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A V Vedpuriswar: Globally, housing appears all set for a crash

Japan is a good example of what happens when a property bubble bursts, and the recent rise in prices is higher than what Japan ever witnessed.

In the past three years, the total value of residential property in developed economies has increased by an estimated \$ 20 trillion, to over \$ 60 trillion.

The rise is double the \$ 10 trillion by which global share values climbed in the three years to 1999. Is this boom sustainable? Or will it turn out to be the biggest financial bubble in history?

In South Africa, prices rose by 35 per cent in the year to the third quarter of 2004, slightly ahead of Hong Kong (31 per cent). Among the developed countries, Spain enjoyed the biggest rise of 17 per cent, followed by France's 15 per cent and the US' 13 per cent.

Prices rose at double-digit rates in half of all American states. In five states, including California, and in Washington, DC, they soared by more than 20 per cent.

In most parts of India, there has been a big real estate boom in the recent past. Only in a few countries like Australia, which topped the table for most of last year, and Britain, house prices are now falling.

Despite the fall in real estate prices in some countries, calculations by The Economist suggest that house prices have hit record levels in relation to incomes in the US, Australia, Britain, France, Ireland, the Netherlands, New Zealand and Spain.

Taking the average ratio of house prices to incomes in 1975-2000 as a baseline, American house prices are now overvalued by almost 30 per cent.

Structural changes in an economy can justify higher real estate prices in relation to incomes. For example, real interest rates in Ireland and Spain dropped significantly when they became members of the Euro zone.

But several studies conclude that factors such as lower interest rates cannot explain all of the surge in house prices. Indeed, today's buoyant demand for housing seems to defy all logic.

The current global housing boom has been unusual. Never before have so many countries had housing booms at the same time. In its latest World Economic Outlook, the IMF has warned that just as the upswing in house prices has been a global phenomenon, so will any downturn — with corresponding adverse implications for global economic activity.

The consequences of a real estate bubble must not be underestimated. Japan is a good example. Japanese property prices have dropped for 13 consecutive years, by a total of 35 per cent from their peak

in 1991.

Yet the 36 per cent rise in real house prices in Japan in the seven years to 1991 was actually less than the increase over the past seven years in all but one of the eight countries listed above.

That is a good indication of what can happen if the current housing boom is indeed a bubble, which later bursts.

In a recent speech, Alan Greenspan, the chairman of the US Federal Reserve, has insisted that the growing concerns about an American housing bubble are highly exaggerated.

His argument is that the housing market is less prone to bubbles than the stockmarket, because home owners cannot buy and sell their houses as easily as speculators can buy and sell shares. People have to live somewhere and large transaction costs discourage trading in houses.

While Greenspan's point is well taken, bubbles can develop in housing markets, because of imperfect information. No two houses are exactly alike and there is no central exchange where prices are being determined by supply and demand, every instant.

Moreover, there is no short-selling in real estate markets. When bullish investors push stock prices above their equilibrium level, the price rise might be moderated by other investors selling for future delivery in the hope of buying more cheaply later and squaring the transaction.

Buyers' expectations about future house prices also tend to be based heavily on recent trends. So a rise in prices will also tend to boost demand further.

Banks can also encourage bubbles as they have an incentive to lend as much as possible when property prices rise and drive up the value of their collateral. This pushes prices even higher. But when prices fall, banks pull out, amplifying the fall.

Another point not sufficiently appreciated is that real estate is different from other investments like stocks. The common man thinks he understands real estate much better than stocks.

In case of stocks, one needs to understand the industry, how the company is doing and monitor various vital indicators of the company's financial health. In case of stocks, even during a bull run, there are some bear investors.

But when it comes to real estate, most investors tend to believe that prices simply cannot fall. This is especially so in developing countries like India.

So people keep on buying even after prices have reached unsustainable levels in relation to income.

There are plenty of symptoms of a bubble mentality in the US. The turnover of existing homes has risen to a record rate of 9 per cent in 2004.

Investors have been buying new properties and reselling within a year in the hope of a large gain. The rate of growth in the housing stock exceeds the rate of growth in the number of households by a bigger margin than at any time in the past 40 years.

In India, there are signs that house prices are becoming unrealistic in many cities. In a city like Hyderabad, where I live, a flat which fetches a monthly rent of about Rs 7,000 may cost about Rs 25 lakh.

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The EMI (equated monthly instalment) on a 15-year loan of Rs 20 lakh works out to about Rs 18,000 a month. The maximum amount of tax that can be saved (on the interest paid) is about Rs 4,500 a month.

Clearly, it makes more sense to rent than to buy a house. Many people are buying property, in the hope of capital appreciation. Quite a few people are looking at housing less as a place to live in and more as an investment.

Real estate advertisements seem to be reinforcing this message. The danger here is that if selling pressures increase as investors try to book profits, the bubble might well and truly burst. If that happens, the consequences can be catastrophic.

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