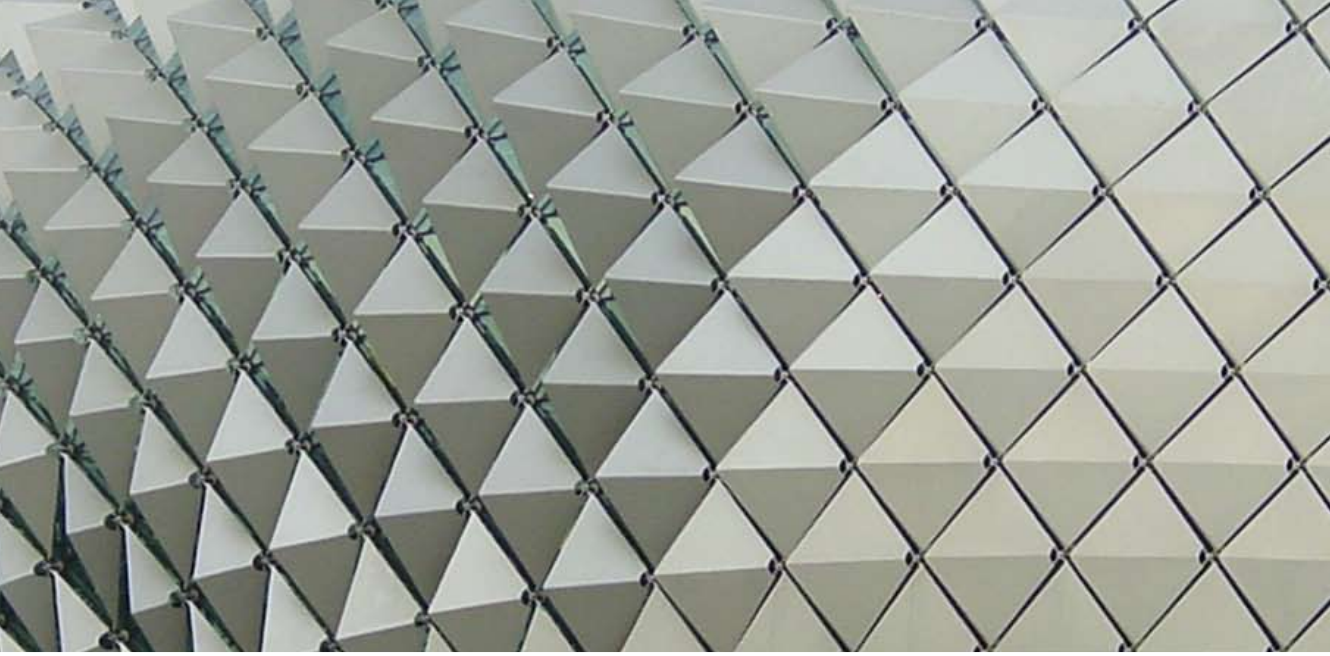

THE IMPACT OF THE GLOBAL FINANCIAL CRISIS ON HOUSING FINANCE

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ON HOUSING FINANCE

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FOREWORD

Urbanization is one of the most powerful, irreversible forces in the world. It is estimated that 93 percent of the future urban population growth will occur in the cities of Asia and Africa, and to a lesser extent, Latin America and the Caribbean.

We live in a new urban era with most of humanity now living in towns and cities.

Global poverty is moving into cities, mostly in developing countries, in a process we call the *urbanisation of poverty.*

The world's slums are growing and growing as are the global urban populations. Indeed, this is one of the greatest challenges we face in the new millennium.

The persistent problems of poverty and slums are in large part due to weak urban economies. Urban economic development is fundamental to UN-HABITAT's mandate. Cities act as engines of national economic development. Strong urban economies are essential for poverty reduction and the provision of adequate housing, infrastructure, education, health, safety, and basic services.

The *Global Urban Economic Dialogue* series presented here is a platform for all sectors of the society to address urban economic development and particularly its contribution to addressing housing issues. This work carries many new ideas, solutions and innovative best practices from some of the world's leading urban thinkers and practitioners from international organisations, national governments, local authorities, the private sector, and civil society.

This series also gives us an interesting insight and deeper understanding of the wide range of urban economic development and human settlements development issues. It will serve UN member States well in their quest for better policies and strategies to address increasing global challenges in these areas.

Joan Clos
Under-Secretary-General, United Nations,
Executive Director, UN-HABITAT

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PART I
THE GLOBAL FINANCIAL CRISIS

CHAPTER 1: THE GLOBAL FINANCIAL CRISIS

The Financial Crisis

The global financial crisis of 2008 was the worst of its kind since the Great Depression of the1930s. It began with the collapse of subprime mortgage markets in USA and led to the failure and subsequent merger and/or government bailout of leading American financial institutions and enterprises such as Bear Stearns, AIG, the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), Merrill Lynch, Citigroup, Ford Motor, etc. The financial crisis rapidly spread to other countries around the world as the credit crunch began to hit the 'real' economy by the end of that fateful year.

Causes

The Breakdown of the Global Financial System

In July 1944, a new international monetary system was agreed at the United Nations Monetary and Financial Conference held in Bretton Woods, New Hampshire, USA. The system was based on fixed exchange rates and a common standard. In the 19th and early 20th centuries, the role of monetary standard was played mainly by gold. The value of currencies was benchmarked against a fixed weight of precious metal. A country with a deficit in its balance of payments would make up the shortfall with sales of some of its gold reserves, with a concomitant reduction in its money supply.

The Bretton Woods system adopted a 'gold exchange' standard whereby one ounce of the metal was worth a fixed US $35.00, a rate the US government promised to maintain. Together with chronic US external deficits, this system established the hegemony of the US dollar in the global financial system, where it became the near-exclusive reserve currency. However, the US government found it increasingly difficult to meet its commitments.

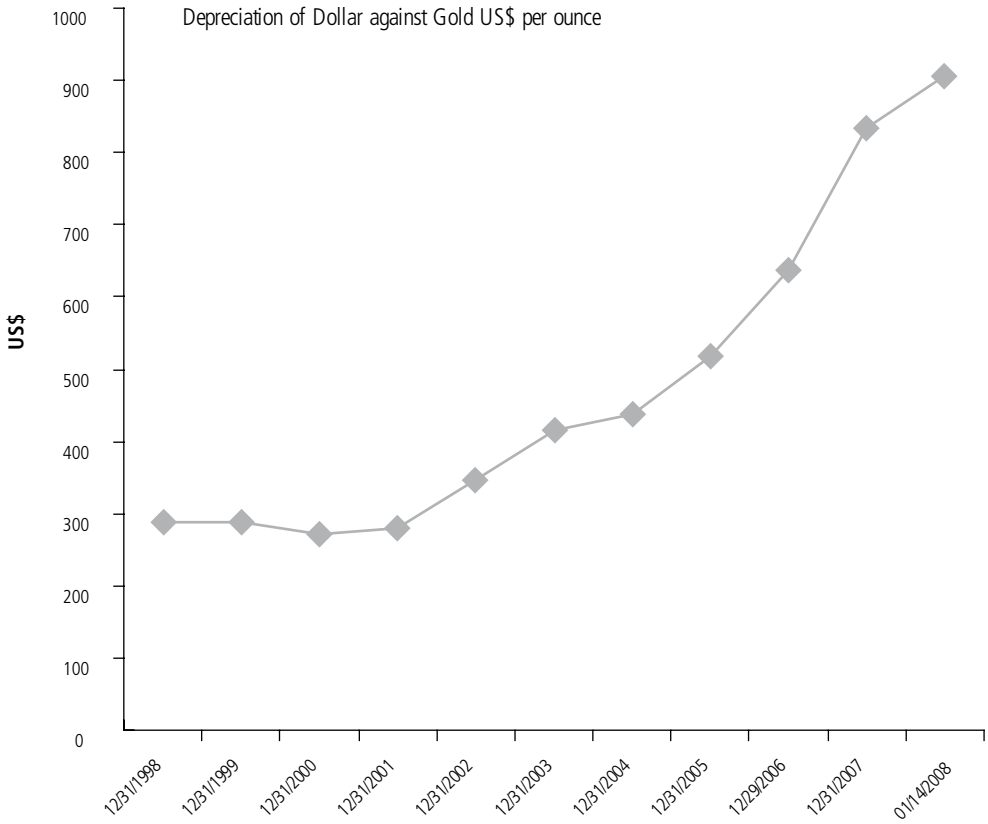
In the post-war decades, the USA acted as the main engine of world growth, importing more goods and services than it exported. The resulting surfeit of dollars around the world was the near-exclusive source of international liquidity. The problem was that if dollar supply was perceived as excessive, confidence in the currency became weaker, and so did its gold peg. After a succession of currency crises in the late 1960s, the US government on 15 August 1971 unilaterally lifted the fixed peg between the dollar and gold. The lifting of the gold exchange standard discipline triggered an era of uncontrolled printing of US dollars, leading to quick inflation and effective devaluation and the dollar had lost about 100 per cent of its value against gold by 1972.

An oversupply of US dollars

In the early 21st century, the United States's domestic and foreign policies had substantially increased government spending and deficits. The budget shortfall was financed through additional issuance of Treasury securities which, together with a huge trade deficit, contributed to a widening gap in the balance of payments. This did not prevent the United States from maintaining expansionary fiscal *and* monetary policies, with more and more low-interest credit supplied to the financial markets, causing an "overflow". The oversupply of low-yielding dollars triggered commodity speculation with attendant high prices and inflation, and reduced the purchasing power parity of the US currency. The magnitude of US dollar depreciation can be reflected in the rocketing rise in gold prices, soaring from US $288 per ounce in 1999 to more than US $905 in 2008 (Figure 1).

The oversupply of US dollars has global impacts on other countries' wealth. Many countries are paid in US dollars for exports, only to see the value and purchasing power of these hard-earned receipts eroded by inflation and oversupply. Countries and individuals holding US dollars lose wealth.

FIGURE 1: **The rise of gold prices against an oversupply of US dollars**



Source: Finfacts Ireland 2008 check out www.research.gold.org > Prices

Oversupply of US dollars, looser Lending Criteria and the Subprime Crisis

Oversupply meant that US financial institutions were flush with low-interest dollars and keen to lend them for higher yields. In their need to expand their client bases, they lowered their lending criteria and developed new products or instruments such as subprime mortgage loans. 'Subprime' refers to (typically low-income) borrowers that do not qualify for housing or other loans on conventional criteria, and, being more risky than their 'prime' counterparts, are only granted credit at higher costs. Eventually this led to what became known as 'the subprime mortgage crisis' as more and more low-income borrowers found they could not repay their loans.

An oversupply of US dollars leads to soaring housing prices

An abundance of dollars flowed into the housing sector, causing prices to soar[1]. The upward trend in prices had already become steeper during the past two decades in the USA (Figure 2). As housing loans are based on "value", soaring prices brought many households to borrow more than they could afford, triggering the time bomb behind the subprime mortgage crisis.

Deregulation opens the door for subprime lending

Another important factor behind the subprime lending boom was financial market deregulation in the USA. The 1980

FIGURE 2: **Year-on-year Housing Price Increases in the USA, 1991-2005**

Source: Office of Federal Housing Enterprise Oversight, 2005

Depository Institutions Deregulation and Monetary Control Act (DIDMCA) enabled savings and loans (S&L) institutions to offer checkable deposits. The 1980 act also allowed financial institutions to charge any interest rates they chose to[2].

Further deregulation came in 1982 with the Alternative Mortgage Transaction Parity Act, which pre-empted state laws that restricted banks from granting mortgage loans, except conventional fixed-rate amortizing mortgages. The 1982 law allowed variable interest and 'balloon' payments and also enabled lenders to grant credit on terms that might effectively obscure the total cost of loans. As a result, many borrowers contracted mortgage loans which they failed to understand and could not afford[3].

In the meantime, these laws paved the way for the development of subprime lending, but the market would not become a viable large-scale lending alternative until the 1986 Tax Reform Act. This piece of legislation removed tax deductions of interest on *consumer* loans but encouraged homeownership as *mortgage* interest deductions were increased on top of low-income housing tax credits.[4]

With credit oversupply and deregulation, the subprime mortgage market expanded rapidly, from US $35 billion in 1994 to US $650 billion in May 2007 (Figure 3)[5].

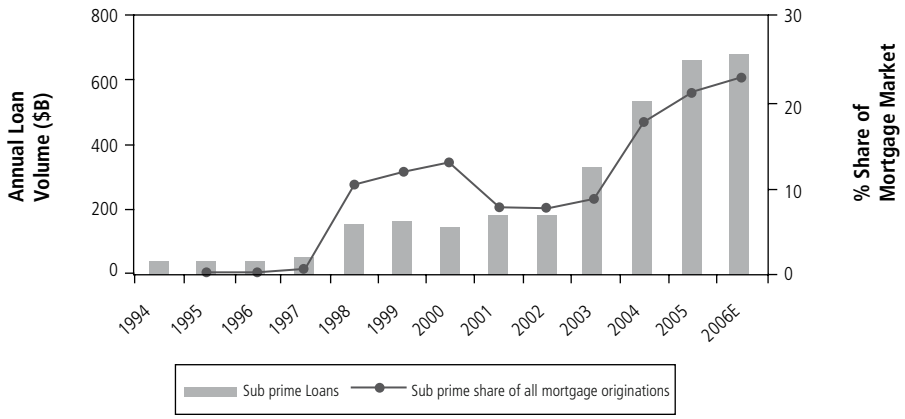
The rapid increase in subprime mortgages leads to the credit crunch

The delinquency rate for subprime mortgages rose to 25 per cent in the second quarter of 2008, which was about six times higher than that on 'prime' loans[6]. By late 2008, the total value of outstanding subprime mortgage loans in the USA was an estimated US $1.3 trillion, which was equivalent to California's gross domestic product[7]. Even before the crisis set in, projections showed that foreclosure rates were set to worsen across the whole country, and particularly in the North-East and South-West (Figure 4).

Bailout plans trigger fresh worries

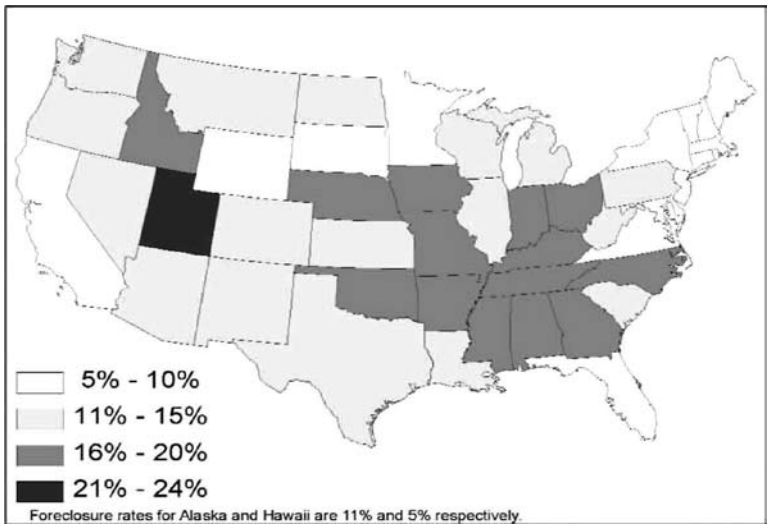
In the face of the severe banking and financial crisis, the US government launched a US $700 billion bailout plan which triggered fresh worries across international markets. The bailout plan sent out confused signals to investors around the world. It appeared as

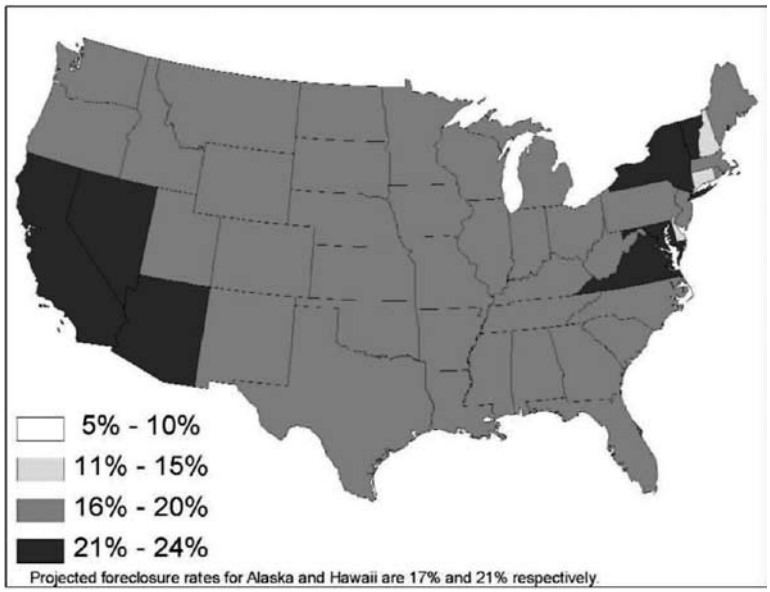
FIGURE 3: **US Subprime Mortgages: Growth and Share of Total Mortgage Market**



Source: Inside Mortgage Finance as published by the Center for Responsible Lending

FIGURE 4: **Projected Foreclosure Rates for Subprime Loans**





inconsistent with the traditional 'free market' value advocated around the world. The bailout plan also kindled worries over an additional massive supply of US dollars which in effect transferred the US crisis to other countries. These negative signals caused the New York stock market index to fall, finishing the day below the 10,000 level for the first time since 2004.[8]

The US bailout plan was followed by others in Germany, France, Italy and a further 12 members of the euro zone. Germany's scheme amounted to EUR5,000 billion[9], which was

proportionally much larger than the US one. Here again, investor fears of a massive oversupply[10] caused a decline in the euro exchange rate. This meant that the world's two main reserve currencies found themselves under pressure, impoverishing many countries around the world (as the value of their central banks' holdings of dollar- and euro-denominated assets was reduced) and affecting their confidence in the international system.

In the USA, the effects of the sudden credit crunch spread way beyond the sole housing sector. Since they sell on credit and refinance operations through bank loans or bond issues, the three largest car makers (General Motors, Ford Motor and Chrysler) went into trouble. They required a US $50 billion government support scheme in November 2008.[11] The United States extended earlier bailout plans and began to inject more money beyond the financial sector.

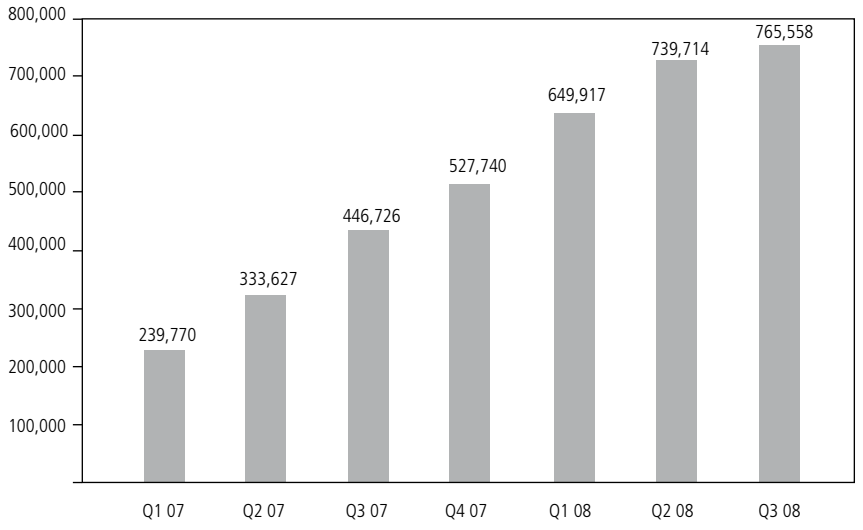
At the same time, the US and some European Union governments also planned to reduce taxes and introduce further stimulus policies to inject more credit into their respective economies, with the potential for further investor worries. Countries and investors worried about the bailout or simulus packages would trigger a new wave of global inflation later on.

Effects

The broken dream of homeownership for US low-income households

The subprime crisis put an abrupt end to many low-income households' dreams of homeownership in the USA. Foreclosure rates deteriorated rapidly (foreclosure refers to loss of title on their home by a defaulting mortgage borrower). In the third quarter of 2007, subprime adjustable rate mortgages (ARMs) only accounted for 6.8 per cent of the total outstanding, but accounted for 43 per cent of all foreclosures. In October 2007, the delinquency rate on subprime ARM

FIGURE 5: **Properties with Foreclosure Activity in the USA**



Source: http://upload.wikimedia.org/wikipedia/en/4/4c/Foreclosure_Trend_-_2007.png

mortgages almost tripled compared with 2005. In This rate increased to 21 per cent in January 2008, and to 25 per cent over the following four months. During 2007, lenders started foreclosure proceedings on about 1.3 million properties, a 79 per cent increase over 2006.[12] The number of properties involved in foreclosure steadily increased (Figure 5).

Oversupplies of US dollars and Euros can wipe out growth in developing countries

The global financial crisis can be detrimental to growth in developing countries. When the United States and the European Union respond to their problems with massive increases in their respective money supplies, this erodes the value of the hard-earned US dollars and Euros developing countries have accumulated through exports of goods, services and commodities. This transfer of domestic problems from one country or a few countries to many developing countries and from a few people to virtually everyone through the inflation mechanisms, making the latter the main victims of a financial crisis for which they have no responsibility. This can not only affect people's quality of life, but also affect people's confidence in governments. It can affect political and social stability in the long-term. Therefore, the negative long term impacts of stimulus packages requires particular attention. Tight financial regulation can possibly have better long term impacts than short term stimulus packages.

Oversupplies of currencies distort the real economy

The oversupply of currencies can be reflected in the rapid growth of the financial assets compared to the value of total outputs measured in national accounts over the past few years. In 2006, global financial assets were equivalent to four times the world's production of goods and services. On any one day of April 2007, the average daily turnover in interest rate and non-traditional foreign exchange derivatives contracts reached US $2,090 billion, or 71 per cent higher than three years earlier. That was 50 times the value of world exports during the same time. The total assets held by hedge funds increased from US $39 billion in 1990 to US $1,900 billion in 2007. The profits of financial institutions in the United States amounted to 41 per cent of total profits after tax in 2007, up from a mere 5 per cent in 1982. In New York, one third of all salaries paid were in the financial sector.[13]

A rapid increase in unemployment

The International Labour Organisation (ILO) found that the global financial crisis could increase world unemployment by an estimated 20 million.[14] This would bring the total number of unemployed in the world to over 200 million in 2009.[15] However, the situation seems far worse. The unemployment caused by the global financial crisis will be far more than the ILO's 20 million figure. In China alone, the crisis led to the closure of more than 67,000 small and medium-sized enterprises and 20 million people lost their jobs. At the time of writing, another 300,000 small enterprises were partially closing down.

Recommendations

Stabilising the value of the US dollar and the Euro and other major World Reserve currencies

The main solution to the global financial crisis is to stabilise the major world reserve currencies exchange rates. This requires the major world reserve currency countries to take the following action:

- adopt more responsible fiscal and monetary policies and refrain from printing extra money.
- the major world reserve currencies governments take immediate action to cut

expenditures and reduce deficits.

- countries commit to free trade and to remove trade barriers, especially on high technology exports in order to reduce trade imbalances.

Reforming the Global Financial System

The crisis has exposed the fundamental weakness of the global financial system as it stands. It has also provided an opportunity for the world to review and reform the existing framework. The 1944 UN Conference at Bretton Woods established a new international monetary system that was abandoned in the early 1970s. A UN conference is needed in order to restructure and reconstruct a fair global financial architecture.

Indeed, a restructured global financial system should be fair and inclusive. In order to achieve this goal, any new system should have the following functions:

- Establishing an international mechanism to control the supply of world reserve currencies which at the moment are only under the control of individual countries or groups thereof;

- Monitoring the deficits of individual countries and establishing international regulations to limit deficits, particularly for those countries whose currencies also serve as international means of payment;

- Establishing a mechanism to control the international (external) debt of those countries whose national currencies have an international role. Countries should remove barriers in order to redress trade imbalances. Countries with the power to print world reserve currencies must guarantee their national external debt with real assets.

- The newly-restructured global financial system should have a fair and inclusive governance structure. It should reflect the changing global economy. Developing countries should have equal power in decisionmaking.

- Monitoring individual countries with a view to establishing sound banking regulations.

- The United Nations should play a role in the development of a new global financial framework, including regulations.

- Creation of a new UN currency to replace other world reserve currencies. Alternatively, use a basket of currencies as the international means of payment as a transition measure .

Strengthening research and monitoring functions on housing finance systems

The global financial crisis had its origin in the US housing finance system. This shows the urgent needs to strengthen research in, and monitoring of, the housing finance systems in the world, with special regard for the relationship between the housing sector and economic development.

PART II

KEYNOTE SPEECHES AT THE SPECIAL SESSION ON THE ROLE OF GOVERNMENT IN HOUSING FINANCE SYSTEMS: THE GLOBAL FINANCIAL CRISIS – IMPLICATIONS, LESSONS AND OPTIONS

CHAPTER 2: SUMMARY OF THE SPECIAL SESSION

Will the financial crisis lead to a paradigm shift in development models?

Over the past three decades, free market values and economies have been vigorously promoted. Housing finance has changed dramatically in both developing and developed countries to respond to this powerful wave of free market forces and privatisation. Many finance innovations have been generated to expand the markets. The subprime mortgage crisis and its ripple effects have shocked the world. The American response to the financial crisis was inconsistent with free market values. This special session aims to expose the myth of the current crisis and the role of government in housing finance systems.

This session discusses the current housing finance crisis and its effects on the housing sector, affordable housing and the global economy. It examines the underlying factors and evolution of the subprime crisis and its dissemination, as well as the major participants, particularly the role of government and agencies, housing finance institutions and innovative funding instruments. The session reviews the effectiveness, efficiency and fairness of the current global financial governance system. Will the American response, such as the bailout plan, bring an end to the crisis, or to a dollar-dominated world? The special session discusses extensive government intervention in the housing finance market and the associated lessons, options and implications.

Main areas of discussion

The subprime mortgage crisis

What is the extent of the subprime lending crisis? What are the underlying factors leading to the crisis? Why does it happen at this time? How does the subprime crisis spread and lead to a much broader problem? Who are the main participants in the crisis? What are the implications of the crisis? How can the US bailout plan manage to buy poor-quality assets and reduce taxes at the same time? Who actually pays the costs of the crisis and finance the bailout plan? How can countries avoid becoming victims of the global financial crisis? How can the USA re-assure other countries and investors that the value of their assets is to be preserved?

The role of Government in housing finance systems

The role of government in establishing housing finance systems; the role of government-sponsored enterprises in housing finance systems; the role of government in

different types of housing finance systems. What are the fundamental systemic and institutional challenges behind the crisis? What recommendations can be made on the role of government in housing finance? How has the world (including the World Bank and the International Monetary Fund) responded to the US financial crisis, by comparison with Asia's own problems in the 1990s?

Lessons, options and the reconstruction of the global financial system

What are the wider implications of the financial crisis for the global economy, the housing sector and affordable housing? Why can the global financial system no longer live up to the new, challenging times? How can countries/institutions/individuals avoid being victimised by the global financial crisis? Does the crisis provide opportunities to re-examine the global financial governance system and to undertake in-depth reform? How can a fair global financial system be established? What can the United Nations do to promote such a system?

CHAPTER 3: **THE US MORTGAGE LENDING CRISIS**

The housing and mortgage market collapse in the USA can be broken down into three parts:

- A bubble in house prices, culminating in a very sharp decline in prices since 2006.
- A huge increase in loan defaults, especially in the subprime mortgage market (the market for borrowers with poor credit histories) and, to a lesser extent, the 'Alt-A' market (otherwise 'prime' loans, but without full documentation of income and wealth).

A seizure in the securities markets where the bulk of these loans have been 'packaged' and sold, which has spread to other markets and is in danger of spreading further.

These developments are fairly recent, and they can largely (though not entirely) be attributed to a major development: the securitization of subprime and, to a lesser extent Alt-A, mortgages, which expanded significantly after 2003. Securitization was a factor (how much is still not clear) in the boom and bust in house prices, and it was the main factor in the deterioration in underwriting quality and, especially, the seizure of markets after the high default rates were discovered.

In the USA, agencies like the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) routinely buy mortgage loans from banks in order to 'repackage' them into securities and sell them on the financial market. These securities provide relatively high yields while benefiting from a degree of guarantee.

Stylized Facts

The main characteristics of U.S. mortgage markets have been as follows:

- Foreclosure rates have mostly increased since at least 1979, and the trend accelerated after 2005 (see Figure 1).
- All product types have been affected by the recent surge in foreclosures, but the adjustable rate mortgage (ARM) sector, especially for subprime borrowers, has clearly been faring worse than fixed-rate mortgages (FRMs) (see Figure 2).
- Subprime mortgages performed reasonably well until about 2006 (see Figure 2).
- Early performance of the 2005-2007 subprime and (albeit to a lesser extent) Alt-A vintages has been extraordinarily bad (see Figure 3).
- 'Hard' data, like loan-to-value ratios (LTVs) and credit scores, eroded in the 1990s, but have not changed much recently. The erosion in underwriting quality occurred in the 'soft' data that was less readily available to investors in securitized pools or even to rating agencies (see Table 1).
- Property values, which had already been increasing at an above-average pace, accelerated after 2003, especially in places like Phoenix (phnx), Las Vegas (lv), Los Angeles (la), Tampa and Miami, which featured the major "bubbles" and subsequent default losses (see Figure 4).
- The market share of subprime and Alt-A loans rose dramatically after 2003 (see Table 2).

The securitization of subprime mortgage loans

Neither subprime loans nor securitization are new. Mortgages have been 'packaged' into securities and sold into the bond markets as mortgage-backed securities for decades by institutions like FNMA and FHLMC. Similarly, subprime loans have been around for some time, and they did not always perform badly. For instance, subprime delinquencies declined rather sharply in the aftermath of the 2001 recession, probably a factor in their subsequent popularity (see Figure 2). On the other hand, *securitization of subprime* mortgage loans is relatively new.

Securitization of *subprime* is more difficult than *prime* loans; this is because subprime default rates are higher, and more importantly, their performance is more sensitive to small mistakes in classification and to things that are not easy to measure. This made them hard to sell to investors, particularly institutional investors who were not familiar with mortgages and were afraid of being sold "lemons," i.e., bad loans by originators and investment bankers who knew more than anyone else did.

This necessitated structuring ('slicing and dicing') of mortgage-backed securities. The basic idea was to divide up the risk in the securities, so that some investors took the first loss via "subordinated tranches (with credit default swaps to cover the risk) while others held "senior" tranches that could be rated 'AAA' despite the low quality of the loans in the pools. This brought in institutional investors and made the market; between 2003 and 2005, the subprime share of mortgage originations rose from 8 per cent to 20 per cent, and 80 per cent of the loans were securitized (up from half).

Structuring is not inherently bad and has sometimes worked well. However, subprime and Alt-A mortgage securitization can be very difficult to understand. If things begin to go wrong, it is not easy for the holders of the senior tranches to assess their losses, and further structuring made the problem worse. The most important parts of the deals are the subordinated tranches, as they carry the bulk of the risk. The problem is that these pieces were not always easy to sell and, therefore, were frequently re-securitized under similar formats (with senior and subordinated tranches), and occasional further securitization would make the ultimate risk even more difficult to assess (see Gorton (2008) and Gerardi *et al.* (2008)).

This obfuscation was an open invitation to moral hazard when the loans were made and subsequently 'repackaged'. It also promoted fear of buying and panic when the house price appreciation that everyone "knew" would continue and bail everyone out, failed to materialise.

Timing and causation

The subprime market played a major role in the bubble. In 2003, the US real estate market was strong, though not obviously heading for a bubble. Interest rates had been low coming out of the recession, but were heading up. Low interest rates encouraged more low-income Americans to buy real estate on mortgage, in the process stimulating rising property prices.

The subprime market contributed to the decline in underwriting quality. That subprime and Alt-A loans went so bad so early suggests that there was something wrong with the underwriting process. This seems to be confirmed by the fact that (see Table 1) the most commonly used observable indicators of borrower credit, like credit history and down payment, did not change much.

However, the sharp decline in house prices and subsequent increase in the share of houses with negative equity have also played a role in the crisis. Anderson *et al.* (2008) provide some

aggregate estimates of the extent to which sub-prime loan defaults were due to economic conditions, as measured by a proprietary index of local economic conditions (especially house prices), versus changes in underwriting standards (as measured by a fixed effect for an observation year.)

The yellow line measures the part due to economic conditions, which favoured a decline in foreclosures until 2004. The pink line shows the contribution of underwriting which, from negative early in the period turned to positive then sharply negative again from 2006 to 2007. It must be noted that the underwriting effects refer to the year in which the loans are observed, not the year in which they were originated: i.e., the poor underwriting in 2006 and 2007 is for loans that were originated earlier. The figure suggests that the post-2005 increase in foreclosures can be apportioned about equally between the underwriting and economic conditions.

The subprime crisis was especially important in the seizing up of the markets. From an economy-wide and global perspective, the important question is the spillover effect, as spread across the financial system through securitization. Most estimates of subsequent losses are around US $200 billion, with possibly an additional 50 to100 billion for Alt-A. However, write-offs on subprime securities have so far exceeded US $500 billion, and recent research by the International Monetary Fund suggests they will eventually be well over one trillion. What accounts for the difference? Almost certainly the difficulty of understanding the individual securities, and fears by traders that if they buy a security they will be left with the worst part the seller can deliver. In any event, the securities are selling at discounts that are way above what their losses are likely to be. The sum of the parts is much worse than the whole.

The subprime losses by themselves would be serious, but manageable. They will almost certainly be smaller, relative to the size of the economy, than were those of Savings and Loans institutions in the 1980s which ultimately were made up for by taxpayers. This was because in the 1980s the bad loans were largely funded with insured deposits, and as institutions failed depositors were paid off quickly and without much problem, so there was no question about the funding behind the loans and only minor spillover effects. The subprime case is different. The loans were funded with securities that were very different from insured deposits. Institutions that hold the securities cannot borrow against them and indeed have trouble raising money anyway because lenders have no idea about the true shape of their balance sheets. This fear of 'lemons' and uncertainty about credit quality is the major factor in the credit crunch.

Policies and regulation

Deregulation: No significant regulation has been imposed on the US mortgage market for years. Problems have arisen in markets that were never much regulated. While regulations could have changed some of the details, they were not going to change the problem: subprime securitization was seen as profitable, the methods were similar to other (structuring) funding mechanisms, and it could be (and usually was) carried out outside the usual channels of regulated institutions. The major subprime lenders were not banks, but typically real estate investment trusts. The major originators of the securities were investment bankers, who secured favourable credit ratings for large portions of the deals.

Excessive deregulation/promoting low-income lending: While mortgage lenders and investors were encouraged to lend to low-income and minority borrowers, the evolution of the subprime market has been in the hands of institutions that did not do it for regulatory benefits. One can certainly argue that pushing borrowers into homeownership when they are not ready is bad policy, but it was not the cause of the problem.

Rate resets on adjustable rate mortgages: This could have been a problem and it looked like it might a year ago, but the Federal Reserve's lenient credit stance made resets (i.e., upward adjustments in contractual interest rates after a determined period) less destructive for subprime borrowers. What really matters is that the number of defaults became very high even *before* resets.

The FNMA and FHLMC: Their mortgage purchases have, if anything, been countercyclical, and their role in the subprime market small. Their combined market share dropped sharply after 2003, as the subprime loans expanded and house price rises accelerated, and this share did not get back to higher levels until recently. The role of the two agencies in the subprime market has not been null, but it has largely been confined to holding senior pieces of subprime deals (total exposure: around 4 per cent of their overall mortgage holdings), accounting for 15 to 20 per cent of the total subprime market. As far as I can tell, the two institutions had nothing to do with the subordinated or re-securitized pieces that were most necessary to get the market off the ground. Perhaps more important, their securities are not subject to the extreme uncertainty attached to subprime deals and have not been much of a factor in the spillover to other markets. They did increase their risk exposure after 2005, but this was especially in the Alt-A market, which has been a significant problem though not so much as subprime and was (to the detriment of shareholders) countercyclical.

Policy issues going forward

Current policy has been directed toward a range of problems, mostly dealing with the short term and the credit crunch.

In the longer term, one can think of four alternatives for the provision of housing finance in the USA, as follows:

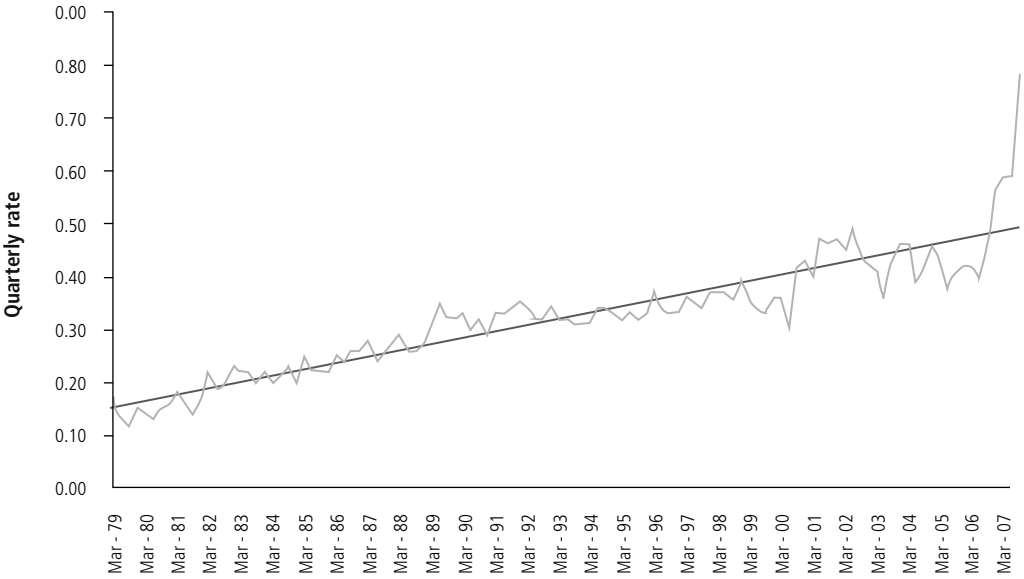
- Banks, with explicit guarantees on deposits and sometimes implicit guarantees on other liabilities.
- A revived version of FNMAE and FHLMC with implicit guarantees on their debt
- Non-agency (i.e., leaving out FNMAE and FHLMC) securitization with, implicit guarantees in some (emergency) cases.
- Government-owned institutions (like the Government National Mortgage Association (GNMA))1 with full guarantees

Each of these options comes with benefits and costs, and none leave taxpayers off the hook. The third is, on its own, the closest thing to full privatization of the US mortgage market (without guarantee) and runs the risk of fragility, with the attendant government bailouts at the end of the day. The first option needs institutions similar to FNMA and FHMLC to provide the required guarantees. Both (1) and (3) encourage risk-taking with the potential need for government bailout. The fourth option comes with the problems that are usually associated with government management and inflexibility (for instance, pricing by both the Federal Housing Association and GNMA is fixed by statute), and it is not clear that risk is reduced. At the same time, the US government has always been involved in the mortgage market, particularly under the form of guarantees, and this is not likely to change.

Another certainty is that more regulation is on the way. A large part of this should focus on the need for more equity stake by investment banks and loan originators who have the best information about the loans. This is likely to happen on its own anyway. Similarly, there will be restrictions on the riskiest sorts of loans, but this is happening as well.

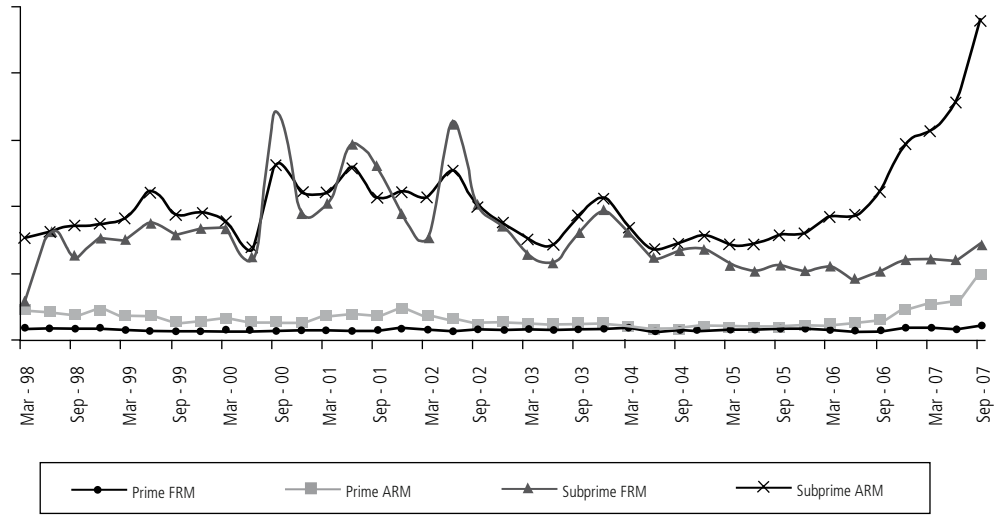
[1] GNMA securitizes government-insured loans, primarily those insured by the Federal Housing Association.

FIGURE 1: **All US foreclosures started, 1979-2007 (quarterly data)**



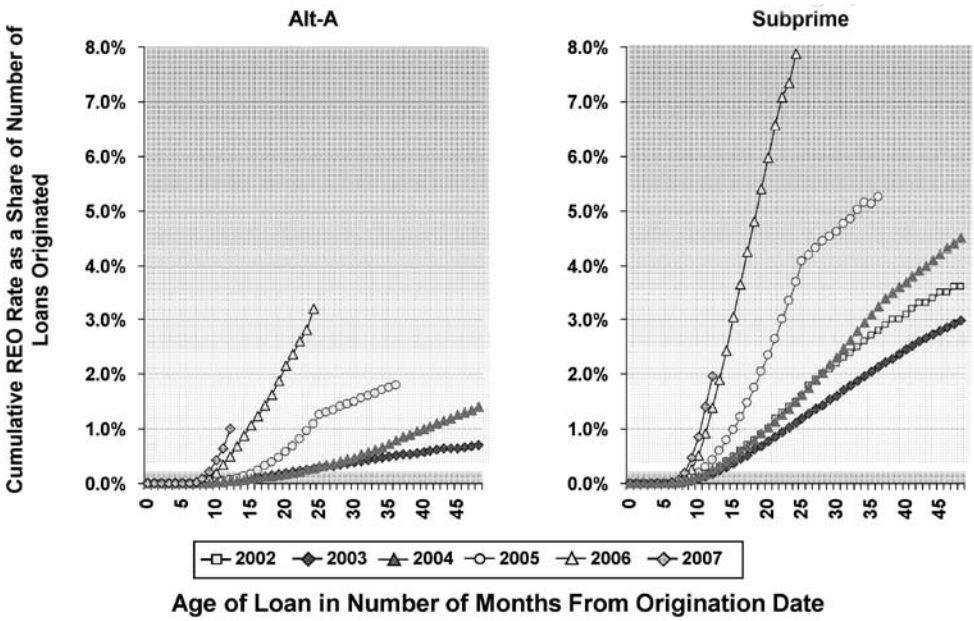
Source: Mortgage Bankers Association

FIGURE 2: **Rate of US foreclosures started, by loan type, 1998-2007 (%)**



Source: Mortgage Bankers Association

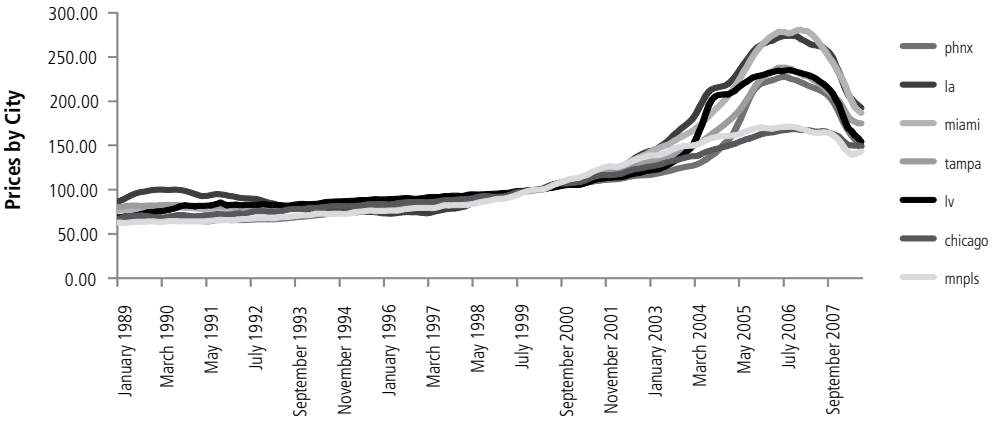
FIGURE 3: **Cumulative REO* rates for Alt-A and subprime mortgages, by vintage**



** REO stands for 'real estate owned' and refers to property owned by a bank after an unsuccessful sale at a foreclosure auction.*

Source: Cutts & Merrill (2007) using data from LoanPerformance.com

FIGURE 4: **The Case-Shiller index of house prices in various US cities**



Source:
http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/0,0,0,0,0,0,0,0,0,0,1,1,0,0,0,0,0.html

FIGURE 5: **Decomposition of subprime foreclosures started**

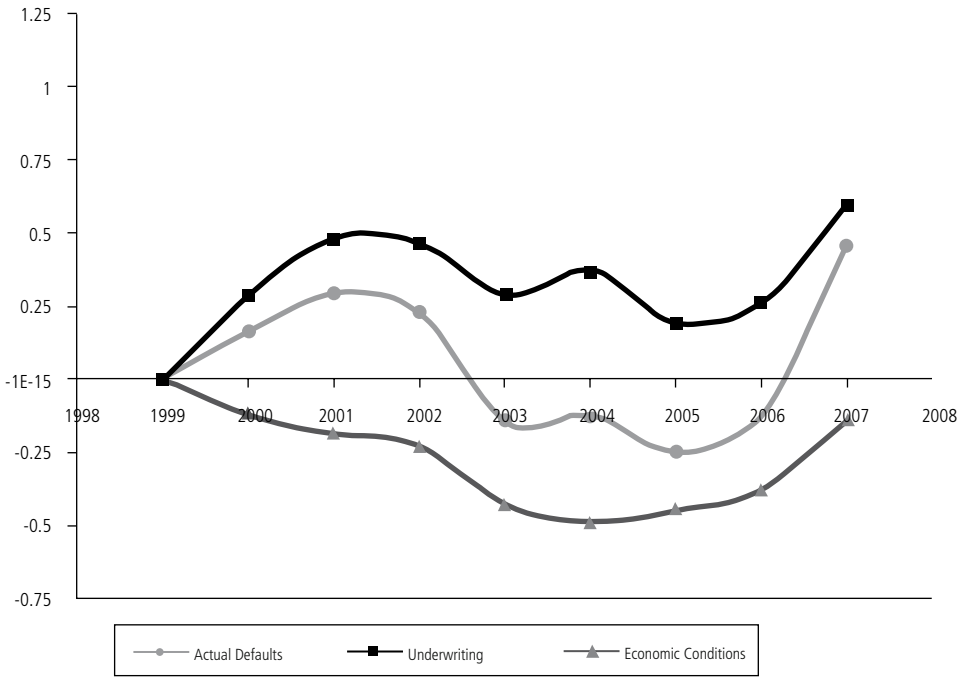


TABLE 1: **Loan characteristics at origination by vintage: Alt-A and subprime**

		2002	2003	2004	2005	2006	2007
Average Loan Size	$000	145	164	180	200	212	220
FRM Share	(%)	29	34	24	19	20	28
ARM Share	(%)	0.4	0.3	0.3	0.4	0.4	0.2
Hybrid Share*	(%)	68	65	76	77	55	44
Balloon Share*	(%)	3	1	0.2	4	25	29
Refinancing (cash out) Share	(%)	52	51	52	48	46	45
FICO Score		609	618	618	621	618	613
Combined LTV	(%)	80	82	84	85	86	83
Debt-to-Income Ratio	(%)	39	39	39	40	41	41
Documentation Dummy	(%)	70	68	66	63	62	67
Mortgage Rate	(%)	8.7	7.7	7.3	7.5	8.4	8.6
Margin for ARM and Hybrid**	(%)	6.6	6.3	6.1	5.9	6.1	6.0

Source: Yuliya Demyanik & Otto Van Hemert (2008), "Understanding the Subprime Mortgage Crisis"

**"Hybrid" refers to ARMs with first adjustments happening after one year. "Balloon" refers to loans that must be paid off before they are fully amortized (e.g., a loan amortizing fully over 30 years, but with the outstanding balance required to be paid off after five years).*

***"Margin" refers to the interest rate that is added on top of the index to which the ARM rate is indexed. Most ARMs have fixed initial rates for a year or more, so that a loan is fully indexed only over time. For instance, for subprime loans the initial rate might be 6.6 per cent (see 2005) and fixed for two years, and subsequently be set at 6 per cent above the chosen index (e.g., the London interbank offered rate).*

TABLE 2: **Market shares of single-family originations by loan type**

Year	FHA&VA	Conventional Conforming	Jumbo	Subprime	Alt-A	Home-Equity Loans	Total ($billion)
2001	7.4%	57.2%	19.4%	8.6%	2.7%	4.6%	2,215
2002	6.4%	59.3%	20.0%	8.0%	2.4%	3.9%	2,885
2003	5.8%	62.4%	16.6%	8.5%	2.2%	4.6%	3,945
2004	4.6%	41.4%	17.6%	18.5%	6.8%	11.0%	2,920
2005	2.7%	35.0%	18.3%	20.0%	12.5%	11.5%	3,120

Source: Inside Mortgage Finance, The 2006 Mortgage Market Statistical Annual- Volume 1

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CHAPTER 4: **A EUROPEAN PERSPECTIVE ON THE GLOBAL FINANCIAL CRISIS**

The more acute phases of the crisis are probably over by now (November 2008), or so suggests thedecrease in inter-bank lending interest rates. The rescue plans on both sides of the Atlantic have recapitalised the banking systems.

However, the present crisis implies, by necessity, a rather poor outlook for global growth in the medium term. We are now in an adjustment period which will take some years to complete. This is why it is important to look at the factors that generate growth in the medium and longer terms.

- Even though we may not be aware of all the ultimate factors behind sustainable growth, we can list some that are necessary or conducive to this: stable macroeconomic parameters like low and stable inflation as well as sound public finances. Other well-known factors are of a more structural nature, such as: An adequate educational system
- A financial system that efficiently allocates savings to productive use
- Non-congested transport systems
- Adequate housing to facilitate population flows
- Effective legal system and institutions

It is obvious that banks and other financial institutions must take prime responsibility for the present crisis. However, policymakers also must take their own fair share.

The explanations behind the present crisis are basically twofold: first, the housing boom in the USA; and second, the failure of the global financial system to assess risk.

The housing bubble has burst in the USA but more countries are to follow suit.

The financial system has failed in its most important task: adequate risk pricing. The reasons for this are, by now, fairly well understood: securitization and the complexity of new products in combination with the "search for yield" in a low interest rate environment. Investors were lured into taking too much risk, both because financial innovations were poorly understood and, in many cases, a short-sighted pursuit of profit due to inadequate compensation systems. Bonuses were based on short-term performance and too little attention was given to risk and return in the longer term.

Rating agencies, too, must take a large share of responsibility for the present crisis. Their risk analysis seems to have relied too much on recent statistical data, i.e., a boom period devoid of severe economic downturns and with very low loss rates. By other yardsticks, it is obvious that housing prices have been out of line with economic fundamentals during the past few years.

From a policy perspective, it is clear that changes are in order. First, we must find ways of preventing large asset price bubbles from arising again. In this respect, policymakers must become more alert to the risk of asset bubbles. One option is to give supervisory authorities, including central banks, extended mandates in this respect. Another option is to set up new, independent institutions with a mandate to value assets and supply the general

public and media with statistical data on asset prices and fundamentals.

At the moment, we are in the first phase of the crisis, with falling asset prices and negative investor sentiment. An important aspect of the adjustment, looking forward, is an increase in US savings and a decrease in Asian and European savings.

Government and housing finance in Europe

A review of the regulatory framework for various types of financial activities is in order. In this respect, the European Union's regulatory framework is more comprehensive than the USA's when it comes, for example, to the possibility for banks and credit institutions to sell on risks to other investors. Supervision of financial firms and markets will also come under focus. At the moment national supervisory authorities in Europe are reviewing cross-border operations. Among Nordic countries, cooperation is already well-developed through so-called "supervisory service agencies" with biggest mandate to supervise the largest financial groups in the region.

Is the European model more resilient to financial crises?

The European Union's decision to put in place a common set of rules to handle the present financial crisis shows the European model is in a position to act, .not least when it comes to agreements on cross-border problems if and where needed. This does not mean that the EU is more resilient to financial crises, but we have an efficient model to solve it when it occurs and when it spreads across borders. It is worth noticing that the need for a common agreement was recognised only once some of the member states had already acted on their own. This goes to show that even if different national conditions prevail in individual countries, a common agreement is in order to prevent problems from spreading from one country to another.

The Swedish experience in housing finance

The following is a comparison with Sweden's experience following the severe economic crisis of the early 1990s. The symptoms at the time were very similar to the present housing and financial crisis in the USA, even though the underlying causes for the crisis were somewhat different.

The 1990s credit crisis in Sweden had five main causes, as follows:

- High inflation
- A non-credible fixed exchange rate. Sweden had a history of several devaluations
- An unsustainable tax system, with very high marginal tax rates (in 1990, the marginal tax rate was 55 per cent for an average blue-collar worker and 66 per cent for a senior civil servant)
- Large subsidies to housing (approximately 2 per cent of gross domestic product in the early 1990s)
- A house price boom largely driven by a negative (after tax) real (i.e., excluding inflation) interest rate on housing

By the end of the 1980s, policy discussions over solutions for the poor macroeconomic performance were intensified. The need for major tax reform was widely recognized. Income tax was lowered and interest rate deductibility was further reduced. Moreover, a decision was made not to devalue the Swedish krona again vis-à-vis the Ecu (a basket of European currencies that was the precursor to the Euro).

In a bid to preserve the peg to the Ecu, the Rijksbank (central bank) had to maintain ever-higher lending rates because of persistent capital outflows and the global recession of 1991/92; – at one point in September 1992, the Rijksbank raised its benchmark rate to 500 per cent. Eventually in November 1992, the currency peg was abandoned and the krona began to float on the foreign exchange market. The short-term negative effects on the economy were substantial, with real gross domestic product declining by more than 4 per cent between 1990 and 1993.

The banking and property sectors were hardest hit by that early-1990s crisis. A couple of banks were taken over by the government and several commercial real estate companies went bankrupt. Even though commercial property prices fell the most, residential property suffered severely as well. Between 1990 and 1993, inflation-adjusted house prices declined by 27 per cent across Sweden, and by 37 per cent in the Stockholm area. Residential investment fell by 70 per cent between 1991 and 1995, and today (November 2008) still amounts to only 70 per cent of the 1991 level.

However, the Swedish economy has since recovered miraculously, with a 3 per cent real annual average growth rate from 1993 to 2007, or double the 1980-1993 rate. This turnaround came in response to lower, stable inflation and sound public finances. Gross public debt declined from over 70 per cent of gross domestic product to about 40 per cent in 2007. High domestic savings have been fuelling capital expenditure and exports have been another very supportive factor.

This experience has paved the way for a major turnaround in Sweden's housing policies. The previous framework combined substantial subsidies and very detailed regulations for construction. . Today, the housing sector thrives on an enabling environment consisting in well-adapted regulation and a 'sustainable' focus, against a more general background of sound economic and financial infrastructures. The rationale is to combine a well-functioning housing market together with stable financial mechanisms.

The European approach to the financial crisis

EU member states concur that it is incumbent on each of them to ensure bank funding and liquidity and to strengthen saver security. It is for every sovereign government to determine the scope of the guarantees and other support it is willing to grant.

At the same time, EU countries continue to work together on a more harmonised regulatory framework for financial services. This includes an overhaul of banks' liquidity, risk and capital ratios. It is important to harmonise regulatory frameworks and financial institutions within the EU, but we also need harmonisation of crisis management approaches among supervisory authorities from different countries. There will also be discussions about deposit insurance harmonisation in respect of what must be guaranteed and how.

The European Commission has also announced forthcoming proposals on four major issues:

- Sharpened, common accounting standards
- Improved supervision of credit rating institutions
- The limits of compensation 'packages' for bankers, including bonuses and 'golden parachutes' for top management
- Doubling individual deposit insurance to EUR100,000.

The fundamental challenges

The situation in the USA today is very much like that of Sweden at the beginning of the 1990s, with one major difference: the US economy is about 30 times as large as Sweden's.

The conclusions that can be drawn from the recent crises in housing finance and banking are as follows:

- The financial industry must be reformed in order to price risk properly. For instance, recent overinvestment in housing has locked-in resources which could have been put to more productive use elsewhere.
- The housing boom implies that housing has become very affordable in many countries. During the last 10 to 15 years, the older generations have benefited from rising house prices, and during the next 10 to 15 years, the younger generations will benefit from cheap houses.
- Higher US saving rates must be met by reduced savings in Asia and in other countries with large current account surpluses. This is the only way in which growth can improve around the world.
- The solution to the crisis can only be a global one.

Europe's role in the reconstruction of the global financial system

Being host to some of the world's major financial centres, Europe must play a major role and already has in place the well-developed functions required to do that at national level. However, any discussion must take place in a broader context where countries from other parts of the world can participate. If we want to build a stable international financial system, a global consensus on common solutions must be found. The goal must be to maintain the overall drive for prosperity in the global financial system at the same time as we improve the capacity to counteract and resist financial crises.

CHAPTER 5: **DEVELOPMENT BANKS AND THE GLOBAL FINANCIAL CRISIS**

Development banks, along with other international institutions, only have a mandate in the crisis in so far as it has implications for global public goods – their *raison d'être*. Further, development banks are *banks* and thus potentially involved, either directly or through the impact of the crisis on their intermediaries and borrowers. In a globalized economy, '*contagion;* has spread to emerging countries who borrow from developing banks. While these are well capitalized, and their clients are generally in a much more robust shape than they were a decade ago, some dangers lie ahead. However, restructuring is inevitable and comes with a number of lessons and opportunities for Asia.

Let me start with the lessons regarding important "public goods" that are part of the financial institutional infrastructure.

1) ***Governance.*** Good governance requires adequate funding of regulatory agencies, consistent incentives for regulators, and political backing. In this regard, the situation in Asia is much better than it used to be, though still vulnerable in some countries. However, a situation where an under-resourced, politically weak regulators stood by while finance houses offered 100 per cent mortgages to people with undocumented/unsubstantiated incomes, or where developers were providing house buyers' 5 per cent equity in the mortgage, is bad governance. And it was bad governance for *years.*

2) ***Deregulation***. This has been a boon to financial innovation and, in this sense, positive. The problem lies will ill-devised, blanket deregulation. "Self-regulation" is a contradiction in terms, as certain monopoly aspects of public goods functions cannot be transferred to the private sector. A situation where competing private companies with an implicit public guarantee effectively guarantee and supervise the mortgage-backed securities sector is a perfect practical illustration of the term "moral hazard".

3) Isolated ***regulatory systems*** are inappropriate against a background of inter-connected markets. Banks' 'parking' of risky assets in off-balance sheet vehicles is dangerous. So is pension fund reliance on the credit ratings of collateralized debt obligations when such ratings are ultimately based on recent (and exclusively positive) experience. These types of practice are dangerous though within the law, so long as regulators in the banking, securities and fund management industries fail to coordinate.

4) Linked to all of the above is an inadequate understanding of ***systemic linkages,*** particularly among asset markets. Some central banks, notably Australia's, have managed to deflate a housing asset bubble. Others did not. Indeed, some claimed they could not, even denying its existence although average house prices had soared to 14 times average earnings (anything over six times should ring alarm bells). The link between asset values and demand in the real economy is by now, quite evident on "main street." Another systemic link was with personal debt, stood at levels *never* reached, 35 per cent more than the previous "record" reached in the depths of the Depression, indicating acute vulnerability of demand to income/asset price shocks.

'Mainstream' economics may be to blame for the collective blindness to these linkages, but is no excuse for gross lack of common sense. The basis for systemic "*contagion*" occurs when the quantity and/or price of assets becomes *unsustainable* on the basis of the amounts of real (as opposed to "derivative") assets and/or the affordability of housing and corporate profits (shares). Collapse in one asset market affects others because, in simplistic terms, they are all priced in relation to each other. Yet economic theory, being focused on money *flows* rather than assets, is silent on the inter-connections among markets, and on the linkage between micro-level markets and macro-level economic systems. The same deficiency restricts the analytical basis of environmental policy.

Against this background, development banks must do the following:

- bolster financial governance systems, maintaining links between regulators and helping them collect the information they need to operate effectively;
- participate in any overhaul of the theories focused on systemic challenges to economic systems, particularly in developing countries;
- provide macro-level support to economic restructuring, in order to ensure that domestic demand plays a stronger role in economic development;
- provide micro-level support to financial institutions, in order to strengthen their governance and secure funding for productive investment;
- help generate real assets in which Asia's keen savers can invest; and
- help develop regional and global capital markets in order better to channel funds into such assets.

But, as they say, the current crisis is an ill wind that blows no one any good. And there may be some positive outcomes from what will undoubtedly be a tough time. First, asset prices, particularly housing, will become more affordable. Second, stimulating national demand and inter-regional trade will strengthen the underpinnings, balance, and sustainability of growth in the long term. Third, lower oil prices come as a window of opportunity in which new policies providing the right price signals for conservation can be put in place; this would benefit government budgets and foster more sustainable growth in the long term. Fourth, the attractiveness of "engineering" contrived financial assets vis-à-vis 'boring' 'real', productive investments in infrastructure is much reduced. Development banks must help countries to make the most of these "silver linings" to the clouds of the global crisis.

This overall situation leaves the Asian Development Bank with four priorities, as follows:

- the Bank stands ready to assist developing member countries just as it did during the Asian financial crises, i.e., lending to assist sector restructuring in a bid to take advantage of any "silver linings";
- Asian Development Bank loans to the financial sector, including housing finance, can counter any credit contraction (due to the need to bolster capital, or if countries raise interest rates to keep currencies stable relative to the US dollar);
- the Bank can help build national and regional systems which monitor asset values relative to underlying assets and affordability – "early warning" systems – and can help stimulate theoretical research into systemic threats;
- the Asian Development Bank can help channel capital expenditure on productive assets, such as infrastructure, for investors, as well as sound derivative instruments based on these assets which could substitute for "financial engineered" assets.

Cities come under special focus in the Asian Development Bank's *Strategy 2020*, particularly the promotion of 'liveable cities' that are competitive and environmentally attractive.. This concern is also at the forefront of the Bank's core strategic directions – addressing the issues of climate change and the huge infrastructure deficit, but also financing productive assets needed in the wake of the financial crisis. In summary, the Strategy focuses on:

- **Liveable cities:** In order to improve quality of life in Asian cities while reducing their carbon footprint – i.e., the amount of harmful greenhouse gases produced – the Bank helps developing member countries and their urban authorities deal with a range of environmental problems resulting from rapid urbanization: reducing air and water pollution, cleaner modes of transport, improved solid waste management, and reducing urban waste.

- **Urban infrastructure:** The Bank's focus is on water supply, sanitation, waste management and urban transport. Beyond building physical systems, the Bank also looks to improved delivery of such services, in the process creating an enabling environment for the private sector. More specifically, the Bank supports (i) developing member countries' capacity-building efforts in favour of improved infrastructure management, (ii) institutional and policy reforms that enhance the operational efficiency and sustainability of infrastructure projects, and (iii) logistical systems, in order to increase trade and investment.

In order to ensure broader ownership of the assets created, urban operations must emphasize public-private partnerships and private sector engagement. The ADB will promote a larger role for the private sector in infrastructure financing, either as project sponsor or institutional (bond or equity) investor. ADB's urban operations will also seek to mainstream efficient mechanisms for enhanced regional participation, partnerships, and cofinancing in line with the 2005 Paris Declaration on aid effectiveness. An example of such mechanisms operating in the urban sector is the Cities Development Initiative for Asia (CDIA).

Together with the German, Swedish and Spanish governments, the Asian Development Bank supports the Initiative which links interested cities to the resources they need to deploy environmental infrastructure. The Initiative supports preliminary work such as investment prioritization and pre-feasibility studies, as well as structuring projects for funding purposes; this can involve cofinancing partnerships and/or private sector funding with minimal transactions costs for client agencies. After nine months' operations (as of early November 2008), the Initiative is active in nine cities located in seven countries, and has disbursed US $2.5 million worth of technical assistance. The environmental infrastructure investment channel associated with its activities is over US $3 billion.

CHAPTER 6: THE ROLE OF GOVERNMENT IN HOUSING FINANCE SYSTEMS: A NORWEGIAN PERSPECTIVE

Housing for the poor has never been easy. At present we are all more than ever in search for adequate solutions that can make a difference.

The Norwegian State Housing Bank is something of an anomaly, as it operates in a highly deregulated and liberalised housing market where the proportion of home-ownership is close to 80 per cent. It is a fact: we have a national, housing-finance policy-agency that is alive and kicking after more than 60 years. And even in these difficult times, our losses are small and minimal.

We must learn any lessons that can be learned, and this is a good opportunity for the institution I represent here to advocate for the 'golden middle ground', i.e., between the rock of the past and today's hard place.

Keeping sight of the social aspects of housing policy

We must make sure that there is no missing link between *the social nature of housing policies* and *the role housing plays in credit policies*. Credit policies alone, involving mortgages and banks, will remain important, but the recent crisis has shown these are not sufficient on their own. The two aspects must be strongly connected. What matters is that housing policies are well-integrated enough and the social aspects are taken care of. No society can, in the longer term, afford to place large segments of its population at risk when it comes to basic needs like housing. But that means that a supplementary, corrective mechanism to the market is needed, and which must work alongside and in close cooperation with private credit and public regulators. This in turn involves a political dimension which lies beyond the scope of this chapter.

The need for an effective private credit market remains

We must not forget even older lessons. There are no 'quick fixes' either through public spending, large subsidy schemes or national budgets. For most of us, housing is the most considerable capital expenditure we undertake in our lives. And as we know too well, the needs are daunting. Adding this up, no national or international organization can in any sustainable manner replace the individual, or the private sector, as predominantly responsible for funding, construction or management on a sufficiently large scale. No sustainable solutions have yet been found to substitute for individuals' drive and willingness to pay as the cornerstones for housing projects. We need to work together, continue to mobilize funds and facilitate a well-functioning housing market; however, as public agents, we must make sure that this happens within a prudent environment that takes the needs and capacities of the underprivileged into consideration.

In the many ongoing discussions of credit market governance issues, what is often missing is a stronger focus on the underlying, not only economic, but social issues. For example, if someone without health insurance, faces a costly family situation with illness and huge treatment needs, or has a child in need of money to pay for college, which one of us

would not take a loan, regardless of price and long-term repayment abilities? The measure of efficiency often used by the credit market is simply different when the focus is kept on providing and securing housing for all. And this implies that the focus is on those that struggle to make it on regular financial terms.

In other words, the social aspects of housing policy must be reintroduced where they seem to have gone missing, and this must work alongside standard credit market involvement in housing issues. On the other hand, we should not think that vast amounts of subsidies and public capital are the solutions. Well-devised, sustainable housing finance guards everyone against the potential for over-investment, while determining exactly the amount of risk that can be borne by everyone involved along the housing loan chain.

How does Norway's State Housing Bank operate?

The Norwegian State Housing Bank hasremained a small and prudent organisation; as the market and welfare system around us developed, so did we. Over the years, though, national housing policies have maintained the focus on social aspects, and so have we, being the government's main implementing tool in this area. Today this means that although we are a supplementary institution to the private market, we keep focusing on social objectives. Over time, we adjust our tool-box as needs change, but always work through our partners. We stick with our specific mandate, leave to others what they do well and even leave more to them as they develop new capacities. And as other stakeholders increasingly become responsible for new housing construction, the Housing Bank becomes more and more focused on special, political priorities.

At present, while other housing institutions may be feeling shaky, the Norwegian State Housing Bank is not. Of course, a government institution backed up by Norway's oil economy can feel reasonably secure. But there is more than that: we like to believe that our legitimacy as an institution is also based on the merit of the system it has evolved. We believe that our position is as it is because we represent something important that may have been neglected as dynamic and modern housing markets have developed – something that adds stability to them.

And just to make it clear, the interesting element in our system is not the size of our yearly budget appropriations. The Housing Bank has, throughout its history, managed with relatively low housing subsidies, compared with most Western economies. We have always been perceived as a stable element by all those involved in housing and building. What really matters is that we have operated in a stable political environment and that our operations have always been transparent for public scrutiny, as they should be.

The Housing Bank is funded by the Norwegian government. Interest on our loans is based on government bond rates, plus a margin. This margin is set so that it covers administrative expenses while bridging some of the gap with commercial rates in order to reduce the potential for unfair competition. In this respect, EU experts have reviewed our system and were satisfied that it was well within European Union competition rules and regulations.

Today, the State Housing Bank focuses on those who have no easy access to a housing market which, otherwise, has served the majority of Norway's population well so far. In this endeavour, we co-operate actively with local authorities, as well as private credit institutions and builders. Our objective goes beyond granting loans, though, as it includes adequate and secure housing for all. Not only should those who may need some assistance in one way or another be helped to access proper housing, but they should also be able

to remain there. In order to do so, we take an increasingly comprehensive look at available resources. Municipal authorities remain our privileged partners but on top of that we look to mobilize various sources, including private banks, and combine them for maximum effect. Testament to our efforts as catalysts was this year, 2008, when on behalf of the State Housing Bank but according to their own priorities and local knowledge Norwegian municipal authorities lent out more than the Bank itself did. These locally disbursed loans were top-ups (i.e., complementary loans), while the Housing Bank traditionally grants primary loans (i.e., directly to individual borrowers). This development came as a turning point; we still manage to keep our losses at a minimum at a time when our lending volumes increase, but we do not expect these to become excessive. Overall, Norway's State Housing Bank continues to assist people with special needs and to give them access to sustainable solutions. So this is the middle ground I mentioned earlier: we need an effective commercial housing credit market, but it should not be left entirely on its own, and the State Housing Bank is there as a reminder that the social aspects of housing must be factored in.

CHAPTER 7: THE GLOBAL FINANCIAL CRISIS: A PERSPECTIVE FROM THAILAND

The 1997 Asian financial crisis began in Thailand and was followed by others in Russia and Brazil. In 2007, exactly a decade later, the US housing bubble burst and eventually led to a severe domestic financial crisis which soon spread across the world. The current 2008 global financial crisis did not arrive without any early warnings, though. Many symptoms of a bubble were obvious, eventually leading to the severe disaster the world has been going through of late.

In 2005, in an article entitled "The Global Housing Boom", *The Economist* magazine said that "the worldwide rise in house prices is the biggest bubble in history – prepare for economic pain when it pops". Many other economic experts and market observers also sent early signals that the US housing bubble would burst and that sub-prime mortgage expansion would trigger a financial crisis.

The Government Housing Bank of Thailand clearly forewarned in 2006 and 2007 that the US housing market was inexorably heading toward a gigantic crash. In 2006, an article in the *Housing Bank Journal* was headlined *"Will the US housing bubble burst in 2006 and 2007? What will be its effect on Thailand?"* According to the author, a close review of most 2006 US housing market indicators showed that the bubble would inevitably burst: "The overall 2006 US housing market is sluggish when compared to 2005. Dropping housing sale volumes, fewer housing units constructed, falling sales prices and a general drop in disposable income are contributing to a faltering US housing sector".

Perhaps more importantly, the article noted that the unsold housing inventory had risen to four million units for new and previously lived-in homes. This increase clearly showed that the housing market was becoming oversupplied and possibly overheated. "The downward momentum began exerting itself in 2004 and 2005 and in 2006 there are obvious signs of a downswing and the appearance of a contraction/recession cycle," the article said.

The article also noted that in 2007, additional negative factors such as higher interest and unemployment rates hurt consumer sentiment and forced housing prices downwards. Initially, housing prices declined slowly but the downward spiral picked up momentum in early 2007, ultimately leading to the bursting of the US real estate housing bubble.

Housing has always been a major contributor to the economic growth of the USA and other countries. Historically, housing sector expansion has always been a positive contributor to overall employment, consumption and social well-being. This is why the bursting of the US housing bubble can only have negative effects on the US economy and, since this is the largest in the world, spillover effects ripple around the world, affecting countries like Thailand.

During 2007, the GH Bank *Housing Journal* featured an article entitled *"The 2007 US Subprime Mortgage Crisis: Its Contagion Effect on Global Financial Markets"***.** The conclusion was that most housing market indicators showed that the US real estate market had dropped to its lowest levels in 16 years. Again, sales figures, construction starts, sales prices and consumer sentiment were all plummeting

while housing inventories were also rising to more than five million units.

By 2007 the US housing market was obviously in the midst of a downward momentum or contraction/recession cycle. The article also highlighted the effects of the housing bubble burst on the subprime mortgage crisis and its contagion effects on sub-prime mortgage lenders, investment banks and global stock markets. "A global financial crisis will inevitably lead to a global economic recession," the article warned.

The 2008 global financial crisis: Effects and response

The world has experienced many financial crises in the past. During the last three decades, these included the Latin American debt crisis in the early 1980s, the US stock market crash in 1987 and the late 1980s collapse of US savings-and-loans institutions that led to the creation of the Resolution Trust Corporation. In the 1990s, the insolvency of many *jusens* (housing loan companies) led to the decade-long Japanese economic slowdown and, ultimately, the 1997 Asian financial crisis.

In 1997 (just prior to the Thai financial crisis) the GH Bank *Housing Journal* featured an article entitled *"Real Estate Crisis* v. *Financial Institutions Crisis: Lessons Learned from the USA and Japan"*. The author made seven major conclusions, as follows: (i) Land and house prices depend largely on market forces (supply and demand), and cannot rise forever; (ii) excessive investment and speculation can lead to the collapse of housing developers; (iii) mortgage lending recklessness and imprudence will inevitably lead to mortgage lender damage or failure; (iv) even though mortgage lenders hold real property as collateral, foreclosure losses can still inflict damage; (v) the bursting of a real estate bubble will affect financial institution stability and ultimately a country's overall economy; (vi) volatile mortgage interest rates have significant effects on home buyers, borrowers and the real estate market; and (vii) effective resolution of the real estate and financial crisis calls for government intervention with appropriate, timely and decisive measures based on sound, accurate information.

The current financial crisis is the worst since the 1930s Great Depression. It is truly a "global crisis" in scope, because it affects the entire global banking and financial markets as well as the overall economy of not only the US and Europe but also the emerging markets of Asia and Latin America. The world has evolved into a single economy linked by a chain of international trade and investment, stock and other financial markets. Even though the world has weathered several crises in the past, they did not involve innovative or complex sub-prime mortgage-backed securities that were ultimately disseminated around the globe by powerful investment banks, hedge funds and other large financial institutions.

According to the Bank for International Settlements, the value of all outstanding global derivative contracts at the end of 2007 reached US $600 trillion. The worldwide losses on debt originated in America will reach US $1.4 trillion, according to the International Monetary Fund.

The current financial storm has severely affected many large global financial institutions. Two major US institutions, the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), as well as the world's largest insurer AIG, , were rescued by the US Treasury and the Federal Reserve. Several European banks have been nationalized or bailed out with public funds. Many more other financial institutions around the globe have become increasingly troubled or insolvent.

The massive size and complexity of the current meltdown has made it very difficult to

handle despite several attempts and concerted central bank efforts (such as the US Federal Reserve, the European Central Bank, the Bank of England, the Bank of Japan, etc.), by the US government and those of other advanced economies. Initiatives and policy actions include liquidity injections and bailout plans for collapsed and insolvent financial institutions (the USA alone had announced a US $700 billion plan). Central banks around the world have announced coordinated cuts in interest rates, State guarantees of personal bank deposits, and programmes to purchase distressed assets. These actions may help boost confidence and ease the worsening situation on a temporary though not conclusive way. More vigorous efforts and further actions are required to stabilize financial markets and support the global economy.

The overall impact and consequences of the crisis have been very deep, broad-ranging and diffuse around the world, resulting in global recession that may take many years to recover. We should hope for the best, but also prepare for a possible worsening future and not become the victims of "optimistic or pessimistic errors".

A global crisis needs a global solution

The current financial crisis is truly a global problem and must be resolved at a global level. A single country does not possess enough power or resources to deal with a systemic, worldwide financial crisis in any effective way. This situation calls for concerted and coordinated efforts by governments and central banks, particularly from economic powers like the USA, Japan, China, Germany, France and the UK.

In today's financial environment, global financial institutions, such as large commercial or investment banks and hedge funds, have not been well-regulated or supervised.

Complex securitized products and derivatives such as collateralized debt obligations (CDOs) and credit default swaps need cross-border supervision and regulation. The current crisis offers the world an opportunity to restructure and reform the regulatory system as required by today's political, economic and financial environment.

The current roles of prominent organizations like the International Monetary Fund, the World Bank, the Bank for International Settlements, the United Nations and regional development banks, etc., must be reviewed and reformed, in order to cope with any future crisis and provide long-term stability. The world now needs new and more powerful organizations in order to deal with the current and future global financial crises in an effective way.

This could be the task for a new 'World Central Bank' with a mandate to monitor the stability of the world financial system, regulate and supervise cross-border financial institutions, coordinate with the central banks of respective countries and devise rescue or stimulus plans during global crises. Beyond individual financial institutions, this world central bank should also take in the national, regional and global dimensions of financial stability.

How the global financial crisis affects Thailand's housing finance sector

Many Thai financial institutions became insolvent and were closed down after the 1997 crisis. The housing sector suffered a meltdown and most developers became insolvent after the bubble burst. The housing market took four to five years to recover.

Since 2002, the Thai housing market has again expanded significantly, and and so far (late 2008) without any symptoms of

overheating. The Thai housing and housing finance industry seems to have learned its lessons from the 1997 financial crisis and has deployed a number of safeguards against bubble-like booms or external shocks:

- **The housing finance sector:** The banking industry has become much more cautious when lending to housing developers and individual borrowers. Prudential mortgage lending practices now include income, employment and National Credit Bureau verifications. No banks are providing US-type subprime loans. In addition, most have adopted mechanisms that mitigate the effect of interest rate rises on repayments during mortgage rate-adjustment periods.

  Typically, most mortgage loans are for 20- to 30-year terms. However, interest rates are usually fixed for a short initial period and then adjusted to a floating rate for the balance of the term. These fixed monthly payments reflect an interest rate that is 1 to 3 per cent higher than the agreed rate. This provides a smooth transition for borrowers: if interest rates have risen by the adjustment date, borrowers' monthly payments are not as adversely affected.

- **The housing sector:** Housing developers, too, have become more cautious in Thailand after the 1997 financial crisis. Many developers have professionalized their operations and joined trade groups such as the Housing Business, Thai Real Estate and Thai Condominium Associations. Compared with 1997, developers are now able to respond much more quickly and effectively to supply and demand imbalances. Many developers closely monitor the housing market and conduct extensive market research before developing projects. The housing associations, the Real Estate Information Center and the GH Bank Housing Journal assist developers as they disseminate housing market, investment and development information based on supply and demand statistics.

As a result, available housing units are not currently in oversupply and the financial condition of most housing developers is much more robust than in the past. In addition, house prices have not increased dramatically in most areas, and speculative buying is not significant in the overall housing market.

Nevertheless, the 2008 US financial crisis has an effect on other economies around the world. Because the Thai economy is integrated with the global economy, it will inevitably suffer from any systemic and contagion fall-out.

The Thai stock market has plunged on the back of the US and other bourses, losing about half its value. The export sector has been steadily shrinking. The tourism industry has been severely affected not only by external economic factors but also by domestic political instability. Private investment and domestic consumption have also been affected by political instability and the worsening economy – resulting in lower overall sentiment and consumer confidence. These combined factors seem bound to lead to a weakening economy in 2009.

As a result, consumer income and savings will be hit, as will purchasing power and housing demand with them. Growth in the Thai real estate market and the housing finance sector will be slower in 2009. A weakening economy will force banks to be more restrictive in their lending practices, including for mortgages where rejection rates will rise. In response to this slowdown, most housing developers will rein in construction in order to reduce risk. Fresh capital expenditure on new housing projects will also be reduced because the global liquidity crunch will make it more difficult to secure financing through securities issues (equity or bonds) or from financial institutions.

Concluding remarks: The root causes of the current crisis - Lessons learned and economic outlook

The 2008 global financial crisis which started in the USA is the worst financial collapse since the 1930s Great Depression. It is bringing turmoil to the US and world financial sectors and simultaneously weaken economies around the world.

Several international banks and financial institutions have needed bailouts. Many countries have asked the International Monetary Fund for liquidity support and rescue schemes. The economic effects have been severe on those countries with sophisticated financial and capital markets.

At the time of writing, financial and economic conditions in many countries continued to present serious downside risks, particularly for their financial systems. Many advanced economies are now in recession and potential 'bust' phases. According to a report by the International Monetary Fund dated November 6, 2008, the gross domestic product of advanced economies such as the USA, United Kingdom, Germany, France, Italy and Japan was to regress further in 2009, by –0.3 to –1.3 per cent depending on countries – the first such fall since World War II.

The current crisis also directly and indirectly affects emerging economies and small developing countries like Thailand. The global economic outlook has weakened. The International Monetary Fund sees world production of goods and services expanding by only 2.2 per cent in 2009, compared with 5 per cent and 3.7 per cent in 2006 and 2007 respectively. According to the World Bank forecast, the world economy was to grow by only be 1 per cent in 2009.

Many lessons can be learned from the 2008 global financial crisis triggered by the US real estate bubble. At first glance, some pundits blamed the proliferation of poor lending practices that led to "subprime loans" and the wholesale global dissemination of the related risks through sophisticated "toxic" derivative financial instruments for igniting the current crisis. Others blame the lack of regulatory controls or political interference for encouraging low-interest rates that jump-started otherwise faltering economic environments that would have been better served by a series of minor market-cycle corrections.

However, the current crisis has its roots in the biggest housing and credit bubble in history and resulted from many causes. It involved many types of participants, including borrowers, mortgage lenders, investment banks, investors, credit rating agencies, financial innovators, securities issuers and dealers, mortgage brokers, financial insurers, regulators, etc. It was a long and complex chain of causes and effects that led to the crisis.

Housing prices rose consecutively for more than 10 years, bringing in more housing speculators that prolonged a booming market. Many mortgage lenders adopted imprudent lending and other practices, including the sale of subprime loans to the secondary mortgage market for securitization.

Huge amounts of mortgage-backed securities as well as other innovative and sophisticated debt products backed by subprime loans (such as collateralized debt obligations and other derivative instruments) were sold to investors, promising higher yield. Rating agencies bolstered confidence in these often complex investments and their issuers with high credit ratings. Strong demand for these complex mortgage securities led to looser lending standards, which in turn encouraged more loans, driving house prices higher and fuelling a bigger bubble.

The bursting of the US housing market bubble in 2008 came as the culmination of a

more than decade-long housing boom that has escalated into a full-blown global economic and financial meltdown. Towards the end of the boom, dubious "sub-prime" loans to "unqualified" buyers prolonged the bubble and eventually triggered the current global financial crisis.

During the boom, many banks increased their leverage by issuing and ultimately holding more of these complex instruments. They were driven by quick profits and engaged in high-risk, unsound risk management. Many central banks and regulators were themselves guilty of poor supervision, turning a blind eye to increased risks.

Today, housing, goods and services, trade, financial and stock markets are closely inter-connected around the world. International interdependence is much greater than ever before. The US housing boom-bust cycle is just one of the factors in the complex processes that triggered the current global financial crisis.

Moreover, a deeper review of the root causes of the current crisis may require more of a historical and human behavioural perspective. The current crisis may just be a culmination of the inevitable "bursting" of a housing and financial bubble that occurs when markets become overly optimistic.

Psychological roots of human behaviour such as excessive greed, overconfidence and optimistic view of the markets, misconceptions or illusion on price appreciation, short-term speculation and easy profit-making and recklessness in borrowing and lending during the upturn all combine with unwarranted fears, panic, distress and depression during any downturn to contribute to boom-bust market cycles, often leading to deep, broad-range crises.

The current crisis is more severe than past ones because more individuals, financial institutions and countries are involved. Therefore, any resolution needs coordinated international efforts for a fundamental restructuring of the global financial environment. It may require a powerful world organization like a World Central Bank to deal with regional or global financial crises.

CHAPTER 8: THE ROLE OF GOVERNMENT IN EUROPEAN SOCIAL HOUSING FINANCE SYSTEMS

This chapter reviews the various approaches to social housing finance that are in operation in Europe today. It examines the key features that may be replicable in other countries, particularly in the developing world. The perspective focuses on the *purpose* of social housing, the sources of *funds* for social housing and the *institutions* that are used to provide social housing. The size and composition of the social housing stock in various countries and the types of provider are identified. So are the relationships between public and private sources of funds and the conditions that promote commercial funding of social housing. The structure of European social housing finance systems and the respective roles of loans, subsidies and equity financing are explored. The effectiveness of social housing finance systems in achieving their purpose and the issues that influence the transferability of European approaches to other countries are discussed.

It will be shown that the case for providing social housing rests on two propositions: (1) market forces will not result in acceptable housing standards for all the population, and (2) improving the housing standards of those who are living in sub-standard accommodation is best done through at least some direct provision of housing, rather than only by the provision of additional financial resources to the poorly housed. When examining the transferability of ideas between countries, it should be stressed that these propositions are contestable and they must be tested against the circumstances that prevail within given countries. The underlying concepts are acceptable housing standards and housing needs. There are no absolute acceptable housing standards. It is for governments to decide what quality of accommodation is sufficient to house its citizens. If households are unable to afford housing of an acceptable standard, there is a difference between what they can *demand* in the marketplace and what, according to prescriptions on acceptable standards, they *need*. Markets work on the basis of demand and supply. If *need* is deemed to be different from *demand*, some kind of housing policy is required to address the difference between what households can afford or demand and acceptable standards of housing that governments deem that they need.

Definitions

Europe lacks a common definition of 'social housing'. Each country features forms of housing that are broadly designed to satisfy the needs of households who are unable to compete in the marketplace for housing of an acceptable standard. Although social housing is generally equated to social rental dwellings, the term is sometimes also used to describe the provision of affordable dwellings for sale to assist low-income households to own or part-own their dwellings. Social rented housing is often supplied by non-profit organisations and rents are typically at sub-market levels. This means that some form of subsidy is almost inevitably involved. The legal status, the rent levels and the existence of subsidies are thus often germane to the definitions that are applied for practical purposes in individual countries. However, in principle, the key distinguishing feature of social housing lies in the way the accommodation is allocated.

Social housing is allocated outside of market mechanisms according to need rather than ability to pay. This means that administrative processes driven by policy decisions are used to allocate dwellings, and access to the accommodation depends on the way needs are defined and interpreted. In this chapter, the term 'social rented housing' refers to housing that is allocated according to need (Oxley, 2000).

The purpose of social housing

Bridging the gap between need and demand

The provision of social housing may be viewed as one way of bridging the gap between need and demand or, more specifically, of meeting the needs of households that are unable to exercise effective demand (Oxley, 2004). The phrase 'housing need' is often poorly understood and ill-defined, and used in a variety of ways which adds to the confusion. A useful definition is as follows:

"Housing need may be defined as the quantity of housing that is required to provide accommodation of an agreed minimum standard and above for a population given its size, household composition, age distribution, etc., without taking into account the individual household's ability to pay for the housing assigned to it." (Robinson, 1979, pp56-57).

This is a definition of aggregate housing need. The 'agreed minimum standard' should be such that housing above this standard, which we may call 'decent housing', is the only housing which is acceptable. Decent housing would provide adequate shelter to households and produce no negative externalities. That is, it would impose no external costs on the community in terms of, for example, adverse effects on crime and health. Individuals have unmet housing need when they are unable to exercise effective demand for decent housing.

Effective demand involves a willingness to buy or to rent. There is no necessity to ascribe to decent housing the status of 'merit good', as is sometimes done, since any lack of effective demand may not be due to individuals failing to recognise the benefits of decent housing, but rather a lack of resources. With 'merit goods', the concept of consumer sovereignty is suspended. The case for society satisfying housing need is not essentially one of overriding individual choice in a paternalistic fashion, but rather of empowering individuals so they can occupy decent housing irrespective of their ability, but not their desire, to pay for that housing. Viewed in this way, housing problems are essentially problems of a lack of effective demand for decent housing. Markets work on the basis of effective demand (Oxley, 2000, p2). Under this perspective, the purpose of social housing is to provide housing for those who are in need but lack effective demand.

A contribution to social, economic and environmental objectives

It has been argued that:

"Social housing serves different client groups in different countries – in some, it is a tenure of the very poor, while in others it houses low-waged working families or even the middle classes while the very poor are accommodated elsewhere. In a few, there is a wide range of income groups. Even so, it is true to say that the social sector generally houses a disproportionate number of single-parent families, the elderly, and the poor." (Whitehead & Scanlon, 2007, p6).

However, social housing may also pursue wider objectives, including promoting mixed tenure communities, ensuring social mix in urban areas and contributing to social, economic and environmental objectives. Through control over the construction, location and allocation of sizeable proportions of the housing stock some governments (e.g., in the UK and the Netherlands) have tried to use

social housing to achieve goals that go beyond simply housing the poor. They have sought to influence the composition of neighbourhoods to achieve a mix of households in specific localities. On top of this, exercising some influence over the design and construction of new social dwellings enables governments to promote environmentally friendly buildings that are 'green' in terms of construction and the energy use. When social housing is targeted at low-income workers, especially in the public sector, the purpose is more clearly to achieve a *labour* market than a *housing* market objective. Subsidised social housing for such 'key workers' can be seen as essential to local supplies of labour and the performance of the local economy.

The social housing stock

The size of the social rented stock, as defined for administrative purposes, varies considerably between countries, as shown in Table 1. The largest social rented sector in Europe is in the Netherlands, where it represents 35 per cent of the housing stock. Social renting is also relatively large, at 20 per cent or more of the stock in Austria, the Czech Republic, Denmark, Sweden and the United Kingdom. At the other end of the scale, many countries have a very small social rented sector. For example, in several countries including Bulgaria, Latvia, Portugal and Spain, only 3 per cent or less of the stock is classified as social rented housing. In Greece there is, according to the relevant official definition, no social rented housing at all. In countries with a large social rented stock, the sector comprises between 43 and 77 per cent of the rented stock, with the remainder made up of private rented housing as allocated by market forces. Even in countries with a small rented social rented sector, the overall contribution to the rented stock can be high if renting is dwarfed by a large home ownership sector. In Hungary, for example, the relatively small social rented sector comprises 66 per cent of the rented stock and over 90 per cent of the stock is owner-occupied. Despite cutbacks in some countries, in others social sector construction continues to make a significant contribution to overall house building: it stands at 35 per cent of total housing construction in Austria and between 10 and 20 per cent in several countries including the Netherlands, Slovakia, England, Sweden and Spain. In the latter case, new construction is adding to a relatively small social sector.

The differences between countries shown in Table 1 are not simply a consequence of current policies. They are the result of various decisions made over many decades. They are typically not the outcome of rational deliberations about how large the sector should be; rather, in practice, a good deal of *ad hoc* actions has been involved. Small rental sectors can be partly attributed to policies that over time have favoured home ownership and larger rental sectors over policies that have placed less emphasis on owner occupation. The relative attractiveness of private rental housing and home ownership as investments can also have important implications for the size of the social rental sector.

Social housing organisations

There is a wide variety of social housing providers in Europe, including central or local governments and a range of voluntary or non-profit associations and foundations, public or private non-profit companies, co-operative organisations and private investors. In some countries, social housing suppliers are encouraged to act in an increasingly competitive fashion (Oxley *et al.*, 2008). The distinction between private and social renting cannot easily be determined by the type of supplier (Oxley, 1995). It has been argued that the most important distinctions are between those countries where the owners and managers of the stock remain formally in the social sector but use private finance to fund additional

TABLE 1: **Social rented housing stock and construction in Europe, 2007**

	% of total housing stock	% of rental stock	% of house building
Austria	21	53	35
Belgium	7	24	6
Bulgaria	2	40	0
Cyprus	3	14	NAv*
Czech Republic	20	61	20
Denmark	20	43	20.7
Estonia	7	44	NAv
Finland	18	52	12
France	19	43	9
Germany	6	11	9
Greece	0	0	0
Hungary	4	66	NAv
Ireland	8.5	38	6.3
Italy	5	26	NAv
Latvia	1	4	0.02
Lithuania	2.3	66	NAv
Luxembourg	2	8	NAv
Malta	6	23	NAv
The Netherlands	35	77	12.8
Poland	12	47	8.3
Portugal	3	14	3
Romania	2.2	58	NAv
Slovakia	4	80	13.7
Slovenia	4	57	NAv
Spain	1	9	10.3
Sweden	21	48	20
United Kingdom	21	68	11

** NAv: Not available*
Source: Czischke & Pittini, 2007

provision (usually with the help of subsidy) – for example, England, the Netherlands and Ireland – and those countries where purely private developers and construction firms are significantly involved in development and ownership. Germany and Austria are suggested to be the most representative countries using this second approach (Whitehead & Scanlon, 2007, p13).

A widespread form of private sector involvement involves a 'State agent' model, as developed by Maclennan & More (1997). The model combines market production and State allocation, leaving the production and pricing of homes and services to market providers. The 'State agent' would then be responsible for securing market vacancies of an acceptable quality, and matching them to qualified

waiting list applicants. Subsidies would then be calculated in relation to household incomes and requirements and be paid directly to the landlord. A contract for an agreed duration, would govern landlord-tenant relations (Maclennan & More, 1997, pp540-541). The same authors suggest that this system could generate market signals and allow subsidies to be well-targeted. However, they acknowledge that in periods of shortage, suppliers could extract scarcity rents. One way of tackling this, it is suggested, is to combine 'social agent' and 'not-for-profit' models. The 'social agent' would contract with not-for-profit providers who would be limited in their desire and ability to charge scarcity rents. However, efficiency would remain a problem and it is argued that "the main challenges concern how not-for-profits can be made to behave as efficiently as possible."(Maclennan & More, 1997, p 541). Efficiency can be promoted through competition. This competition could involve a variety of housing providers, both profit- and non-profit making. If the rents set by these providers reflect consumer preferences, then they also provide the signals for any new production that may be required (Oxley, 2000, pp14-15).

In Ireland, under the Rental Accommodation Scheme (RAS) local authorities have, since 1995, applied a version of the State agent model that uses the private sector to supply social housing. They have established contracts with market landlords who agree to provide accommodation that meets minimum standards. The RAS is expected to expand the amount of market rented accommodation available on a long-term basis to low-income tenants who are unable to access local authority housing. The scheme is also expected to improve the quality of accommodation provided and increase tenant choice. The local authority makes direct payments to the provider and the tenant makes a contribution to the costs through a payment to the local authority. Being in the implementation process, the RAS had only been deployed on a relatively small scale at the time of writing (Buchanan, 2006).

Mechanisms for financing social housing

Many varieties of funding mechanisms can be found across Europe. Any review must be aware that the adequacy of existing mechanisms has been in question in several countries. It has been argued that:

"Many countries have recognised that if the social sector is to be sustainable, there is a need for additional provision, better maintenance and improvement, regeneration and a wider range of services. However, almost no additional streams of funding have been identified. The majority of investment schemes involve either using existing assets more effectively, selling property on the market, or mechanisms by which land values can be used to cross-subsidise development." (Whitehead & Scanlon, p32).

The increasing emphasis on supporting people, rather than 'bricks and mortar', is also clear:

"Additional funding is increasingly limited to private finance, public land and recycling existing assets. The commitment to provide for lower income employed households but using shallower subsidy remains strong, in part because of growing affordability problems among younger households. However, it is often being addressed through non-traditional means such as low-cost homeownership schemes. The commitment to provide for the most vulnerable is generally becoming more person specific, and depends increasingly heavily on income related allowances and private and charitable providers. The immediate policy emphasis is on initiatives for providing new housing and supporting broader regeneration projects." (Whitehead & Scanlon, p33).

An important development over the last three decades has been the increased involvement of private sector financial institutions in the provision of funds for social housing. In its simplest form, this means that social housing providers borrow from banks or other commercial sources who lend on terms that are deemed to be mutually beneficial. When granting these loans, financial institutions will take into account the risks and returns attached. The risks will be determined by the creditworthiness of the social housing organisations and the probability that they will repay the loans. The interest charged will reflect the risk attached to the lending. Any measures that reduce risks are likely to reduce borrowing costs.

If the lending is in some way underwritten by the State, this will reduce the risk and the interest rate. Loans in the Netherlands, for example, are supported by the Guarantee Fund for Social Housing. This was set up in the 1980s and it is funded by the housing associations with back-up by the government. It results in a top 'AAA' credit rating for Dutch housing associations. This facilitates access to the capital market and results in low interest loans (Elsinga & Wassenberg, 2007). In England, there is no explicit guarantee fund, but regulatory underpinning by the Housing Corporation has made it highly unlikely that a housing association will default on its loans (Oxley, 1999). Consequently, English housing associations enjoy strong credit ratings and have been able to access funds at commercially beneficial rates. More generally, the professionalism and competence of social housing managers will influence the capacity of social housing suppliers to access commercial funds. An increase in perceived managerial skills will have positive effects on creditworthiness. The fact that social housing organisations have, on balance, been run in a more business-like fashion in recent years has helped them to attract adequate flows of commercial finance.

In summary, the opportunity for private finance to support social housing is greatest where the following conditions apply:

- The existence of social housing providers that are perceived as 'good risks' with a secure and predictable revenue stream.
- Financial institutions that understand the tasks and the financial circumstances of social housing providers
- Regulatory underpinning and possibly the underwriting of loans by government.

The structure of European social housing finance systems

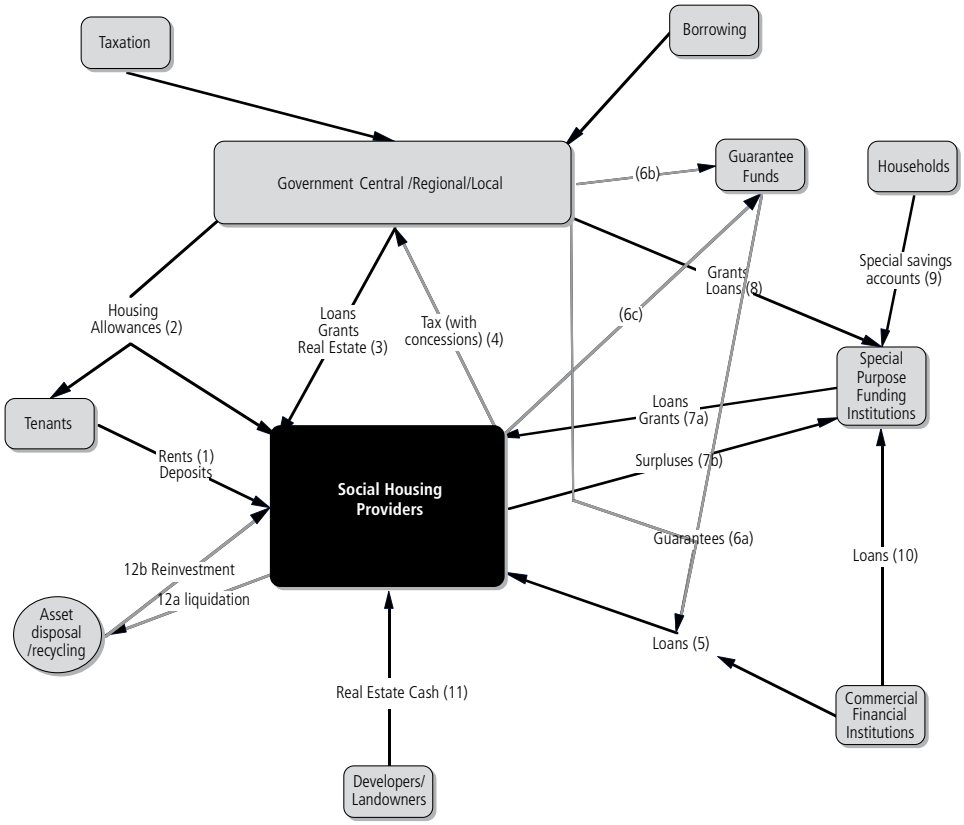
Figure 1[2] summarises the key flows that fund social housing in Europe. Not all of the flows apply in all countries. Some countries feature several of the funding sources shown and others have only one or two. The main options in use are identified. The social housing providers at the centre of Figure 1 comprise (as explained previously) a variety of public and private bodies including municipalities, non-profit housing associations, profit- making landlords and co-operatives.

Payments by tenants

The importance of payments by tenants in the form of rents and deposits (1) varies from case to case and is dependent on trends in rents and the levels of rent that can be extracted given the policy context and the provider's given stock of housing. It is possible that rents cover more than current costs and providers can make a surplus. This has been the case for some English local authorities and for some Danish housing associations. Rental income might thus be a source for both contributions to current costs and future capital expenditure, depending on the relationship between current revenues and ongoing management, maintenance and debt financing costs.

[2] The numbers in brackets in this section refer to the flows shown in Figure 1

FIGURE 1: **Social Housing Finance Systems**



Housing allowances

Housing allowances (2) paid either directly to tenants or to the providers, depending on the country, support the rental income stream and have become an increasingly significant form of social housing funding in the last two decades. In England, supply subsidies have fallen since the 1980s but have risen again recently. Subsidies overall are now concentrated more on housing allowances in the form of Housing Benefit (an individual, means-tested welfare allocation). Within the social rented sector, tenants receive support up to 100 per cent of rent plus eligible service income and charges, depending upon income and household circumstances. The scheme is technically the same in the private rented sector, but additional constraints mean that most tenants pay some rent. The British government is currently piloting a Local Housing Allowance based on average relevant rents in the local area rather than the rents private tenants actually pay (Whitehead, 2007, pp54-69).

In Germany, *supply* subsidies have been phased out since the 1980s in favour of a *personal* subsidy, *Wohngeld* (a form of housing allowance). In the year 2000, expenditure on housing allowances for the first time surpassed expenditure on bricks-and-mortar subsidies. These allowances look to reduce housing costs to 15-30 per cent of disposable household income. The amount of benefit is based on household size and income, the year that the

dwelling became available for occupation, and local rents. Housing allowances are subject to a maximum local rent level and a maximum household income, which is adjusted for the number of members of the household. The allowance is available to tenants but owner-occupiers can apply for it, although tenants dominate the recipients. Housing allowances are always paid to the occupant, not to the landlord in the case of rented property (Tomann, 1990, p928; Kofner, 2007). It has been claimed that "housing allowances are widely seen in Germany as a relatively market-conforming instrument of social policy … with the ability to act as a substitute for an important part of the social housing programmes" Kofner (2007, p159). However, only about 40-50 per cent of entitled households claim the allowance, mostly the working poor, the unemployed and the retired.

Direct support from government

Social housing providers have usually required support from government in the form of loans, grants or real estate (3). The provision of real estate usually means cheap land but can also include the transfer of publicly owned buildings at low cost. Direct government funding has become less important in recent years and in the Netherlands and Germany, for example, this type of direct central government support has been completely phased out. However, in Germany some of the federated states have individually decided to provide support. The funding made available by governments is mostly raised by general taxation and borrowing. However there are also examples of hypothecated taxes. An important example is the employers' levy in France where it has been known as the "1 per cent contribution" to affordable housing since 1953. The rate is now 0.9 per cent of the total wage bill for firms with more than 10 staff. The funds are used to finance housing allowances and to support cheap loans and grants to HLM (i.e., 'moderate-rent housing') organisations. In return, employers can designate beneficiaries among their employees. The funds also support loans to promote home ownership and specifically to finance a guarantee scheme for first-time buyers. On top of this, the contribution provides security to help low-income households rent in the private or social housing sector. In Austria, social housing is financed by a fixed, earmarked proportion of income tax, as well as corporation tax and 'housing contributions' (paid by all employees). The Austrian housing sector is subsidised in three ways: direct subsidies for construction and renovation (which make up approximately 70 per cent by value); individual subsidies for low-income households (approximately 5-10 per cent), and tax incentives (15 per cent) (Reinprecht, 2007, pp35-43).

In England, housing subsidies to local authorities make up for any difference between deemed rental income and deemed expenditure. Since new output declined in the 1980s and outstanding debt fell, most local authorities are in a position to use rental income to pay for rent rebates for lower-income tenants. Despite this, many authorities are in 'negative subsidy', allowing them to make a contribution to central government, which is reallocated to areas still eligible for subsidy (Whitehead, 2007, pp54-69).

Tax concessions

Government subsidies now often take the less direct form of tax concessions (4). These concessions are typically significant sources of subsidy. In France, concessions apply to value-added tax and property taxes and are linked to lending schemes for particular types of dwellings. For example, dwellings that are financed with the help of PLUS loans (loans for social housing rental, *see below*) are subject to a reduced value-added tax rate (5.5 per cent instead of 19.6 per cent) and no land or property tax is due for the first 25 years. PLUS loans are subsidised and can be used

for the purchase of buildings, land or existing dwellings, construction of new dwellings, conversion of non-residential buildings into dwellings and the development of hostels/ day centres for vulnerable groups. The loans may also be invested in urban restructuring operations. Non-profit housing providers such as HLM and housing associations are typically not subject to corporate tax.

In Germany, high depreciation rates have provided a major form of tax reduction (Droste & Knorr-Siedow, 2007; Hubert, 1998). Until recently, all housing received indirect subsidies in the form of high depreciation rates (100 per cent over 10 years) under a scheme that was set up in 1953 (Leutner, 1990) and has continued, with variations, since then. In 1964, the period of fiscal depreciation for a building was cut in half, from 100 to 50 years. Linear and digressive rates of depreciation have been authorized, enabling owners to opt for one or the other in the case of new-build homes (Kirchner, 2006). Tax relief on depreciation also applies to properties for which bricks-and-mortar subsidies have been provided in the past. The regressive rates of depreciation for new-build properties were increased in the early 1980s (Hubert, 1998). Nowadays, properties that were built from 1925 onwards can be depreciated at a rate of 2 per cent for 50 years. For properties built before 1925, the depreciation rate is 2.5 per cent for 40 years (Kirchner, 2006).

Commercial borrowing

It has become commonplace for social housing providers to borrow from commercial financial institutions such as banks and building societies (5). For example, in England since 1988, funding for new social sector building by housing associations has come from a mix of debt finance (raised on the open market against future rental income) and capital subsidies provided by central government. Funding from the private sector comes from a relatively small number of financial institutions involved in the provision of mortgages across the housing sector. The risk premium is relatively small because of the safety net of Housing Benefit (for low-income households), the comfort provided by the Housing Corporation's regulatory powers and the capital subsidy. Large-scale voluntary transfers (LSVT) of local authority stock to housing associations are funded 100 per cent through the private sector, except to the extent that new investment in the stock to make improvements may be eligible for capital subsidy (Whitehead, 2007, pp54-69). In Sweden, new construction by Municipal Housing Companies is funded on the open credit market. For a typical project, 80-90 per cent of building costs will be met by long-term loans (with a maturity of 40 years or more); the rest will be paid out of the housing company's own resources (Turner, 2007, pp148-164).

Guarantees

Commercial borrowing by social housing providers is sometimes backed by government guarantees (6a). Borrowings by the Swedish municipal housing companies, for example, is sometimes backed by municipal guarantees (Turner, 2007) and such guarantees are also used in Denmark (Scanlon, 2007). The loan guarantee process is in some cases organised through a dedicated fund that is supported by government allocations (6b) and possibly supported collectively by the social housing providers (6c). This is the case in the Netherlands, where the specialist Guarantee Fund for Social Housing (WSW) is funded by housing associations and backed by the government. In France, loans to HLM organisations are guaranteed either by local authorities or by the Mutual Fund for Guarantees of Social Rented Housing (CGLLS).

Special-purpose funding institutions

In several countries, special-purpose institutions have been set up to support the

funding of social housing organisations. The institutions provide loans and grants to help fund new building and improvements (7a). There are complex variations in the type of special-purpose institution and the sources of their funding. Examples of such institutions include the Housing Corporation in England (which also has a regulatory function)[3], *Caisse des Dépôts et Consignations* (CDC) in France and the National Building Fund for Social Housing and the National Fund for Non-Profit Housing Associations in Denmark.

Subsidised loans

The flow of subsidised loans is an important source of support in many countries. For example, in France, what is known as *Prêt Locatif à Usage Social* (PLUS) is a loan with a maximum term of 40 years (or 50 years for land purchases) and with a subsidy that ranges between 5 and 22 per cent of the estimated costs, depending on the region and the type of investment. Housing that is subsidised through PLUS is subject to maximum rent and income levels that differ between regions. Other subsidised loans are available for lower income and for higher income households, and loan maturities vary with the intended income and rent levels. Special loans (*Prêt Locatif Social* – PLS) are available to any investor in the intermediate sector where tenants must not earn more than 130 per cent of the income limit for 'normal' social housing (i.e., the income ceiling for the PLUS). The loans can be used either to build new homes or to purchase and refurbish existing property.

To apply for a PLS loan, the landlord must enter into a contract with the French State that runs for 15 to 30 years. During this period, the landlord is required to comply with guidelines on rent levels and tenant income. For social rental landlords, these obligations remain after the loan is repaid (Amzallag & Taffin, 2003, p9). Also, the contract between the landlord and the French State entitles tenants of a PLS home to a housing allowance – *Aide Personnalisée au Logement* (APL) – provided they meet the income conditions for this scheme. Another subsidised loan scheme – known as *Prêt Locatif Intermédiaire* (PLI) – targets a more upmarket segment of the intermediary rental sector.

Subsidised loans from special-purpose funding institutions can be used explicitly for the improvement of dwellings. An example from France shows how grants and loans can be combined. The *Prime à l'amélioration des logements à utilisation locative et à occupation sociale* (PALULOS) is a subsidy that social rental landlords can use for the renovation of dwellings that are at least 15 years old. The subsidy generally amounts to 10 per cent of the renovation costs with a maximum of EUR13,000 (US $20,985) per dwelling. Since 1980, more than 60 per cent of the social rental dwelling stock has been renovated through the scheme (Amzallag & Taffin, 2003, p48).

Funding special-purpose institutions

It is possible for social housing providers to contribute funds to a special-purpose institution (7b). For example, over 50 per cent of the surpluses generated by rents covering more than costs (because cost rents have been calculated as if interest on loans is still due, even if loans have been repaid) for the Danish associations has gone to the National Fund for Non-Profit Housing Associations. The funds have been recycled from the fund for the renovation and repair of older social housing stock. It is more usual for special-purpose institutions to be funded by central government (8), as in the case of the English Housing Corporation. In this case, the special-purpose institution essentially acts as a vehicle for the distribution of government funding.

France's *Caisse des dépôts* is funded through household savings accumulated in the State-

[3] In 2009 this funding role was to be taken over by a new body, the Homes and Communities Agency, and the regulatory role by the Tenant Services Authority.

regulated *Caisses d'épargne*. Most of these savings are in tax-free or fiscally advantageous savings accounts such as *Livret A* or similar schemes (Amzallag & Taffin, 2003). Currently, *Caisse des dépôts* provides four different loans that can be used for the construction, acquisition or renovation of social rental dwellings. Each type of loan focuses on a specific segment of the social rental market.

Special-purpose institutions can borrow from commercial sources (10). For example, the Danish National Building Fund for Social Housing borrows long term. In England, the National Housing Finance Corporation raises private sector finance to develop social housing. It was established in 1987 as a joint initiative between the Housing Corporation, the National Housing Federation (an umbrella organisation of non-profit housing associations in England) and the private sector. So far, the Corporation has raised over GBP1.5 billion (US $2.92 billion) in bonds and bank loans for on-lending to housing associations.

Support from private sector developers and landowners

In some countries, developers and landowners are required to contribute to the provision of affordable housing as a condition of planning permission (11). This practice is well developed in England but it is also significant in Ireland and the Netherlands. In England, private sector developments above specific thresholds must include a well-defined proportion of affordable housing, which can be a mix of social rented housing and low- cost home ownership dwellings. The details vary across municipalities and are subject to site-specific negotiations. The preference is for the affordable homes to sit next to the market-rate dwellings in order to promote mixed-tenure communities, but affordable homes can also be built on different sites, or money is provided in lieu of dwellings.

The assets of social housing providers

Social housing providers can use their own asset bases to support investment. This can take a variety of forms, including the liquidation of assets (12a), reinvestment in new stock, or refurbishment (12b). Liquidation can involve the sale of dwellings to tenants or to other housing providers. The use of assets can mean that equity capital is provided directly by social housing organisations. In France, the share of equity capital provided by an HLM organization depends on its financial condition: some are relatively well off, with very low debt and a strong asset base, while others have borrowed significant amounts. Many Dutch social housing associations feature a strong asset base, making them able to invest large amounts of capital in new provision. In 1995, through the so-called "grossing and balancing operation" (*brutering*) the government wrote off all outstanding loans to associations and at the same time cancelled "bricks and mortar" subsidies. Dutch housing associations are therefore funded by rents and sale of properties and their own assets. However, an ongoing question is who actually owns the associations' assets: the associations themselves or the government (Elsinga & Wassenberg, 2007). In Sweden, the net worth (total assets less total liabilities) of municipal housing companies, averaged 20 per cent in 2005, and return on total capital was 6.1 per cent; however, these ratios vary considerably across the country. Many municipalities receive a 6-8 per cent return on the capital contributed by the municipality to the company (Turner, 2007).

The effectiveness of social housing finance and transferability issues

The effectiveness of a social housing finance system is measured by its ability to achieve its purposes. It would be completely wrong to

design a new system or to propose changes to an existing one without a clear view of the *purpose of social housing* within the context of the overall *purpose of housing policy* and the place of social housing within that policy (King & Oxley, 2000). The design of the social housing finance system will then be influenced by the *mix of policy instruments* that are used to achieve the policy aims. A new or reformed system might work within existing *institutional structures* or it might, more radically, require the development of new institutions. Political choices must be made about the degree of *subsidisation* that is to support social housing and about the *market/State funding mix*, that is, the extent to which funding is to come from commercial as opposed to public sources. There must also be a view on the key *levels of decisionmaking*. This means, essentially, how much is to be determined nationally, regionally and locally, and it means how much discretion exists at each level of government, and how much rests with individual housing providers. There will thus not be a single 'best' housing finance system, but rather some that are more fit for purpose than others given the context within which they operate.

A tentative though not exhaustive list of policy aims could read as follows:

- Help low-income groups access decent housing
- Help low-income households have adequate post-housing expenditure incomes
- Improve the quality of housing consumed by low-income groups
- Increase housing choices for households with unmet housing needs
- Increase the supply of housing
- Improve the quality of urban neighbourhoods
- Improve the functioning of urban labour markets
- Promote community cohesion
- Improve macro-economic performance
- Promote environmental sustainability

In Europe, housing policy has become increasingly integrated with a range of wide social and economic objectives which mean that policy is reaching further down the 10-point list above than was the case in past decades. A housing policy that pursues broad goals is much more complex than one that simply focuses on low-income households. Any finance system must be compatible with the goals of policy in the given country.

When policy focuses on helping low-income groups access decent housing, the setting of the appropriate standards for decent housing is a key element in the success of policy. Meeting needs for decent housing means that government policies must bridge the gap between what is needed and what is demanded. If the standards of decent housing are set too high and what is needed is too great, housing policies will be extremely expensive. It has been argued that setting standards at inappropriate levels has been one of the failures of policies in developing countries (UN-HABITAT, 1994).

Social housing can be seen as a means of helping low-income households access decent housing, but in some countries it plays a wider inclusive role that includes a broad spectrum of the population. Social housing may also be expected to contribute to wider objectives – adding to the economic strength, social cohesion and sustainability of local communities.

Most housing arrangements include a mix of conditional subject and conditional object subsidies. The more housing problems are viewed as *demand*-side affordability problems, the greater is the propensity to use conditional *subject* subsidies. The more the emphasis is on *supply*-side housing shortage problems, the greater the emphasis is likely to be on conditional *object* subsidies. Whilst housing finance systems can support housing suppliers

directly by means of conditional object subsidies, they can also do so indirectly by conditional subject subsidies that underpin the rental revenue stream.

The institutions responsible for delivering and for financing social housing might at one extreme all be in the private sector and at the other extreme all in the public sector. In most cases, both sectors are mixed and often specialist quasi-governmental institutions are established to support social housing. Policymakers may decide to use existing institutions, and in some cases to promote provision with the help of subsidies. Alternatively, it might be concluded that new institutions must be created.

When they have been assisted by adequate conditional object subsidies tied to contracts to supply decent housing at affordable levels, private sector institutions have proved capable of supplying social rented housing. In developing countries in particular, the barriers to market sector institutions acting as social sector suppliers might usefully be investigated before alternative new institutions are created. It has been widely argued that a strengthening of property rights and reductions in transactions costs are needed to enhance the role of market sector suppliers in several developing countries (Habitat, 1992; Buckley, 1996; Groves, 2004). It has also been suggested that government-imposed high transaction costs have driven out formal sector suppliers and contributed to the growth of informal slum settlements (Boudreaux, 2008).

A housing subsidy involves a direct or indirect flow of funds that reduces housing costs (for consumers or producers) below the level that would otherwise prevail. Direct flows of funds involve governments using powers of taxation and/or borrowing to channel money into a housing organisation. This might be a lump sum or a period flow of funds. The funding might be a non-repayable grant or it could be a loan that is made available on terms that are better than those obtainable from commercial sources. Typically this means a lower rate of interest, but it could also involve longer term lending than is available commercially. Both options can reduce current repayment costs. Rather than supplying the loans themselves, governments may choose to reduce the costs of loans from commercial providers. This can be achieved in a variety of ways, such as underwriting the loans to reduce the risk and thus the interest rate. Governments may also create a 'special circuit' for social housing finance, allowing some financial institutions to collect funds (that are to be on-lent for social housing provision) at preferential rates. They can do this by either subsidising depositors (e.g., through bonuses that increase the rate of return on savings), or by legislation that requires certain types of organisations (e.g., firms with more than a specified number of employees) to deposit funds with the financial institution. This amounts to a special tax that is hypothecated for housing purposes.

Subsidies can be paid by any level of government and can include assistance in kind as well as direct financial grants. A major form of provision in kind occurs when housing providers are supplied with land at sub-market, including zero, costs.

Public authorities can also engineer cross-subsidies for the benefit of housing provision. The prime example is the subsidisation that comes from developers and/or land owners as a result of arrangements that require developers to supply a given proportion of housing or cash in lieu as a condition of planning permission for private sector development.

Increasing proportions of funding are now provided by financial markets as opposed to public authorities. This change has come about as governments have sought to reduce the budgetary burden of social housing. Government funding can lever in private sector funding, with housing providers expected to use commercial sources as a condition for agreed amounts of public funding. The specific

mix will depend on political decisions and be influenced by the maturity of the housing providers and the willingness of commercial institutions to support social housing. As explained previously, State guarantees can improve the availability and costs of market funding.

Depending on the structure of the State, major funding decisions can be made at national, regional or a more local level. The degrees of power and discretion attached to every tier of government have important consequences for housing finance systems. It has become common in Europe for detailed financial decisions to be devolved to municipal authorities and, in some countries, the more substantial subsidies are available only from regional or local rather than central government. In Germany, for example, since 2007 no more 'bricks and mortar' subsidies are available from the federal government, and it is now left to individual federated states to set their own legislation based on local needs. In France, various tiers of government (municipalities, groups of municipalities, *départements* and regions) can provide financial aid to social rental landlords. The support may take the form of direct funding, but can also involve the provision of cheap land for building purposes (Amzallag & Taffin, 2003). A further component of the decisionmaking process relates to the degree of discretion that is left with individual housing providers. Subsidies are sometimes tied to particular projects, but providers that are given some choice about the application of funding, possibly including the application of their own equity and borrowing powers, are able to make important decisions about investment for themselves.

It is essential that a housing finance system fits the circumstances of the country in which it is to be applied. Renaud (1999, p755) has pointed out that in countries where the majority of people are poor and demographic growth is fast-paced, "private as well as public institutions are often weak and fiscal resources are severely constrained". The search for alternative forms of financing systems must have regard for the financial sector as a whole and "There is no such thing as a homogeneous 'Third World' across which identical policies and instruments could be conveniently applied".

A discussion of the lessons countries in transition can draw from those more developed with regard to housing finance (UNECE, 2005) rightly points out that there is no "best" system, and whether a particular technique is appropriate depends on such factors as the level of economic development, monetary and fiscal policy and the legal and administrative structure. This applies equally to developing countries, as does the need for a reliable system for securing property rights and transactions. "Once these conditions are established, the appropriate finance institutions will emerge" (UNECE, 2005, p1).

Summary and conclusions

The need to analyse housing policy issues

The starting point for the design of a social housing finance system should logically be a statement of the housing policy issue(s) that social housing is expected to address, and an analysis of the causes of that problem. European social housing systems have been expected to address affordability and production issues. These arise in a context where governments have been concerned about minimum acceptable housing standards. The inability by households to afford housing of an acceptable standard can be viewed as a housing need and the source of inadequate effective demand by households. It can also be viewed as a lack of supply of an acceptable standard. Housing markets are geared to meeting *demand* though not necessarily *needs*. In recent decades, the problems that social housing has been expected to address have gone beyond affordability and housing supply issues, and now include an

expectation that social housing will contribute to solve much broader economic, social and environmental problems.

A supply problem?

Social housing systems arose and were supported strongly by governments when housing was seen mainly as a supply-side problem. That is, decent housing was in short supply and institutional and financial arrangements developed in response to this deficit. In many cases, the institutional arrangements involved public sector and non-profit suppliers who were assisted by State subsidies. This was not always the case, however. In some cases, Germany for example, private sector firms have played an important part in the supply process. Governments have given such firms conditional object subsidies that have allowed them to supply housing at below-market rents for households on lower incomes. In all cases, whatever the type of supplier, some form of subsidisation involving redistribution of resources has been required. When housing problems came to be viewed less as a supply-side problem and more as a lack of effective demand by lower-income households, finance systems that relied heavily on housing allowances were developed. As has been explained, several countries (including England) in recent years have come again to recognize housing as a supply-side problem and have developed fresh initiatives to expand social housing.

For countries that view housing needs as a supply-side problem, the nature of that problem should be probed in some depth before any changes in the finance system are put in place. Deficient supply might be related to inadequacies in physical infrastructure such as roads, drainage and utility services. Alternatively, it might be related to a lack of appropriative supply-side institutions that can develop and manage sufficient housing, or it might be that the necessary institutional arrangements are in place but they lack the financial incentives enabling them to supply housing of the required volume, quality and rents or prices, including for lower-income households. In the first case, additional spending on infrastructure should be the priority. In the second case, the development of appropriate housing production and management institutions should be the priority; and in the third case, finance to encourage supply from existing institutions should be the priority. In every case, extra supply of adequate housing can be viewed broadly to include more construction, improvements to the existing stock and an improved flow of maintenance and management services from the stock. Taking the third case, where existing institutions are deemed to be capable of delivery but financial incentives are inadequate, the focus should be on the best form of incentives.

Contracts to promote supply

The use of a contractual form of provision is a good way of tying incentives to supply, with the potential to promote good value for money. The contracts can be arranged between any level of government or government agency and any form of supplier. A financial system that promotes competition between suppliers for the award of such contracts can promote efficiency in supply and in the use of public finance (Maclennan & More, 1997). These contracts to supply social housing can be with profit-making or non-profit institutions, but the suppliers must be motivated by the incentives that are built into the contracts. The payments to suppliers in these contracts can be seen as subsidies if they allow provision to be at sub-market rents or prices, but they can also be seen as payments for the supply of the service defined in the contract. The use of conditional object subsidies has typified social rental housing provision in many European countries, but one crucial aspect has usually been lacking, namely, competition between suppliers for the award of contracts (Oxley *et al.,* 2008). Explicit, or more often implicit

contracts, have frequently been awarded to uncompetitive, privileged and protected social sector suppliers. This is changing a little in some countries. In England, for example, since 2004 housing associations and approved private firms have been able to bid competitively for contracts from the Housing Corporation for the award of public funds.

An effective form of contract provision requires that the products and services to be delivered are closely defined in the contract, with financial penalties for failure to deliver. This type of provision also requires open competition between suppliers with the capacity to deliver. Payments under the contract can, in principle, take various forms including flows of funds, the provision of land and the granting of tax concessions. The flows of funds can take the form of grants or cheap loans. The key point is that there should be a connection between the payments and what is delivered. The contract might be just for the delivery of real estate but, if it is for the management of social housing, a flow of housing services will be expected for several years and on-going monitoring of delivery, including customer satisfaction, should be linked to contractual payments. While in practice contracts are often for the perpetual supply of services, time-limited contracts increase the opportunities for the provider to ensure effective delivery. If a satisfactory service is not delivered, the contract should not be renewed. Tough clauses should also ensure that contracts can be terminated before the end of the agreed period if delivery is unsatisfactory.

Effective regulation

Ensuring that the quality of housing service delivered is adequate requires a strong link between the contractual obligations of the social housing supplier and the rewards and penalties that they face. This can mean deliberately placing the supplier in a risk-taking situation where other suppliers can take over provision in the event of unsatisfactory performance. Whether there is competition or not, the connection between finance and the regulation of social housing providers should be a strong one. Regulation must involve significant rewards and penalties if it is effectively to improve standards of delivery, including promoting high quality management and maintenance.

Commercial funding

Borrowed funds have been central to the expansion of social housing providers in Europe, as they supported new building and improvements to the existing stock. The sources and costs of borrowed funds are key features of social housing finance systems. The private sector has provided an increasing proportion of this funding. It has been shown that well-run and effectively supervised social housing providers, with a predictable revenue stream and an acceptable risk profile, are more likely to attract commercial funding on favourable terms than poorly run, risk-fraught institutions. The underwriting of the loans by government, in either a formal or informal fashion, can also facilitate this flow of funds, as can governmental support for providers' revenue streams by means of housing allowances. The use of guarantee funds, coupled with effective regulation and supervision, can reduce the cost of commercial credit.

Social housing providers' equity

The use of social housing institutions' own equity can be an important source of finance. This is dependent on the maturity of the institution, its debt profile and costs. In countries without mature social housing providers that have been allowed to retain their equity, such opportunities will be sparse.

The need for subsidies

Pressure on governments to reduce public

subsidies has increased as a consequence of macroeconomic policies, and therefore new sources of subsidies have been sought. A significant and growing source of cross-subsidy is the implicit taxation of developers and landowners through the planning system. The potential for such "affordable housing through planning", both within and outside Europe, is constrained by several considerations that have to do with a given country's planning system and the buoyancy of the land and housing markets. Affordable housing through planning can only work well if the planning system results in significant private sector gains when land is developed for housing purposes. These gains are likely to be more significant, and the potential for cross-subsidy to social housing development greater, when land and house prices are rising. In situations where the amount of affordable housing provision required from developers is negotiated, as in the English case, the relative skills and bargaining powers of private sector developers and public sector planners are additional factors influencing delivery.

Any social housing finance that supports low-income households is likely to involve a subsidy. Subsidies redistribute either resources within countries, or flows of funds in the form of aid to countries. The important political decisions for governments centre around how much redistribution they wish to support and how much of this redistribution is to come from taxation, cross-subsidisation or external sources. The transfer of ideas from Europe to developing countries must have proper regard for the purpose of social housing and the institutional structures in any specific country under consideration. Analysis has shown that there are no "easy fixes". Some form of subsidy, and thus some form of transfer of resources into social housing, will be needed if social housing is to meet housing *needs*, as opposed to satisfying housing *demand*.

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PART III
REAL ESTATE MARKET CYCLES: THE CASE OF THAILAND

CHAPTER 9: REAL ESTATE MARKET CYCLES IN THAILAND: A CASE STUDY OF THE 1997 FINANCIAL CRISIS

The real estate industry can be viewed from many perspectives: from the demand side, supply side, financial institutions, policymakers, and related professionals. This industry is a critical element of any economy.

The real estate industry in Thailand contributed about 6.5 per cent of gross domestic product (GDP) in 2006. Although a home is one of life's essentials, the real estate industry involves many stakeholders: design-related professionals, construction companies, building materials producers and suppliers, advertising and sales, etc. As a result, any real estate boom-bust cycle has a significant impact on a country. This is why it is important that all stakeholders gain a comprehensive understanding of these recurring cycles.

As modified from Bongsadadt (2000), Figure 1 compares new housing registered and gross domestic product (the period saw many Thai government changes and other major political, economic and real estate related events). During the past 40 years, the two factors fluctuated in a cyclical and asymmetrical pattern. All real estate industry observers would like to know where the market is heading as it would enable them to develop more relevant business plans.

The fundamental elements of real estate cycles

According to theory, real estate cycles track economic and other business cycles. The interaction between demand and supply causes vacancy rates, rents and housing inventories to rise and fall over and over again, like a bouncing tennis ball that has dropped to the floor.

The elements of a real-estate cycle

Figure 2 shows that a cycle can be divided into four successive phases:

At the *peak* of the cycle housing inventories are high, reflecting a lack of buyers. Developers take to delaying fresh investments and the market enters a ***Contraction Phase***. This is a buyers' market, i.e., one where buyers have more bargaining power than sellers.

As the overall economy slows down further, developers and buyers become more cautious, particularly in their spending on 'big-ticket' items. During this ***Recession Phase***, real estate transactions still occur, but few new housing projects are started and consumers delay buying decisions.

At the *bottom* of the cycle, housing

inventories are low and few new projects are offered. No one is sure how long the phase is to last – whether it will be a short "V" shaped or a longer "U" shaped bottom.

When the economy begins recovering, confidence returns and people take to spending again. Demand for housing and other buildings accumulates. Because it takes time to develop new housing, demand outpaces supply during this, the ***Recovery Phase***. This is a sellers' market, i.e., one where sellers have more bargaining power than buyers.

As economic momentum builds up, housing markets follow suit and enter an ***Expansion Phase***. New and existing developers gain confidence and bring new projects to the market. This phase ends when demand is absorbed and excess supply appears again. The market moves cyclically up and down, though with different durations and amplitudes.

Types of real estate cycles

After World War II, American and British authors identified property cycles and classified them into three types based on duration and time, as follows (Lee, 1999):

- Short cycle: three to five years. This type of cycle is based on housing and building demand, fluctuating along with other business cycles.
- Major cycle: nine to 10 years. This cycle is based on a supply-side production lag. It occurs because real estate products require lengthy periods to develop when they respond to the demand induced by the 'boom' phase of a business cycle. This cycle affects many types of property, including office buildings and industrial development.
- Long swing: 20 to 30 years. This cycle reflects waves of urbanization. Populations expand away from the nation's capital during periods of economic growth.

Different cycles for different property sectors

Real estate encompasses different sectors such as residential, low-rise and high-rise developments including condominiums, offices, retail outlets, and industrial developments. Each sector may experience market fluctuations at different times. For example, during the economic crisis (1997-2000), mega-stores expanded rapidly while other property sectors were at the bottom. Residential properties, including detached homes, townhouses or condominiums all involve different market cycles.

The factors influencing real estate cycles

Similar to other businesses, the real estate sector is influenced by the macro-economic background and business-specific micro-economic factors. Many researchers have identified these factors and their respective degrees of influence and types of relationship to business cycles.

Macro-economic factors can be categorized as follows:

- Growth in gross domestic product and employment rate
- Financial factors, including interest and exchange rates
- Capital-linked factors, for example the stock exchange index, and
- Socio-economic factors such as national income and age structure of the population.

Micro-economic factors include real estate-specific variables. A widely-used variable is "Housing Starts", which refers to the number of approvals for housing development applications with government agencies. This is a leading indicator that identifies housing numbers before construction permits are issued and before title deeds are transferred.

Statistics for the latter two items come at a much later date.

Indicators for three distinct timeframes

These indicators can also be categorized into three different stages (Dachavas & Lertbunnapong, 1999):

- *Leading Indicators* are factors that occur before the other phases and can be used to determine market supply – i.e., housing starts.
- *Coincident Indicators* reflect current conditions at any point in a cycle.
- *Lagging Indicators* are factors that occur after other events have taken place.

During the past several decades, many researchers from many parts of the world have built related statistical and mathematical models. These used data and specific cases to explain countrywide and city-specific real estate cycles. Many of these authors have pinpointed interesting relationships between these important factors. However, these results cannot be applied to, or used to explain, phenomena that take place in different locations.

The 1997 financial crisis in Thailand

Any real estate cycle has a variety of effects on the underlying economy. Thailand's real estate industry has by and large learned its lesson from previous cycles. The country's most recent, 1997 economic crisis had a severe effect on everyone, including the real estate industry.

The following findings are from research by Vanichvatana (2004). This author explored the 1997 economic crisis, which was partly triggered by an oversupply of real estate. The real cause can be linked back to the Thai government's 1992 financial liberalization policies. The author outlined the contributing factors from many perspectives: the international environment, the national environment in terms of financial and other government policies, real estate development companies, and consumer behaviour. The author went on to describe various government remedies and supporting policies and regulations. He also reviewed government efforts in favour of more accurate information on real estate demand and supply, and the measures deployed to prevent any reoccurrence of massively excessive housing inventories.

Thailand's 1992-2000 real estate cycle

This section describes the environment just prior to and after the 1997 economic crisis, from 1992 to the year 2000. This particular cycle can be split into four phases: (1) 1990/93: the beginning of financial liberalization; (2) 1994/96: the boom years; (3) 1997: the crisis year; and (4) 1997-2000: the recovery years, as shown in Figure 3.

1990/93: The beginning of financial liberalization

Two milestones characterise financial liberalization in Thailand (Siamwalla, 2000):

- In 1990, Thailand accepted its obligations under Article VIII of the International Monetary Fund charter, which requires the lifting of all controls on foreign exchange transactions on current account. An immediate result was a large influx of offshore loans, as everyone wanted to benefit from low offshore interest rates.
- In 1993, the gradual opening of capital accounts with the launching of Bangkok International Banking Facilities (BIBF)[4].

[4] Bangkok International Banking Facilities (BIBF) were

> Through this policy, all financial institutions, both local and offshore, could freely transfer and exchange foreign currencies. Institutions receiving BIBF approval could accept deposits, and lend, in foreign currencies. Deposits and loans could be made offshore or in Thailand. Borrowed funds could be invested in the country or offshore. However, the new policies increased the amount of foreign debt (Chunhawan & Mahutanobol, 2006).

The country was not ready for liberalization

Thailand was not ready for financial liberalization and this led to the financial crisis of 1997. The more specific causes included: inadequate supervision, poor assessment and management, adherence to a relatively fixed exchange rate, implicit government deposit guarantees, and policies that primarily used property as collateral for loans.

The real estate profession was not ready

In addition to real estate loans, the new policies resulted in significant inflows of foreign capital for businesses. However, most of the medium- and short-term loans were used to fund long-term real estate projects. With relatively easy project-funding, many poor investment decisions were made that had little regard for yields, sustainable rents, or capital value. Moreover, during this period (and as had happened in the USA during the commercial real estate crisis of the early 1980s), almost anyone with little if any experience or ability could enter the real estate industry.

1994/97: The boom years

During this phase, all asset prices, including land, property and securities were appreciating. Everyone wanted to get into the real estate business because everyone there seemed to be making money. However, before long most real estate sectors peaked and quickly became oversupplied. Many purchasers had overpaid and had purchased long-term real estate investments with medium- and short-term loans. Most severely hit were office developments, low-rise housing, condominiums and industrial estates.

Consumers and speculators were also caught up in the euphoria. By 1995, oversupplies of offices and lower-quality condominiums became noticeable.

1997: The crisis year

By 1997 the situation became untenable and the Thai baht (THB) came under pressure on the currency markets as foreign capital and lenders began to beat a retreat. The government mistakenly allowed the baht to float freely, causing an abrupt decline in the exchange rate as foreign capital inflows diminished further. As a result, financial institutions stopped lending to many businesses, including real estate developers, causing cash flow problems that were further compounded by a precipitous drop in the demand for housing. Moreover, those companies with foreign currency loans suffered massively, as a lower baht made repayments much heavier. Consumer demand also dropped as many people stopped spending and the business climate soured as many employers laid off staff.

1997-2000: The recovery years

After the 1997 crisis, the number of housing developers in Thailand declined drastically from about 2,000 to only 200. Research (Vanichvatana, 2004) showed that only those companies that had found ways to manage cash flows and liquidity problems had survived. Many were able to restructure loans. Some turned their lenders into partners and completed partially-finished housing projects.

authorised in 1993 to obtain deposits or loans in foreign currencies from abroad, and to do so under a privileged tax regime. Easy access to foreign markets enabled Thai and foreign banks that had been granted BIBF licenses to reduce borrowing costs with short-term credit from abroad.

After the crisis, developers began paying much more attention to building design and product strategy, including energy-saving solutions.

Government support policies

After 1997, the Thai government realized that the real estate industry was a significant driver of the country's economic growth and decided to use it to jumpstart the economy This involved supply and demand side remedies and well-devised policies and regulations.

The main supporting strategy sought to keep demand and supply in equilibrium (Jatusripitak, 2002). Since the crises had resulted from oversupply, government policies promoted demand and strengthened the operations of real estate developers and related areas. These policies included the following:

Supporting the demand side

In order to encourage homebuyers to make quicker purchasing decisions, ownership, costs, such as tax and transfer fees, were reduced, as follows:

Tax privileges and transfer fee reductions

The following incentives were offered during 2001 and 2003:

- Reduced special business tax rate
- Reduced personal income tax through specific deductions (house purchase expenses and interest rate)
- Reduced real estate title transfer fees
- Reduce registration fees when real estate is used as loan collateral

Encouraging home purchases through independent government agencies: The government supported the demand side through: (i) incentives for civil servants under the Government and the State Enterprises staff pension funds (GPF, 2003), and (ii) provision of special low-price housing for those segments population (NHA, 2003).

Supply-side support policies

Thai government supply-side policies also sought to support real estate developers, as follows:

Amendments to the Bankruptcy Act

In 1999, the Bankruptcy Act was amended, with a new section on Company Rehabilitation. This gave businesses more time and opportunities to agree with lenders before filing for bankruptcy. These new rules allowed debtors and lenders to set up teams to continue operating a business while rescheduling and restructuring debt (Ministry of Justice, 2003).

Resolving non-performing loan problems with TAMC

Thai Assets Management Corporation (TAMC) was set up in 2001 to take over banks' and financial institutions' non-performing loans problems resulting from the 1997 crisis. Because of loan payment conditions, much of the reduction in non-performing loans was due to rescheduling rather than outright restructuring (BizAsia, 2001).

Increasing investment capital through Property Funds

Since 1997, the Ministry of Finance and the Securities Exchange Commission have \ authorised five types of property funds[5] that provide equity financing for properties.

[5] Property Funds have been under the care of the Securities Exchange Commission (SEC). The four (out of five) types of property fund directly related to solving real estate issues are the Property Funds for Public Offerings ('Type I' fund) and for Resolving Financial Institution Problems ('Type II'), and the Property and Loan Fund ('Type IV'). The other one is known as Type III: Mutual Fund for Resolving Financial Institutions Problems (SEC 2003; 2000).

The sustainable development of Thailan'd real estate sector

From the above analysis, it appears that all stakeholders, both public agencies and private organizations, must act more responsibly for the sake of the sustainable long-term development of the Thai real estate industry. On the public side, new policies, laws and regulations must be continuously adapted. A clear example is the recent cooperation between the Bank of Thailand and the Ministry of Finance to guard against past monetary and financial control mistakes, with tighter controls against currency attacks, and limits on mortgage loan amounts. In order to prevent the market from overheating, mortgage loans on homes priced at THB10 million and more are limited to 70 per cent of market value.

Developers and investors have also been encouraged to further their education and obtain professional qualifications. Real estate is not a hobby; it is a real business.

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FIGURE 2: **THE ELEMENTS OF THE REAL ESTATE CYCLE**

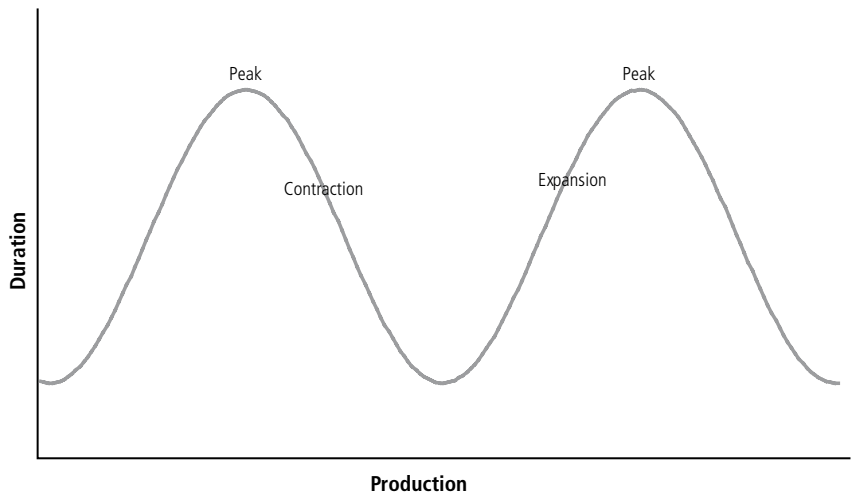

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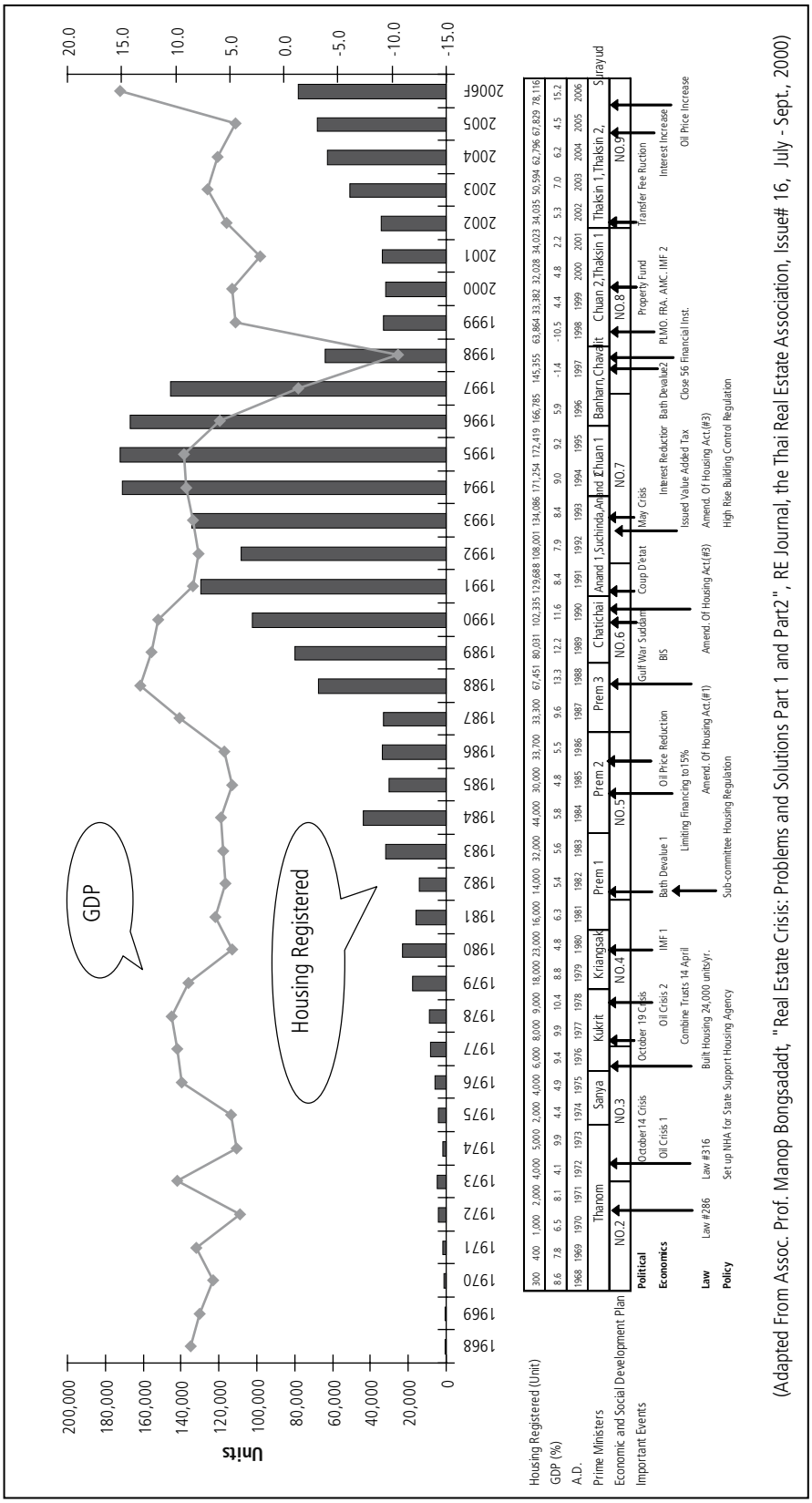
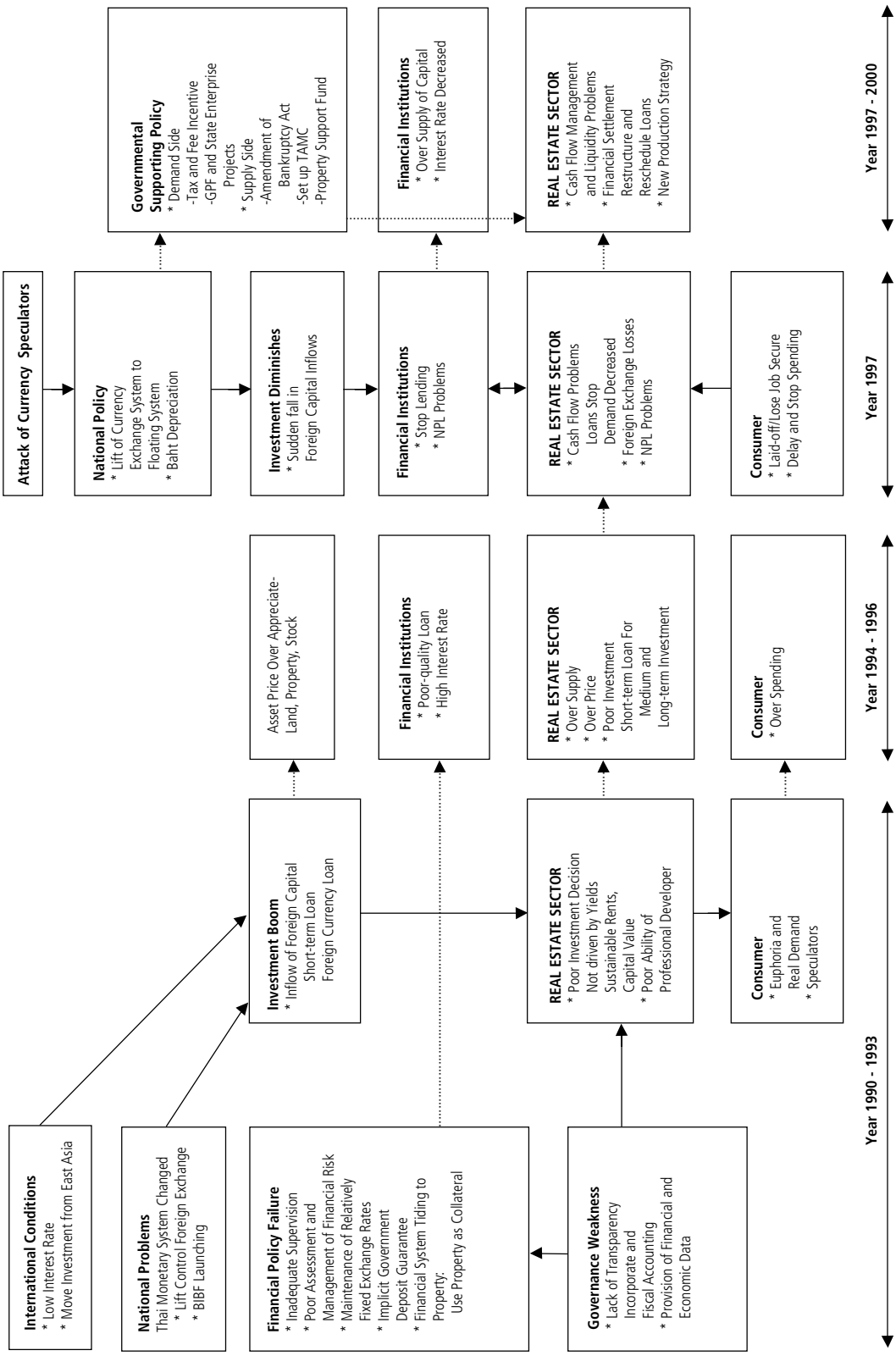
FIGURE 1: **Comparing housing starts, GDP and major events**



(Adapted From Assoc. Prof. Manop Bongsadadt, "Real Estate Crisis: Problems and Solutions Part 1 and Part2" , RE Journal, the Thai Real Estate Association, Issue# 16, July - Sept., 2000)



Source: Source: Vanichvatana, 2004

CHAPTER 10: **RETHINKING REAL ESTATE CYCLES**

Thailand has gained valuable experience dealing with housing-market cycles and 'bubbles; during the past two decades. Although the real estate market recovered in 2001, it declined again from 2005 to 2007. This would go to show that in order to ensure the sustainable development of the Thai real estate market, lessons must be learned from the calamitous 1997 experiences. This chapter identifies and explains cause-and-effect relationships with a view to strengthening the country's overall real estate market.

Real Estate Markets in Thailand

The Thai real estate markets have experienced numerous boom-bust cycles. The latest one (1997-2001) is worth reviewing.

Recent (2006) research by Thailand's Agency for Real Estate Affairs (AREA: 2007-1) found that housing markets were declining again, after sustained activity in 2004. Figures show that in 2004 the number of newly-launched units and their value was greater than in 1997 (the beginning of the crisis). From the year 2000 to 2004, this number doubled every year. Subsequently, development values dropped significantly, but this was no 1997-style crisis. The number of units developed remained more or less the same, implying that developers lowered prices to attract buyers to a market that has begun to slow down.

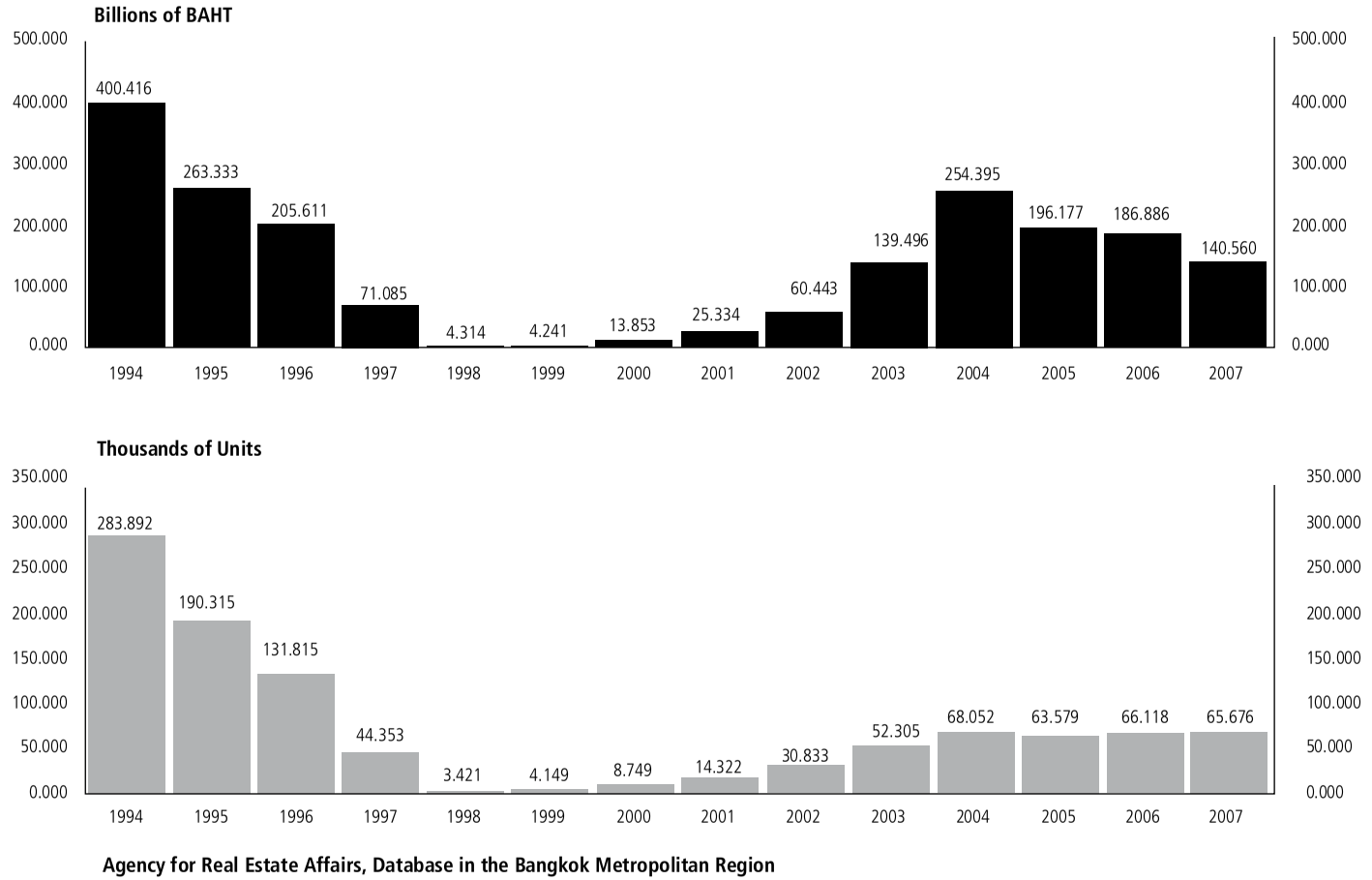
AREA (2007-1) research shows that new 66,118 units were launched in 2006 and units sold totalled about 70,000, implying that the market was still somewhat healthy. Lower prices attracted more prospective buyers. By the end of 2006, 92,000 housing units, or 2.3 per cent of Bangkok's total housing stock, were still available for sale.

At the time of writing, the most recent survey (first quarter 2007 AREA, 2007-2) showed that approximately 17,000 real estate units had been launched; however, most (16,000 units) were housing units. Of these, 11,000 were condominiums priced below THB2.0 million. Public companies launched 50 per cent fewer units than in the prior quarter. This implies that many private developers held back their units because of unfavourable political conditions, while those public companies listed on the stock exchange could not as easily curtail projects, since they needed the revenues for the purposes of stock market valuation.

The real estate business cycle

All businesses experience cyclical changes over time. Real estate cycles are critical for everyone. Investors, developers and even homebuyers should know which part of the cycle they are currently experiencing when they make crucial buying or selling decisions. In general, property and housing markets in particular are rarely in equilibrium (University of South Australia, 2003: 28). Because of more or less inherent imperfections (especially in terms of availability, information time-lags, substantial delays between the development of surplus demand and the ability to satisfy it through additional supply), these markets swing through excesses and shortfalls. These circumstances produce a long-recognized cyclical behaviour and explain why speculation

FIGURE 1: **Launching of New Housing Units in the BMR, 1994 - 2007**



Agency for Real Estate Affairs, Database in the Bangkok Metropolitan Region

develops rapidly during certain phases in a cycle.

Evans (1968: 417) summarized the nature of business cycles as follows:

> *"... the cycle is sometimes represented as a smooth sine curve taken relative to a trend. In this case not only are the period of expansion and contraction easily identifiable, but four stages of the cycle can be observed. The period of expansion below the trend line is known as 'recovery', and above the trend line as 'prosperity'; the period of contraction above the trend line is known as 'recession' and below the trend line as 'depression."*

In reality, many countries around the world experience boom-bust real estate markets. However, little scrutiny has been paid to this phenomenon. The following studies have dealt with the issue.

Yusof (2001:5) has reviewed the chronological characteristics of a business cycle based on the findings of MacGregor & Hoesli (1999) as follows:

- Business upturn and development: an upturn in the business cycle, typically at a time of low real interest rates and high liquidity. This scenario boosts economic activity and user demand.
- Business downturn and over-building: real interest rates rise in response to the boom and the business cycle turns downwards.
- Adjustment
- Slump: growth falls to its lowest level
- The next cycle: as soon as the slump is over, a new cycle begins and goes through the same successive phases again, but cycle lengths can differ.

Small (2000: 7) synthesised the real estate cycle as follows:

- With lower interest rates, general credit and available funding expand. This increases demand.
- Subsequently, prices rise. This increases capital gains. In turn, yields would be depressed.
- Property owners look to improve yield and increase rent.
- Small (2000: 13) also observed that the land price cycle was driven by credit availability, rental yield, and bidder attitudes, as follows:
- When funding is available while demand expands, this boom time is characterized by increasing turnover and strong price growth. During a boom period, confidence and speculative optimism prevail.
- The peak, is reached when yields decline and credit becomes more expensive. The market stalls and caution takes over.
- Price corrections follow. Forced sales and foreclosures dominate the market.
- The bottom of the cycle occurs when most forced sales are cleared.
- The recovery period is evidenced by increasing rents and falling interest rates.
- Higher yields and improved credit availability again lead to increasing prices and a new boom.

Figure 2 in Chapter 10 illustrates this cyclical process. The first stage is the beginning of the recovery from a previous downturn where excess supply has been absorbed and demand is now increasing. Because of accompanying housing prices increases, confidence begins rising (Point A to B or E to F in Figure 2). The price rises are caused by four major factors:

- the market recovers after a 'bust' phase
- infrastructure and services improve in a particular area, making it a preferred area for home buyers
- an improving economy creates greater affordability and opportunities, and

- availability of properties at distressed prices that make them attractive to profiteers.

Speculation

Speculation can be seen from both a negative and a positive perspective, depending on its overall market impact. Speculation is the major driving force behind major real estate booms. Therefore, it is worthwhile to discuss this issue further. Normally, in boom periods, people are very optimistic and enjoy (over-)investing irrespective of any obvious warning signs. At the same time, when the environment turns negative, people panic and become very pessimistic. An example was the real estate 'bust' phase in the USA in the late 1980s and early 1990s. At that time, some prime commercial properties costing US$ 1,000 per sq foot were sold for US$ 150 per sq ft. Some analysts predicted that the oversupply could last for a hundred years (Pornchokchai, 2001-1: 15).

A speculator is defined as a property buyer whose principal buying motive is reselling in the future for a significant capital gain (Ring & Bodkin, 1986: 285; Feagin, 1982: 42; Haila, 1989: 350). While explaining the common phenomenon of speculators and their actions, Friedman (1993: 325) defines a speculator as one who invests with the anticipation that an event or a series of events will occur to increase the value of the investment. For example, if the value of single-family houses has recently appreciated rapidly, speculators purchase several units, anticipating that prices will continue rising. The drive behind speculation is securing capital gains from holding and selling properties at higher prices.

Speculation does not result from individual behaviour but is a complex and collective phenomenon. (Kindleberger (1978), as quoted by Batra, 1987: 121). Individual buyers, property developers, investors and financiers become obsessed with speculation. The latter group finance and build additional housing units for speculation. This phenomenon was observed long ago by Evans (1968: 203) as a macro-economic activity prevailing in the housing market. Roehner (1999: 86) added that the transmission of speculative attitudes played a vital economic role because it triggered price increases even in areas that were not prime locations.

Ordinary people also become obsessed with speculation and blindly follow shrewd speculators, buying properties until the market collapses. Most lack market insights and are careless in their decisionmaking. The speculation obsession causes them to ignore obvious warning signals and saps any inclination to understand the risks involved.

Again, speculation can be seen negatively and positively depending on scope and market impact. Generally, speculation is viewed negatively as unproductive and not helpful to the national economy (Feagin, 1982: 43; Flint-Hartle & De Bruin, 2000: 14).

During a crisis, properties tend to be priced cheaply so bargains are easily found (Schumacher & Bucy, 1992: 152). Speculation is a major reason for purchases. This paves the way for clearing excess inventory and bringing market equilibrium. Ho & Kwong (2002: 360) found in their statistical tests that although property price changes lead to speculation, they are not the cause of price increases. In other words, surging prices cannot be attributed to speculation; therefore, anti-speculation measures to curb fast-rising property prices may not be effective. Governments had better implement measures that reduce the effects of speculation rather than try to cure it, particularly after the markets reach the mania stage.

On the 10th anniversary of Thailand's Agency for Real Estate Affairs, keynote speaker Arlo Woolery (2001: 34) said in his concluding remarks that greed was the crux

of speculation. He added that even though speculators may have modern analytical tools, information technology, and adequate time, they can still fail because greed entices people to invest blindly without proper diagnosis or scrutiny.

Thailand's 1997 economic and real estate crisis

Thailand's 1997 economic crisis seriously affected the real estate industry. The industry depends on a sound, growing economy and other global variables. The 1997 financial crisis not only affected real estate projects with low development potential, but also wiped out many good projects already under construction and where most of the units were already booked. After the economic crisis, most financial institutions would not lend to developers, including those with good track records. Many projects were stalled and contractors and other material suppliers also suffered. Last but not least, many homebuyers had to cancel bookings. Eventually, most projects were stopped dead in their tracks.

Prior to the 1997 economic crisis, the Thai economy was still growing, albeit at a slower pace, as exports began to decline. The largest declines were for lower-wage and labour-intensive exports that had been the country's major external growth source since the Japanese investment inflows of the mid-1980s (Doner & Ramsay: 1999: 176). The reasons behind the export-growth slowdown included a worldwide export downturn (Kittiprapas, 2000: 7), the conditions in Japan (recession, and a yen depreciation that made exports to Japan, one of Thailand's largest markets, more expensive), US and European trade protectionism, competition with other emerging economies (particularly China), as well as a strong baht on the back of its peg to the US dollar (Suppakulkittiwattana, 1998: 35). Thailand's weakened economy resulted in an overvalued baht which came under increasing pressure on the foreign exchange market. On July 2, 1997 the baht was floated and effectively devalued.

Many authors question whether the economic slump was foreseeable. The export decline implied a weaker economy and became the crux of the crisis. Some might say that the crisis was unforeseeable and unexpected. However, this was not the case. Many warning signs became more visible, particularly rapidly expanding financial sector non-performing loans, (and volatile) short-term capital flows, as well as the magnitude of external debt (Hill & Arndt: 2000: 8). Krugman (2003) even questioned the "Asian Miracle" in 1994 when prosperity was prevailing in Asia. However, few paid serious attention.

The boom also triggered and exacerbated the effects of the subsequent 'bust' phase. The rapid Thai financial sector liberalization that began in 1992 encouraged further capital inflows and helped create a bubble economy. Liberalization was introduced without adequate preparation and was an important factor behind the subsequent slump in the Thai economy (Suppakulkittiwattana, 1998: 28). Therefore, the crisis was inevitable. Unproductive investment financed by short-term capital flows from abroad ignited the crisis. (Nidhiprabha, 2000: 67).

Another major cause was the fundamental weakness of the Thai banking sector (Wong, 1999: 392) and the lack of transparent accounting standards, a factor that was overlooked during the period of prosperity. Financial institutions also lacked industry-specific expertise. They only had the will to lend (Vines and Warr, 2003: 457). This implied that they operated under outdated regulatory rules, and lack of supervision, with insider lending, lack of disclosure, and unsound practices (Bertrand, 2000: 195). Yap & Kirinpanu (1999: 12) added that close relationships prevailed among commercial banks, private companies, finance companies,

real estate developers, and politicians.

After the economy crashed in 1997, local politics exacerbated its effects by delaying appropriate remedies (Jackson, 1999: 11). In other words, government mismanagement and inefficient supervision were major triggering points for the crisis (Unganjanakul, 1999: 64). For example, when the crisis came, the authorities raised interest rates and tightened market liquidity. This exacerbated the situation after the baht was floated.

All of this does not mean that Foreign Direct Investment (FDI) is bad for Thailand or other developing Asian countries. FDI transfers not only funds for fixed investment but also technology and managerial know-how (Urata, 2001: 452). Protectionist policies deepened the world depression in the 1930s. Therefore, developing countries should encourage more FDI and foreign trade to achieve economic growth by lowering or removing trade barriers (regional liberalization), improving infrastructure (transportation and communication facilities), practicing good public and private governance, and assimilating foreign technology transfers (Urata, 2001: 453-454). FDI in Thailand has mainly benefited the manufacturing and other productive sectors, but also real estate.

Real estate markets and the economy

Japanese direct investment not only boosted the overall economy but also spurred property market and urban development in Bangkok and Thailand in general. Expanded industrial developments strengthened urban economies, prompting the real estate market to develop residential, commercial, and service activities (TDRI, 2003).

Many analysts think that ill-conceived real estate projects and other ill thought-out investments led to the crisis in Thailand. For example, Roehner (1999: 76) believed that the 1997 financial crisis in Thailand was partly triggered by a bursting real estate bubble. This hypothesis must be clarified. When FDI first began entering the country, some agricultural land was converted to manufacturing because the development potential was significantly higher. In Japan, when the yen's value doubled two years after the 1985 Plaza Accord on exchange rates, real estate prices doubled in four years (Miller, 2003). Similarly, when large amounts of FDI were injected into the Thai economy, real estate prices also rose sharply.

Another reason for soaring real estate development growth was the stilted growth during the bust period prior to 1985 when Thailand devalued its currency (1983 and 1984). When the economy recovered, pent-up demand emerged. By 1987, housing supply grew faster than population growth (Planning and Development Collaborative International, 1987: 17).

The bubble in real estate prices should have ended after the 1990 Gulf War. However, the real estate market remained buoyant on the back of foreign fund inflows. The Bangkok International Banking Facilities (BIBFs) were another source of cheap loans. Many developers were encouraged to borrow funds to develop real estate projects. The stock market boom led to irrational exuberance and more people turned to real estate. However, between 1992 and 1996, land prices rose only by 18 per cent or 4.3 per cent per annum, or much less than prevailing deposit interest rates (Agency for Real Estate Affairs, 1999: 163). This implies that although foreign funds inflows were significant, the effect on property prices was not. This was because real estate markets had already undergone a bubble between 1985 and 1990.

Real estate was not the culprit for the 1997 economic crisis. Actually, major loans were not made for real estate projects but to stock investors who were granted some US $ 4.8

billion by finance companies (Blustein, 2001: 56-57). According to the Bank of Thailand (2000), real estate-related credit accounted for only 15 per cent of all non-performing loans. In addition, only 24 per cent of the impaired assets transferred to the Thai Asset Management Corporation in 1999 were from real estate projects. The majority came from the manufacturing sector, wholesale and retail trades, service industries and the like. The "real estate" items were simply collateral for loans made for non real-estate purposes (MacIntire, 2000: 143). Most 'bad' real estate investments were not general owner-occupied housing projects but luxury residential developments, commercial buildings and recreational properties. For example, office vacancy rates were almost 30 per cent in 1998 (Jackson, 1999: 11) and only 14 per cent for housing (Agency for Real Estate Affairs, 1999). Therefore, Thailand's housing developments were not the trigger for the 1997 economic 'bust' phase.

In reality, real estate, and housing in particular, contributes to economic and national development. A unique feature of housing in Thailand is that almost all of it is provided by the private sector, particularly during boom periods. The government did not subsidize housing development. By contrast, in Singapore, 85 per cent of all housing units are built and subsidized by the Housing Development Board. However, the success of subsidies is dubious. For example, subsidies can create more inequality in opportunities for housing.

Prior to Thailand's economic crisis, many private housing developers did not understand the overall economic effect of foreign direct investment, especially its contribution to a real estate bubble. They were not prepared for a 'hard landing' after the real estate bubble burst in 1997, either. As a result, they suffered immensely and their experiences should be analyzed so that future developers can learn from their mistakes.

Concluding remarks

Excessive speculation in housing markets leads to over-investment by developers who are responding to unrealistic and unsustainable demand, and that is why market equilibrium is disrupted. Blind speculation occurs in an environment where there adequate market information is not available to potential buyers. Financial institutions that provide financing without evaluating market dynamics also inadvertently encourage speculation. If those institutions had had access to accurate market information and indicators such as the number of unoccupied housing units as a sign of overproduction, there would not have been such an excessive oversupply of housing units.

Inadequate dissemination of available information and the markets' disregard for real estate data to analyze investment decisions seriously have harmed real estate buyers and sellers and financiers during the crisis. When every investor expects short-term capital gains without using accurate market information, the market will eventually collapse and hurt everyone involved. This is what brought about to the housing sector crisis in the Bangkok Metropolitan Region.

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CHAPTER 11: HOUSING BOOM-BUST CYCLES IN THAILAND

This chapter reviews the circumstances which, over the past 40 years, led to a string of boom- bust housing cycles in Thailand, and particularly the severe 1996/97 crisis. We hope that our findings will help Thailand avoid boom- bust housing cycles in the future.

40 Years of Housing Boom-Bust Cycles in Thailand

Thailand's housing sector experienced no fewer than six successive boom-bust cycles between 1957 and 1997, or one every six and a half years on average. This chapter scrutinizes the factors behind each of these cycles, including the recovery phase.

As might be expected, the two major factors behind these boom-bust housing cycles were none other than excessive supply and demand. When demand was high, housing prices rose. Developers would respond promptly with increased supply which ended up exceeding demand, and the attendant price declines would plunge the market into the 'bust' phase of the cycle. The following review of Thailand's six successive cycles show that beyond this basic pattern, a number of specific factors and circumstances have been at play.

Land division development: Thailand's first housing boom-bust cycle (1957/67)

The Thai housing market emerged around 1957. Prior to that, people would build their own homes as a matter of routine. However, rapid industrialization brought about an environment that fostered the development of a viable housing industry.

The early foundations of the Thai real estate market included three main types of developments.

- Row housing: this was a popular development technique because it could be used for both housing and commercial purposes.
- Flats or apartments for rent: high-rise buildings for middle-income Thais and foreigners.
- Land subdivision development projects: These serviced subdivisions did not include any housing but provided electric power, water and roads and proved immediately popular.

It is important to note that during the initial stages (1957/67), financial institutions offered few housing loans. Developers primarily used their own funds or co-invested with land owners for a share of the profits. Home buyers were required to use their own savings to buy land and build homes. Purchasers usually occupied the houses and had no intention to sell them for speculative profit. Home-buyers' purchasing power was rather limited. This means that the real estate housing market lacked depth and this environment precipitated a boom-bust cycle.

The 2nd boom-bust cycle (1968/74)

In 1968, Thailand's housing market began to improve and a new boom developed between 1969 and 1972. However, the market again veered downward in 1973/74.

Land developers began building and selling single homes in large-scale housing

development projects in 1968. Selling land with a home was a new, effective marketing strategy to encourage home buyers. This occurred against a background of stronger economic growth and increasing liquidity for financial institutions which took to granting more housing loans to both developers and home buyers.

The problem was that an outdated legislative and regulatory framework proved unable to control land developers, allowing a rapidly expanding housing market to spawn many types of excess. By the end of 1972, a Revolutionary Party Announcement (No. 286 - 'Por.Vor. 286') sought to protect home buyers. In addition, the National Housing Authority (NHA) was established as a government agency to promote housing, particularly for the low-and-middle income segments of the Thai population (Por.Vor. 316).

At the same time, the Government Housing Bank's land and housing development role was transferred to the National Housing Agency. The Housing Bank's changing role brought significant benefits to developers as well as home buyers who could now access a wider variety of housing loans.

The 1973 oil-shock-induced economic crisis was when Thailand's second housing boom turned to bust. The quadrupling of oil prices reverberated throughout the country's economy. Caught between higher construction material and equipment costs, on the one hand, and lower disposable incomes, on the other hand, fewer Thais could afford homes.

In addition, the government imposed more restrictive legal requirements on land sub-division (Por.Vor. 286), which came as a disincentive to land developers. The new laws increased the minimum surface area for subdivision lots while requiring more extensive infrastructure developments. Developers cut back on projects in response, paving the way for a new housing supply shortage.

The 3rd boom-bust cycle (1975/82)

By 1975, the Thai housing market began to recover, ushering in another boom between 1976 and 1978, which was followed by the 1980/82 'bust' phase.

Three factors were behind the housing market recovery and expansion during 1975/78 :

- Supporting investor confidence: the National Housing Agency was commissioned by the government to provide 120,000 units under a five-year scheme.
- Loans to developers were adequately funded: commercial banks and financial institutions had adequate liquidity, resulting in reduced interest rates.
- Funding for home buyers: the Government Housing Bank, the major specialist institution, stimulated the market by speeding-up the delivery of sub-market interest-rate loans to low- and middle-income home buyers.

During that 1975/78 period, developers began focusing on inner-city projects. Townhouses became popular because more could be built on smaller land areas and could yield similar prices as single-family homes in suburban areas. Thailand's Condominium Act 1979 facilitated the process. Because of high land values, most initial developments were higher-priced units in prime areas. However, townhouses were also built in inner-cities and suburban areas for the lower segment of the market.

In early 1980, after the second oil crisis, the Thai housing market began slowing down. The Bank of Thailand set strict ceilings on bank lending. Interest rates rose sharply to 18-19 per cent in 1982. Developers were adversely affected, and many abandoned projects, especially condominiums because

of high construction costs and the shortage of funds. They stopped construction of many mega-projects and turned instead to smaller scope projects and custom, made-to-order single-family homes. Developers also took to building new housing projects away from the city and in the suburbs, where land prices were substantially lower.

The 4th boom-bust cycle (1983/86)

The Thai housing market experienced a brief recovery in 1983, mainly due to more liquid financial markets. Interest rates decreased only slightly, to 17-18 per cent. The Thai housing market again dipped into recession in 1984. Real estate prices fell after the government devalued the baht (THB) and the Bank of Thailand took to restricting housing loans, with aggregate annual growth limited to 18 per cent. Together with higher mortgage rates, the market was also disrupted by major tax policy changes in March 1985, which effectively reduced disposable incomes. Many developers faced a cash crunch. Construction costs remained high and so were overseas funding costs. Many condominium projects were halted and the housing market continued its downslide until 1986.

The 5th boom -bust cycle (1987/92)

The Thai housing market recovered by mid-1986 and a new boom period took place between 1987 and 1990, which slowed down in 1991 and 1992.

When the housing market had begun to slow down in 1984/85, the government deployed new policies to accelerate housing development and boost the economic recovery. The government believed that a healthy housing market recovery would stimulate economic growth and create massive new employment opportunities, and undertook to promote home ownership.

The government encouraged the Housing Bank to widen its housing-loan recipient base and encouraged commercial banks to provide construction loans to developers. On top of this came several tax measures to promote home ownership, including monthly interest payment deductions up to THB7,000 per month. Perhaps most importantly, the Thai government amended land sub-division regulations (Por.Vor. 286) and streamlined project approval procedures, in the process giving developers greater flexibility to provide lower-cost housing.

In mid-1986, the government announced oil and electricity price reductions. Cement prices were also reduced and low interest rates prevailed. The government began to encourage overseas investors. The Thai economy grew speedily at more than 10 per cent per annum from 1988 to 1990, with a high of 13.3 per cent in 1988.

As the Thai economy boomed, personal incomes rose commensurately. The accompanying lower interest-rate environment also helped the real estate sector to recover and the housing market grew spectacularly between 1987 and 1990. This period is often considered as Thailand's best-ever real estate boom market. This extended way beyond housing as office buildings, agricultural land, golf courses, resorts and mini-factories were all selling at a brisk pace and prices soared relentlessly. Property was changing hands daily with rising prices a constant background. The sector became so overheated that speculators were crowding ordinary purchasers out of the housing market.

By the end of 1990, the Bank of Thailand sought to cool the booming real estate market and the "bubble economy" through restrictions on new loans and higher interest rates. Then came the 1991 Gulf War and the accompanying world economic downturn seriously affected the Thai housing market.

Speculators began giving up on purchase deposits. Developers followed suit as they halted half-completed housing and

condominium projects. The real estate market began slowing down in 1990 and 1991 and by 1992 another 'bust' phase began.

The 6th boom-bust cycle (1993/97)

In 1993, the Thai government promoted low- and middle-priced housing through reduced corporate income taxes for developers who built low-priced housing (for a maximum value of THB600,000) for low- and middle-income purchasers. The government also increased civil service pay and the Bank of Thailand moved to allow commercial banks and other financial institutions to make more housing loans.

Thai financial institutions reduced lending rates to 10 per cent in 1994, the lowest in recorded history. As land prices remained stable, developers added to existing land banks. Registered companies issued more than THB10 billion in foreign bonds, invested the proceeds in land and launched many projects in new locations as they expected the economy to continue growing. In 1994, more than 250,000 housing units were for sale in Bangkok and surrounding areas. The housing market was fast becoming over-supplied.

In April 1995, the Government Housing Bank sent an ominous signal to the market when its Research Department conducted a survey of "empty or unoccupied completed-houses in developer-built housing projects" in Bangkok and surrounding area between 1990 and 1995. The Housing Bank found that in 1994, 160,000 units were unoccupied and predicted that by the end of 1995, the number would nearly double to 300,000 units, or 14 per cent of the total housing stock. In addition, the Housing Bank found that during 1994/96, developers were delivering about 170,000 housing units per year while demand was between 100,000-120,000 units per year, which accounted for the predicted strong rise in the number of "empty houses".

The Housing Bank survey was one of the factors behind developers' decision to cut back on projects. The Bank of Thailand also moved to restrict property-sector lending. On top of this, interest rate increases in 1995 forced many developers to curtail new projects. As a result, new housing developments fell 50 per cent in 1996 when compared with 1995.

A combination of lack of financial system liquidity, high mortgage rates and construction costs were the main factors that precipitated the first four boom-bust housing cycles in Thailand. However, the fifth and sixth cycles resulted from oversupply.

Boom-bust cycles

Boom-bust housing and real estate cycles are an inevitable economic phenomenon. They typically involve four successive stages, as follows.

The recovery period

As the economy recovers, employment and personal incomes increase, the investment environment turns favourable again and individuals and businesses begin purchasing land for commercial, industrial and residential developments. Prices begin to rise and developers launch new projects.

The boom phase

During stage two, housing provision and land prices increase at an accelerated pace because land developers and speculators purchase more and more. Housing prices rise quickly because housing demand is much greater than the available supply, encouraging developers to produce more units. During this period, many purchasers are buying homes for investment rather than for primary residences, and they are encouraged by financial institutions that compete fiercely for new loans. Lending risk is perceived as low during this period because

collateral value is increasing continuously. Most developers are also realizing large profits in this environment.

New developers also take to housing construction during boom periods, while many existing developers begin expanding land banks for future development as they expect prices to continue rising.

The recession phase

When the market reaches a point of oversupply, developers begin competing intensely for customers. They also stop investing in land banks and speculators move away from the market. By then home purchasers buy for own occupation. However, during this period housing demand does not increase because prices are still too high compared with most potential purchasers' income levels.

Although developers realize that demand is falling, it is usually too late for them to take any action because projects are already under way. In addition, land for subsequent projects has already been purchased. Existing projects are continued even though they will attract fewer purchasers and provide lower profits. However, new projects can be halted or adjusted to reflect the new market conditions.

The problem for the low-income segments of the population is that since construction has already begun on higher-price homes, developers cannot switch to much-demanded lower-cost housing projects.

The bust phase

Although new projects are few in the 'bust' phase of a cycle, others are still undergoing completion and a huge oversupply of homes must be sold. Purchasing power declines as the economy suffers a housing-bust related downturn. The bust can turn into a crisis where negative factors such as a protracted economic recession, a stock market collapse, a credit crunch, deflation or high interest rates and unemployment are allowed to fester. In a bust phase the market is vastly over-supplied and developers' profits are decreasing or turning into losses as land and housing prices plummet. More developers and home owners default on loans. If the bust phase is protracted, the financial performance of both developers and financial institutions is seriously affected.

Housing boom-bust cycles typically last longer than normal economic cycles because of the longer production cycle of the housing industry, which requires land procurement and construction before the finished product is delivered to end-buyers. The process usually takes two to four years. During this time, the pace of the economy may change while developers are still completing projects. This means that many developers find themselves completing projects during economic downturns. Faced with this potential mismatch between economic and housing sector cycles, the industry should develop reliable leading indicators to aid developers (such as warning them during early downturn stages to avoid more pronounced boom-bust cycles).

Globalization and trade liberalization will lead to more housing boom-bust cycles. Housing market volatility or cyclical property fluctuations occur worldwide, not just in Thailand: this was the case in England, Australia, Singapore, Japan, the US, Ireland, Denmark and Korea during the 1985-1994 period.

The Causes of the 1996 Housing 'Bust' phase in Thailand

In 1996 and 1997, the Thai housing market went through a 'bust' phase which seemed much more severe than any previous one. Many experts warned that short of a quick resolution of the downturn and its effects, the country would experience a severe financial crisis and the stability of its banking system

would be in doubt. Massive oversupply and decreased demand resulting from slower rising incomes exacerbated the situation.

However, on closer analysis, three other factors were at play:

Financial liberalization and deregulation

In the 10 years prior to 1996, Thailand deregulated its financial infrastructure. This included allowing foreign capital inflows through 'Bangkok International Banking Facilities' (BIBFs). Many housing developers funded and expanded operations through issuance of international and convertible bonds that carried much lower interest rates. As Thai financial markets liberalized, large amounts of low-cost foreign capital became available.

Thailand's previous housing boom-bust cycles usually arose because of diminishing liquidity in the *domestic* market. However, the 1996.97 downturn was different because it was largely caused by massive *foreign* capital outflows. Low-interest rate short-term funds had been popular among borrowers, but the subsequent sharp increase in the cost of credit caught many developers short and they had great difficulty repaying or refinancing these loans. Their liquidity problems were compounded because they could not sell as many homes as projected.

International standards for housing loans

In 1993 the Bank of Thailand endorsed a set of bank capital adequacy ratios agreed under the aegis of the Bank for International Settlements. The risk ratio assigned to commercial banks' housing loans was 50 per cent (i.e., banks must maintain liquid reserves equivalent to 50 per cent of total housing loans). By 1994, finance companies had to comply with the ratios, too. As a result, Thai financial institutions competed aggressively for housing loans, and as underwriting terms relaxed access to this type of credit became easier.

Financial liquidity and speedier housing loans for developers

Because of high financial system liquidity, Thai financial institutions competed for 50 per cent per cent risk-weighted housing loans by offering low interest rates to both developers, to finance projects, and individual home buyers. As a result, these two types of loans grew at a faster rate than any other type of credit.

Sloppy Lending Practices

During the 1987/90 housing boom, commercial banks were the major lenders but by the end of 1990 the Bank of Thailand moved to restrict their business in that area. This reduced commercial banks' share 68 per cent of housing project loans to 53.2 per cent in 1995 and 51.5 per cent in 1996. Thai finance companies quickly filled in the void and their share of outstanding housing project loans increased rapidly from 29 per cent in 1992 to 44.7 per cent in 1995 and 46.4 per cent in 1996. Thereafter, the Bank of Thailand decided that all finance companies must operate under the same rules as commercial banks.

The problem was that in many finance companies, sloppy procedures presided over the granting of housing loans, many of which became non-performing during the ensuing 'bust' phase. The same situation occurred with home loans for lack of adequate property valuations and analysis of borrower creditworthiness.

Easy Entry

During the real estate boom, everyone was interested in taking a share in the market, which scarce government controls enticed thousands of new and inexperienced developers to do.

Under Thai law (Por.Vor. 286) developers could sell homes without a license. More than 50 per cent of non-city projects were

constructed by unlicensed developers without any land-subdivision permits. The government was unable to monitor the vast number of housing projects under development and did not know the exact number of homes being built. The Thai consumer ultimately paid the price as many developers failed to complete projects when the market plummeted into deep recession.

Stock market-listed housing developers

During the 1988/89 housing market boom, only two real estate companies were listed on the Stock Exchange of Thailand (SET). The number grew to eight in 1990/91. Although only one additional company listed in 1992, the widely expected 1993-1995 housing boom attracted 12 more real estate companies to the Exchange.

However, listed companies are expected to generate continuous profits and under this constraint many of these newly-listed developers to compete, assembling land banks and building more housing projects. This led to an over-supply of housing in 1995 and 1996.

The rise and fall of speculative demand

Although most home purchases during 1987/90 were for owner-occupied residential purposes, prices still rose rapidly. Speculative demand increased significantly in 1991/92 because of fast-rising housing prices and high economic growth. Housing supply also skyrocketed. According to the Government Housing Bank, 160,000 housing units were unoccupied during 1990/95 (April), and as many as 87 per cent of these homes had already been sold.

The proliferation of new housing projects in 1994 increased the number of unoccupied houses on the market. At the same time, the public's purchasing power was decreasing while prices remained stable because of massive over-supply. Speculators abandoned the housing market and it became a residential purchasers market. The housing market began slowing down in 1996.

Thai stock market down

The SET index peaked at 1,682 in 1994 and plummeted to 816 in 1996. During that period, the property index declined more, from a peak of 2,266 in early 1994 to 519 by the end of 1996. The downturn on the stock exchange further eroded purchasing power and the declining property index caused many people to postpone property purchases.

The effect of interest rates

As determined by central banks, lower loan-interest rates have a direct, disproportional effect on housing affordability for households. For instance, monthly payments can decline by five to seven per cent (for 15- to 20-year loans) where interest rates drop by only one per cent. In 1994, Thai home buyers' purchasing power increased immensely as interest rates dropped to 10 per cent. Many new housing projects were launched and the market began recovering. However, this was a brief recovery as interest rates began rising again in 1995 and 1996.

Lack of statistics and housing indicators

Developers must closely monitor the market because each project requires a long time to complete. Thailand's National Economic and Social Development Board (NESDB) recognized that information on the sector was needed and started producing an Annual Housing Report in 1987. The Government Housing Bank also published a quarterly journal articles and statistics. In addition, the National Housing Authority and many private companies provided other housing statistics.

However, these statistics did not provide the information which property developers and

policymakers specifically needed to monitor the market and to derive the proper policy and investment decisions. No organization produced information in such key areas as housing starts, the overall number and value of construction projects, amount of project loans, monthly sale volumes, housing completions, financial information, etc.

The lack of relevant market information was behind the mistaken strategies which many Thai developers and financial institutions made in 1996/97.

The Effect of Housing Busts and How to Solve the Problem

Housing market 'bust' phase will continue seriously to affect the Thai economy's overall development, and of course particularly property-related industries such as land development and financial institutions.

From a financial point of view, the main consequence of any housing market and concomitant economic downturn is a large number of mortgage payment defaults. By the end of 1996, more than 150,000 accounts representing no less than 10 per cent of total loans outstanding were delinquent.

This prompted the Thai government and three housing developers' associations to cooperate to develop solutions. As many as 10 separate programmes were deployed to help the Thai housing market recover. The most important one involved restructuring the non-performing loans, with extended maturities and more lenient interest rates. The commercial banks and finance companies also jointly set up a Resolution Property Trust Fund to restructure problem loans.

Summary

Boom-bust cycles regularly occur in almost any liberalised property market. The 1996/97 Thai crisis provides many important lessons for developers, home buyers, financial institutions and other related companies as well as the government sector. These three lessons are as follows:

- Boom-bust housing cycles recur on a regular basis. Some cycles are short and others are longer. We must closely monitor the market and analyse the factors affecting demand and supply.

- In order to do this, we must develop reliable information systems and learn from past experiences not only in Thailand but also from other countries. We must foresee the problems that may occur and prepare to face them with prudence. We must recognize the critical factors and develop reliable tools that will allow us to analyze and effectively deal with them.

- Last but not least, we must also carefully analyze all government policies and measures that may affect the housing market, develop new ideas and mechanisms that will prevent future severe housing cycles, and support policies that will ensure a well-functioning, stable long-term housing market.

Notes

(Endnotes)

i Dilorenzo, T J (2007), The Government-Created Subprime Mortgage Meltdown, LewRockwell

ii Tashman H M (2007), The Subprime Lending Industry: An Industry in Crisis, The Banking Law Journal, May 2007

iii *Ibid.*

iv *Ibid.*

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