

Real Estate Investments in India: Lessons from Experience in JAPAN and USA

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ABSTRACT

The paper analyses the Japanese real estate boom-bust cycle in 1980-1990 and American real estate cycle in 2007-09. In both the nation economic growth warranted lowering interest rates as well as expansion of credit supply which spurred housing price boom. When the interest rates tightened, defaults increased, banks profitability eroded which affected further lending thus disrupting economic growth in Japan as well as in America. This paper also provides an analysis of the behavior of housing market in India. House prices have risen considerably in India and are stagnating now. The strongest lesson for India is to maintain financial stability and credit discipline.

1. Introduction

Property investment in India is always a most preferred investment avenue for long term. It is generally believed that property prices will always upscale and highly appreciate due to limited supply of land. The growing population, rise in income and the emergence of nuclear families all support the demand for housing and property buying in India.

In the recent past the property prices have seen a meteoric rise in all the major cities in India. The "Housing" serves as a dual motives; consumption as well as investment purpose. The demand for housing can be motivated by residential purpose or from investment-orientation. The investment-orientation is based on rental yields and/or income arising out of capital gains.

However, the concerning questions regarding investments in real estate are:

1. Are the rapid rises in housing prices sustainable in the long run?
2. Are the housing prices driven by its economic fundamentals or driven by speculative behavior?
3. Which factors contributed to the rapid growth in housing prices?

The general perception that holds true is housing prices will always continue to rise and investment in real estate is always going to be lucrative. These perceptions got defeated in Japan, USA and other Asian economies.

Japan's economy has experienced a substantial fluctuation in the asset prices in the 1980-90. There existed a real estate bubble which finally busted. The asset prices (stock as well as real estate) saw rapid surge in the early half of the 1980s followed by a drastic fall and subsequently the country experienced a collapse and failure of banking institutions followed by worst financial crisis and sluggish economic growth which is described as the "Lost Decade".

The US economy had also undergone financial crisis in 2007-09. The subprime market crisis was triggered by housing boom; easy monetary policies also aggravated the banking crisis, which finally led to the collapse of banking institutions.

This paper attempts to draw lessons from similar experience in Japan and USA. However, no financial crisis can be easily comparable, as the severity and the complexity of the crisis may vary across nations. This study analyses the behavior of the banks in fuelling the real estate boom and subsequently getting into banking crisis. The paper also presents the behavior of the Indian real estate market.

2. The Japanese Experience

Post World War II, the Japanese rebuilt its economy. In the 1950-80 Japan achieved rapid economic growth as it focused on innovation and research. Japan's economy was heavily driven by exports and it commanded sizeable share in global exports. As the exports increased, it led to current account surplus. The domestic savings surged which meant excess liquidity in banks. The Banks were then motivated to provide easy credit to encourage investments and to stimulate the economic growth.

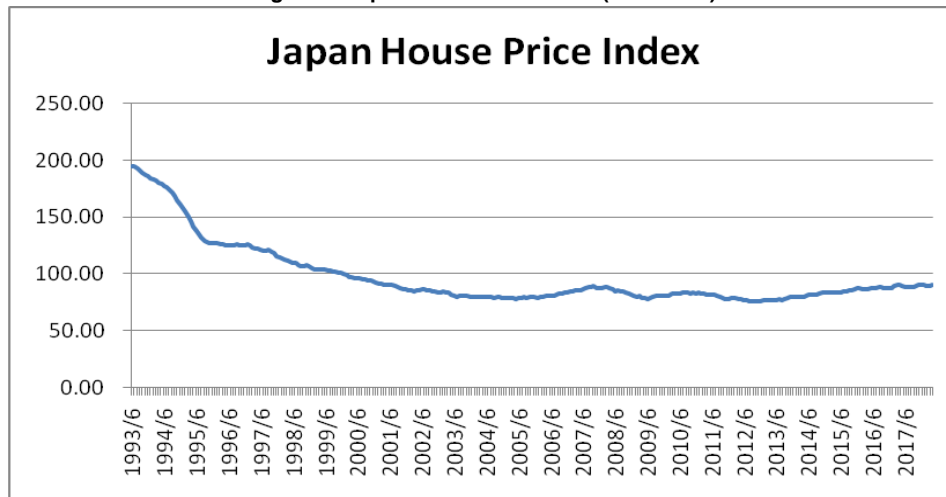
During the period of monetary easing from 1980-85, the banks provided aggressive loans which made possible a huge rally in assets prices. The real estate prices in major cities saw steep over valuations. It is in this time period the real estate bubble thrived. The overheated Japanese economy badly affected the consumption and investments. Taking cognizance of the situation and to maintain financial stability, the Bank of Japan (BoJ) tightened the monetary policy.

As credit became tight, economic activity slowed. When the interest rates increased, the asset prices plummeted and the investors' confidence weakened. The real estate prices crashed and the banks were then saddled with heavy debts and non performing loans. The value of the collateral properties with the banks also declined.

Japan's boom- bust cycle led to prolonged years of sluggish economic growth for a decade. It is estimated that from 1992 to 2005, the Japanese banks wrote off ¥ 96 trillion of loans, or

about 19% of GDP. According to Japan Real Estate Institute land prices more than doubled from 1980 to 1991 and by 2003 the land prices had fallen back to the level of 19805.

Figure 1: Japan House Price Index (1993-2018)



(Source: Authors calculation based on Japan Real Estate Institute Home Price Indices historical data)

3. The United States of America Experience

The U.S. also experienced a housing boom-bust cycle during the period from 2000 to 2009. Loosening of monetary policy by the US Federal Reserve led to credit boom, it pushed the demand for housing across all major cities and the housing prices drove upwards. The increase in housing prices were particularly noticed in four states- Arizona, California, Florida and Nevada.

With easy credit and low interest rates, real estate prices in US began rising rapidly. The banks also aggressively started lending without paying heed to the borrower's creditworthiness. The banks offered housing loans as the collateral value of the loan always outperformed with the rising prices.

As the housing bubble burst, subprime borrowers failed in repaying and the banks reported heavy losses. On one hand households were saddled with excessive debts and on the other hand the banks were in deep financial turmoil. The complexity of the bubble was further aggravated with securitization and repackaging of loans as Mortgage Backed Securities (MBS). Finally led to collapse of well established financial and investment houses like the Lehman Brothers.

The housing bubble burst and its consequent slowdown is not limited to the United States but it engulfed the entire globe.

4. Lessons Learnt

i. Irrational consumer expectations

It is clearly evident from the international experiences and in the graphical presentations above that it is a myth that land prices will always sharply appreciate. The asset price bubble existed in the two economies due to irrational consumer expectations. As the speculators quit the market, the irrational bubble gradually decreased. Land prices deteriorated and affected the overall financial stability.

ii. Massive economic growth and credit boom

To stimulate economic growth it is imperative to provide easy credit. However, as the credit becomes cheaper it allows more borrowing leading to surge in demand for land that increases the prices. This leads to subprime borrowing. The monetary policy has to ensure credit discipline at this juncture.

iii. Failure of Banks followed by deep financial crisis

Banks aggressive behavior as well as undirected financial liberalization impacted banks profitability. Banks reported heavy losses on account of bad loans and curtailed further lending. As a consequence the SME sector was badly affected and led to prolonged years of sluggish economic growth.

Housing problem is not only limited to unrealistic pricing it has serious socio-economic problem. In India, the purchase of house involves investment of one's lifetime savings.

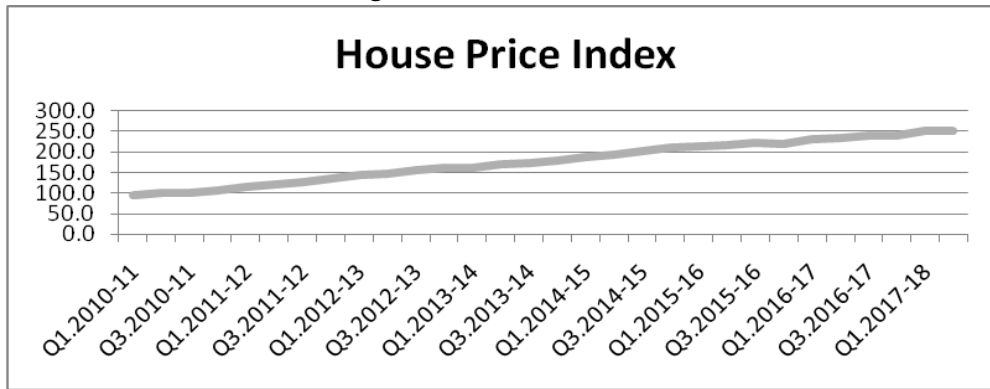
iv. Portfolio allocation:

Perhaps the lessons learnt from Japan and USA can guide Indians in proper portfolio allocation. In a real estate cycle an investor can either reap exponentially higher returns or can destroy his wealth in down turn cycle. What has happened in other economies with respect to housing can very well happen in India.

5. Assessing the House Prices dynamics in India

In India, favourable demographics, rising global capital inflows, dominance of IT sector all played its role to support the growth in real estate prices. The House Price Index as tracked by the RBI from 2010-18 has also shown a steep rise. The home prices are rapidly raised to unrealistic levels and are a matter of concern for policy makers as the asset price bubble can destroy the financial stability of the nation. The following two factors support the existence of real estate boom in India.

Figure 2: House Price Index



(Source: Authors calculation based on Database of Indian Economy, RBI, <https://dbie.rbi.org.in/DBIE/dbie.rbi?site=statistics>)

a) Surge in Retail credit

As per the RBI Trends and Progress Report (2015-16) there is sharp increase in the retail loan portfolio. The housing loan component constitutes 54 per cent of the total retail loan portfolio of banks increased by 16.4 per cent from previous year.

b) Falling interest rates:

Loosening of the monetary policy is essential to stimulate economic growth; however lowering interest rates exerted a significant impact on housing market and contributed to housing boom. The housing loan interest rates for 20 year tenure substantially reduced. From a high of 13-14 per cent in 2000 to about 7-8 per cent in 2006 and at present 9-10 per cent. Rise in housing prices also demand higher share of credit. It is an area of concerns; if defaults begin the value of collateral would decline, resulting in potential losses for banks.

At present the housing markets denote low affordability and the prices are not expected to rise exponentially as it did in earlier years. The demand-supply misalignment would plunge

the prices. Already with economic slowdown and Government's policy changes, warning signs in realty sectors are observed:

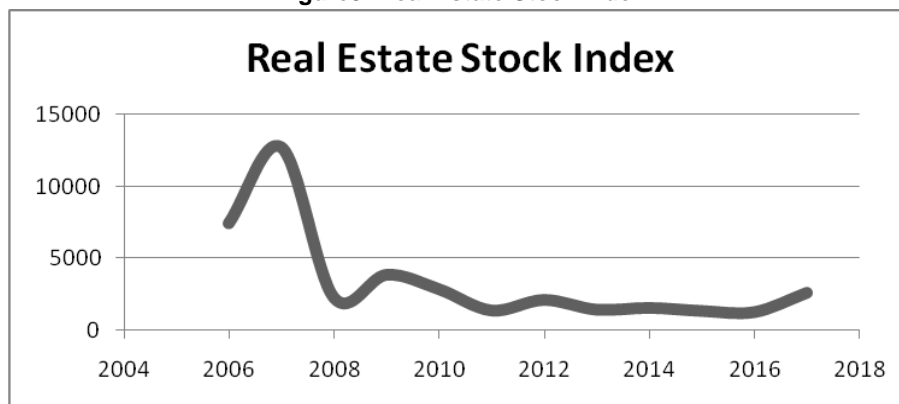
i. Demonetization:

Prior to demonetization, people with lot of cash invested in land to evade taxes. A lot of unaccounted wealth was pumped in real estate sector which inflated realty prices in India. Post demonetization the demand for realty sector has weakened. The total disbursement of housing loans by Public Sector Banks as well as Housing Finance Companies witnessed deceleration in 2016-17.

ii. Real estate companies reeling under mounting losses:

Increasing raw material costs, huge debt burden, volume pressures has strained profits of real estate companies. The Real Estate Stock index which captures the health of real estate sector have dwindled from the peak of Rs.12,727 points in 2007 to Rs. 2,250 in 2018.

Figure3: Real Estate Stock Index



(Source: Authors calculation based on S&P BSE Realty)

iii. Rising NPA concerns:

Aggressive lending by banks resulted in deterioration of asset quality. The share of bank lending to realty sector has fallen drastically. Rising NPA, higher risk provisioning has made banks resultant to lend to realty sector.

iv. Poor Affordability:

As per HDFC report 2016, the affordability ratio, defined as property prices to annual income, has declined from 22 in 1995-96 to 4 in 2016. It clearly points out the mismatch of growth in income with the growth in property prices. These results are also consistent with H. Joshi (2006) study on identification of asset price bubble in housing which concluded that income plays a minor role in determining house prices. It would be the speculative behavior that drives up the housing prices in India.

6. Concluding Remarks

The current real estate market scenario is not like the earlier years, when investors reaped heavy returns. On one side the buyer's are chasing property and are finding it unaffordable. On the other hand the developer's have pile of unsold inventory. Besides regulators are tightening the sector to maintain financial stability and for sustainable development.

The demonetization, GST and RERA effects have impacted the real estate industry. Income tax has curbed benefits on let out house property by fixing a maximum limit of deduction on interest payment on housing loans to Rs. 2,00,000 from A.Y 2018-19. Whereas in earlier years the deduction had no

maximum ceiling that move facilitated purchases in house property with investment motive. RBI has also demanded higher provisioning for risky assets to improve asset quality. "Housing for all by 2020" which is affordable housing project is another step in the right direction. With slew of these measures rise in housing prices is expected to slowdown in near future.

Perhaps the lessons learnt from Japan and America can guide India to prevent similar asset price bubble burst. The fiscal and monetary measures need to ensure financial stability and credit discipline.

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