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Subir Gokarn: The housing imperative

Keeping ongoing housing projects afloat is essential to stabilization and recovery

Subir Gokarn | Bangalore February 09, 2009 Last Updated at 00:25 IST

There is a widely held view that, since housing in the US was at the heart of the current global economic turmoil, it will have to be at the core of any solution. Until the demand for housing revives and absorbs the mounting stock of empty houses, construction of new ones will not resume. This, in turn, puts a damper on the demand for a whole range of products and services. While enhanced government spending, particularly on infrastructure, will help offset some of the adverse impact of stagnant home building, the return of the economy to its trend rate of growth will depend significantly on a turnaround in the housing sector.

Despite the significant differences between the US and India with respect to the structure of the housing sector, I believe that it is critical to the recovery of the Indian economy as well. The boom in housing, fuelled by a combination of falling interest rates, rising incomes and tax exemptions, was a huge contributor to the acceleration of growth in 2003. In turn, sagging demand for housing has played its role in the growth slowdown in recent months.

Its multiple linkages to the rest of the economy, including, importantly, in generating large numbers of jobs at the lower levels of the skill ladder, give it a central role in stabilizing growth and, eventually, bringing about a revival. This role has obviously been recognized by the various stimulus measures that the government has taken over the past couple of months.

As far as interest rates go, apart from the steady reduction in policy rates by the Reserve Bank of India, there have been efforts to further lower lending rates for home purchases below Rs 20 lakh. Besides this, credit terms for developers have been modified somewhat, reducing the risk that projects in progress will come to a complete standstill because of lack of finance.

Ultimately, though, the impact of all these measures will have to be judged with respect to whether they get people to buy homes again. Until that happens, construction activity will not resume and its economic linkages cannot be exploited. It is important to recognize that, if a stimulus is to work in the short run, it cannot rely on initiating new projects. These will take too long to reach a stage at which construction activity will actually begin. Given the situation the economy is in, it is absolutely imperative that projects that have already been initiated remain active. By this reasoning, the test of effectives of the policy measures is whether they can sustain construction activity in projects that have already made a start.

Are the measures taken so far adequate to bring about a revival in housing demand and, thereby, keep projects alive? The short answer is: no. All the steps taken are necessary but not sufficient. A number of other constraints need to be addressed in order to provide any hopes of a recovery in the immediate future. These can best be understood in the context of the risk and return considerations that go into the typical home purchase decision.

Simply put, the return on a home purchase, even if it is intended for self-occupation, is the expected price appreciation. In general, the risk emanates from price volatility, but that has not been a major factor in the Indian context. There is, however, a significant risk that investors in new projects have to deal with. This is “completion” risk, which captures the uncertainty about whether a property, once committed to, will be delivered on time and with the promised budget and quality standards.

In the current situation, the state of the real estate sector has hugely increased the completion risk. Even with extremely favourable prices and falling interest rates, this makes it very difficult for potential buyers to commit to a purchase. Suppose you are tempted by property that fits your location and budget requirements and are confident of getting a loan. You visit the site, only to see a development in the early stages of construction, with little work going on. The developer assures you that things will begin moving as soon as some sales are made, but you realize that if the other potential buyers are anything like you, they would be rather reluctant to buy into a project in this state. If not enough people buy, the project will not be completed. There is, therefore, no incentive for you to buy and, correspondingly, none for people like you.

The completion risk, significant for any property in the current circumstances, is exacerbated if the developer is small, geographically concentrated and has no reserves of capital. Virtually all the developers who would cater to the price segments that are eligible for concessional loans are very likely to have exactly those attributes. The availability of finance at attractive interest rates will not be enough to offset the risk of non-delivery.

From the perspective of return, the incentive to buy is contingent on the extent to which prices decline. The lower the price for a given property, the greater the likelihood of price appreciation and, therefore, the greater the expected return will be. Even if prices have begun to come down, the fact that they are perceived to be still too high clearly deters potential buyers.

The implications of this reasoning for policy are straightforward. Interventions that simultaneously minimize and/or mitigate completion risk and put a floor on price expectations are necessary to get the market for housing going again. This is how construction activity in ongoing projects will be sustained and the macroeconomic benefits from its linkages to other sectors realized.

Three types of intervention need to be considered. One, some projects, particularly in the lower price segments, could actually be taken over by the government, which would then ensure completion as well as guarantee a price. Two, a financing window could be created for projects that are willing to accept conditionalities with respect to pricing and completion schedules. Third, the flow of funds could be reinforced by acquiring undeveloped land, which, having already been zoned for development, could be re-sold through auctions when a more favourable environment emerges.

Keeping construction activity going is an imperative for stabilizing economic growth and creating conditions for a recovery. What has been done so far, though appropriate, isn’t enough. Further interventions, based on an appreciation of the returns and risks intrinsic to the housing market, are required, and quickly.

The author is Chief Economist, Standard & Poor’s Asia-Pacific. Views are personal.