

This week brought news that the British economy shrank in the third quarter, marking the first contraction in GDP since 1992. There's much worse to come for Ireland's largest trading partner, as the UK feels the fallout from a third boom and bust cycle in property in less than three decades. To suffer one property crash may be regarded as a misfortune; to suffer three looks like carelessness.

After remaining more or less unchanged throughout the 1990s, UK house prices trebled between 1995 and their peak in early 2007. Over that same period, rents rose 4 per cent on average each year. As a result, the price-rent ratio more than doubled over the period 1995-2007.

Some commentators dispute the usefulness of the price-rent ratio as a measure of housing valuation. They argue that the ratio ignores demographics and other factors. But in practice the measure seems to work well. The evidence for the US shows that following large deviations from its historical trend, the ratio has tended to move back to its trend value. This general tendency is likely to hold for other advanced countries also.

What does the price-rent ratio predict for UK house prices? Prices have plunged 15 per cent in the past year -- and the price-rent ratio has begun to move down. If the overvaluation is to be entirely worked off, more declines are needed. My occasional co-author, Fed economist Rob Martin, puts a number on it in a recent study. He calculates that if rents continue to rise by 4 per cent annually, house prices must fall 50 per cent from their peak to bring the price-rent ratio back in line by 2015. He points out that consumer spending in the UK is closely tied with house prices. The UK should prepare for a deep and prolonged recession.