negotiations. Shortly after a deal appeared imminent in the early afternoon of Thursday, September 25, Congressional leaders and the Presidential candidates, Senators John McCain and Barack Obama, met with Bush in the Roosevelt Room of the White House to forge a final agreement. But free-market purist House Republicans had been enraged at what Texas Representative Jeb Hensarling described as "being asked to choose between financial meltdown on one hand and the

[48] *Wall Street Journal* (2008). "Treasury's Financial Bailout Proposal to Congress." Real Time Economics blog, at http://blogs.wsj.com/economics, September 20, accessed September 20.
[49] David Wessel (2008). "In Turmoil, Capitalism in U.S. Sets New Course." *Wall Street Journal*, September 20.
[50] George W. Bush (2008). "President's Address to the Nation." September 24. Washington, DC: Office of the Press Secretary, the White House.

road to socialism," and being "told to do it in 24 hours."[51] In the Roosevelt Room, House Republican leader John Boehner surprised everyone with a stark declaration that his caucus would deny support for the Administration's plan. When McCain dodged the question on whether he would support the legislation, "all hell broke loose," and McCain "just sat there and let them scream."[52] At one point, Secretary Paulson literally bent down on one knee before the Democratic Speaker of the House, Nancy Pelosi, and begged her not to reverse her party's support for the plan. Pelosi felt betrayed by what seemed to be a Republican strategy to force Democrats to pass the bailout on their own with no Republican votes, thereby chaining them to a despised Wall Street welfare program crafted by a despised lame-duck President. "I didn't know you were Catholic," Pelosi said when Paulson kneeled before her; "It's not me blowing this up, it's the Republicans." Paulson sighed, replying, "I know. I know."[53] After a grueling weekend of bare-knuckle negotiations that yielded a revised, 110 page proposal, Hensarling repeated the "road to socialism" sound byte and 132 other House Republicans agreed, sending the measure down to a 228-205 defeat on Monday, September 29. This time the markets bent down on one knee, with the Dow posting its largest percentage loss in twenty years. By the end of the week a revised, 450-page measure stuffed with more than $100 billion extra in legislative sweeteners and tax cuts passed both houses and went to Bush for his signature.

[51] Carl Hulse (2008). "Conservatives Viewed Bailout Plan as Last Straw." *New York Times*, September 26, A1.
[52] John D. McKinnon, Laura Mecker, and Christopher Cooper (2008). "An Inside View of a Stormy White House Summit." *Wall Street Journal*, September 27.
[53] David Herszenhorn, Carl Hulse, and Sheryl Gay Stolberg (2008). "Talks Implode During a Day of Crisis; Fate of Bailout Plan Remains Unresolved." *New York Times*, September 25, A1, A22.

Former U.S. Federal Reserve Chairman Alan Greenspan. Economists are trained in universities, and educated in crises. After a global credit crisis that began in subprime mortgages engulfed much of the world financial system in turmoil during 2008, former Fed Chairman Greenspan finally conceded that he had placed too much faith in the de-regulated free market. Greenspan stepped down as Fed Chair in 2006, and was replaced by Ben Bernanke, a scholar who had specialized in the Great Depression of the 1930s. Greenspan was responsible for fighting back against many proposals to regulate the complex financial instruments and risky mortgages that eventually set the world financial system into crisis. "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief," Greenspan testified to the Senate Banking Committee in October, 2008. *Source:* Endmund Andrews (2008). "Greenspan Concedes Error on Regulation." *New York Times*, October 23. Photograph in the public domain from the House Financial Services Committee, via Wikimedia Commons.

Conclusions

The implications of the city as a real-estate-growth-machine:

1. The old intra-urban theories of location and land-use -- Alonso's bid rent model -- are now integrated with the inter-urban dynamics of globalization and world-cities investment and speculation networks.

2. The local use values of housing markets have become intertwined with transnational exchange values.

3. Homeownership has become an ever more important axis of social inequality.

4. The closer integration of local real estate with global financial markets brought a flood of investment into many cities and neighborhoods -- but worsened the risks of deception, exploitation, and fraud. In 2008, one of the greatest housing booms in history collapsed in the worst global financial crisis since the Great Depression of the 1930s.

Urban housing markets have changed considerably in recent years. These changes have had a number of implications for cities and urban life.

First, the intra-urban dynamics of the old way of understanding location and land use – the Alonso bid-rent model – have been integrated with the inter-urban dynamics of globalization and world cities competition. Understanding how local land use patterns evolve now requires at least some reference to a city's position in world urban hierarchies, and the subsequent competition amongst firms and mobile, high-income households looking for the best places to have offices or homes.

Second, the local use-values of housing markets have become more closely intertwined with transnational exchange values. Increasingly, understanding the experience of a family in the housing market requires understanding how shifts in national banking conditions or global stock markets will affect the cost of capital, and hence the cost of borrowing and the prevailing prices for housing in a particular city.

Third, homeownership is becoming an ever more important dividing line of inequality in cities in Canada, the United States, and many other developed-world economies.

Fourth, the closer connections between world financial markets and local urban housing markets brought a massive flood of investment into many cities and neighborhoods. But this investment was not always an unquestioned good thing. Subprime mortgages, the high-cost, high-risk lending to borrowers perceived to have poorer credit records, flourished for many years, but

eventually precipitated a full-fledged crisis that is now being described as the worst financial shock since the Great Depression of the 1930s.