Responding to the Crisis

Real Estate, Asia, and the Global Economy

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A divided world

- Strong growth in Asia
  - Had learned lessons from previous crises—need for good financial regulation
  - Strong public finances provided them resources to respond to crisis
  - Adopted effective Keynesian policies—and they worked
    - Strong infrastructure investment will simultaneously provide basis for long term economic growth

Strong growth in Asia

- Helping other developing countries (Latin America, Africa)
- But Asia is still too small to restore growth in advanced industrial countries
  - Partial decoupling
  - Question is: can Asia continue to grow while U.S. and Europe stagnate?
    - Will require changing "economic model"
    - Real estate investment and green investments will be an important part of the answer

Prospects for U.S and Europe: A Japanese-style malaise

- Continuing weaknesses in Europe and the U.S.
- Growth too slow to create enough jobs for new entrants to labor force
  - Exacerbating already high levels of unemployment
- Underlying problem: lack of aggregate demand
  - Before crisis US economy was fueled by unsustainable housing bubble
  - Breaking of bubble left in its wake legacy of excess capacity and debt

Why prospects of US recovery are so dim

- Consumption likely to remain weak, given overhang of debt, high unemployment, weak wages
- Investment likely to remain weak, given excess capacity, overhang from excess investment in real estate during boom years
  - Small businesses cannot get access to credit
    - Source of job creation
    - Banking system—especially that part engaged in lending—remains weak
    - Most borrowing is collateral based; collateral real estate; real estate prices down markedly
- Exports uncertain, given weaknesses in global economy
  - US lost capacity for exporting in many industries

Weak prospects for US

- End of stimulus implies fiscal contraction
  - Stimulus worked, but was too small and not well designed
  - Administration underestimated depth and duration of downturn
    - Thought that the underlying problem was *just* a banking crisis; repair the banks and the economy will be repaired
    - Even if banks were working perfectly, economy would be weak
- Exacerbated by declines in state revenues
  - States have balanced budget frameworks

What US needs –
and what we are likely to get

- Large second round of stimulus
  - Likely only to get 2-3 year extension of Bush tax cuts
    - Likely to stimulate economy only a little
    - But will probably increase deficit substantially: bang for buck low
  - Can the U.S. afford stimulus?
    - Can't afford not to
    - Long-term fiscal position will be improved if government spends on investments, e.g. in infrastructure, technology, education

What US needs and what we are likely to get

- Restructuring mortgages
  - ¼ of all mortgages underwater
  - Nothing likely to happen
- Inducing banks to lend at affordable interest rates
  - Money went disproportionately to banks that were not engaged in SME lending
  - Restructuring of banking system led to less competition, increased gap between lending rate and deposit rate
  - Dodd-Frank bill did little to redirect attention of banks towards lending
  - Securitization model for housing has not be repaired—and not likely to be—implying increased reliance on banks
  - Government has been buying all mortgages—not a sustainable policy
  - Deficit reduction pressure likely to highlight tax preferences for real estate, leverage

Monetary Policy likely to be relatively ineffective

- Quantitative easing has considerable risks, few benefits
- Short-term interest rate already near zero, small change in LT interest rates not likely to have much effect
  - Large firms awash with capital
  - Banks unlikely to increase significantly lending to SME's at more favorable terms
  - Other channels quantitatively small (except possibly competitive devaluation)
- Costs
  - Expected capital loss by government
  - Lower income to older individuals relying on government interest rates
  - Increased uncertainty—
    - Bubbles
    - Inflation
    - Future conduct of monetary policy
    - Responses of competitors to competitive devaluation—likely fragmentation of global financial markets

Europe is equally frail

- Some countries in particularly bad fiscal position
- But even those that are not (such as UK) are engaging in austerity
  - We were all Keynesians, but for a moment
  - Austerity will slow growth markedly
- Euro under strain
  - Took away interest rate and exchange rate mechanisms for adjustment, put nothing in place
  - Spring measures only temporary palliative
  - Political issue: will they be able to create more permanent institutions ("solidarity fund for stabilization")
  - Uncertainty will cast pallor over Europe and global economy

Global Perspective

- Political gridlock in US combined with new enthusiasm for austerity likely to prolong recovery
- Underlying problems in US not being addressed
- In world of globalization, what matters is global aggregate demand; underlying weaknesses due to
  - Growing inequality
  - Precautionary savings—build up of reserves—in aftermath of East Asia crisis
  - Crisis may have exacerbated problems, not reduced them
- With end of fiscal policy, ineffectiveness of monetary policy, attention will switch to trade —protectionism and competitive devaluations
  - Heightening tensions, uncertainty

Currency war

- Beggar thy neighbor policies won’t lead to global recovery
- Worry about asset bubbles (especially in emerging markets) is leading to currency interventions, capital controls, taxes, etc
- Global imbalances are a major source of worry
  - Didn’t cause the last crisis
  - But could cause the next
  - Moderate changes in exchange rates not likely to affect global imbalances significantly
  - But large changes in exchange rate could contribute to global instability and impair recovery

What is needed: a growth compact

- If US, Europe reignite growth, currency realignment would be much easier
- Both China and US need to increase wages, reduce inequality
- Both China and US need economic restructuring
  - US: away from consumption, away from sectors in which they have lost global comparative advantage; need to repair dysfunctional financial sector
  - China: away from dependency on exports, toward service sectors; recycle savings in a way that is more productive

- Both China and US need to improve energy efficiency, respond to challenge of global warming
- Infrastructure and real estate investments to “retrofit” economies all over the world to changing economic circumstances and environmental demands could be crucial element in pulling the global economy out of its current malaise
  - And ensuring growth in Asia is sustainable

Real estate in Asia:
a key part of solution

- Challenge is to avoid boom/bust pattern that has contributed to macroeconomic volatility, playing a major role in the current economic downturn
- Challenge is to create "livable" and "sustainable" cities for the 21st century

Drivers of the demand for real estate

- Demographics in China
  - Population growth—1995-2008: population increases 10%, and number of household increases 21%
  - Migration in China—Urban population share grows from 26 % in 1990 to 47% in 2009
    - An additional 10 mn urban migrants per year expected over next 5 years
    - Urbanization rate expected to reach 75% by 2050
    - More spread out
  - Likely decline in housing demand from 20% annual increase in last ten years to 10% in next ten years
    - Housing ownership already reached 80%
    - Per capita living space already surpassing mid-income countries' level by 50%
    - "Inverted U-shape" demand—growth in demand slows when income exceeds RMB 35,000
    - Deceleration of household formation

Drivers of the demand for real estate

- **Changing economic structures**
  - Twenty first century cities for a service economy are markedly different from early 19th century cities for a manufacturing economy
- Changing economic structures, residential patterns, consumer preferences, and environmental needs will require substantial investments in commercial real estate

Other drivers of the demand for real estate

- **Interest rates**
  - Global context: **may rise with increasing global indebtedness of governments**
- Land availability
  - Affected by local government revenue needs
  - Possible alternative models of financing
- **Government policies**
  - Taxes/ subsidies
  - Zoning, energy regulations
  - Infrastructure
  - **Directed at creating more livable cities, promoting environment (especially greenhouse has emissions), preventing bubbles**

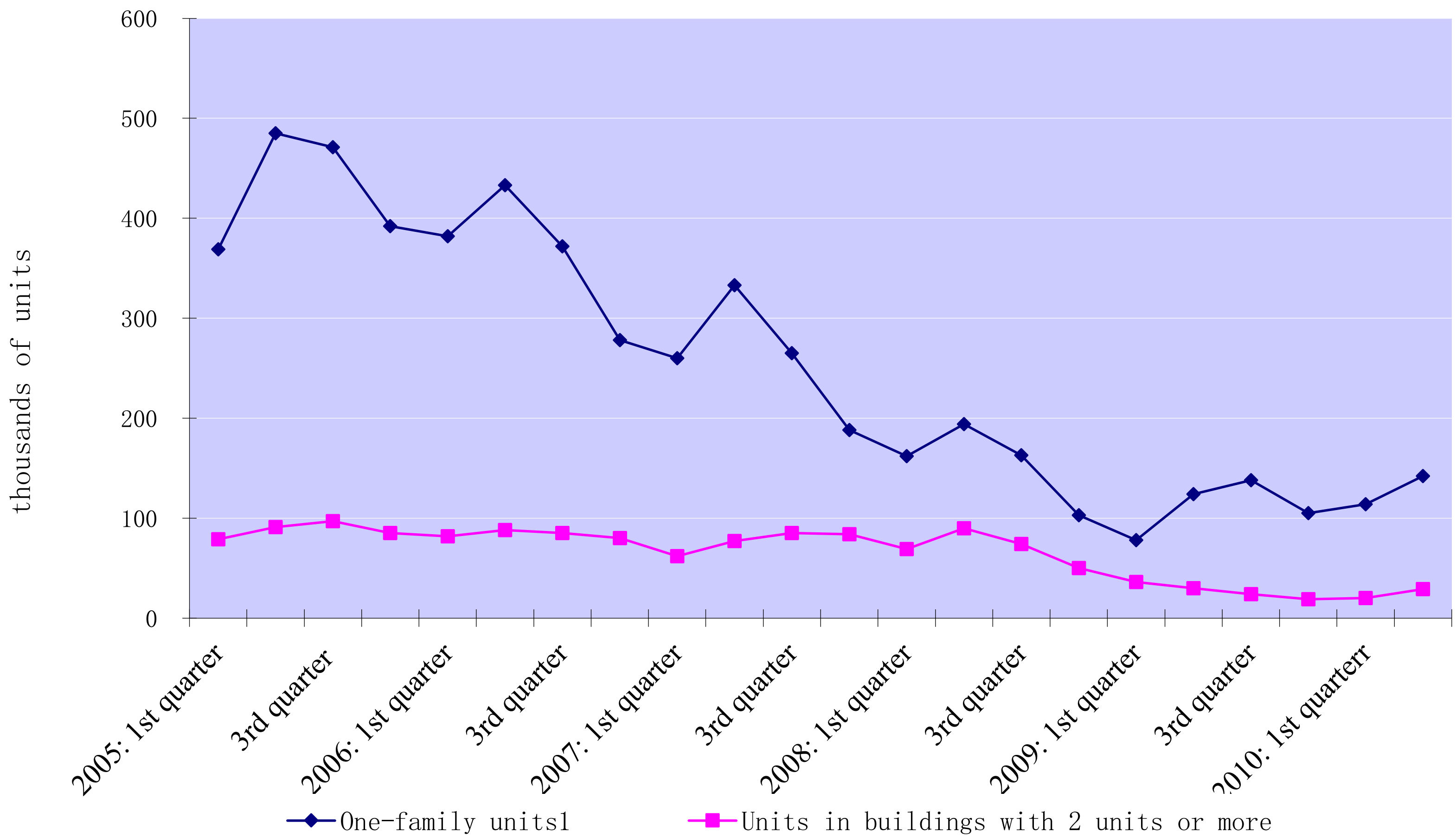
Two key concerns in China

- Affordable housing
  - China has one of largest shares of household ownership (80%), only behind Spain and Greece, and higher than U.K., US, and Canada (around 65%), Japan, HK (around 60%), Germany (around 42%)
    - Privatization agenda completed
  - But housing seems less affordable than elsewhere
    - Median house price/median household income
      - Shanghai 31, HK, 7.6
      - L.A. 11.5, Sydney, 8.6, Vancouver, 8.4, London, 7.7,
  - Public housing in China less than 7% (Singapore, slightly less than 90%, HK, around 50%)

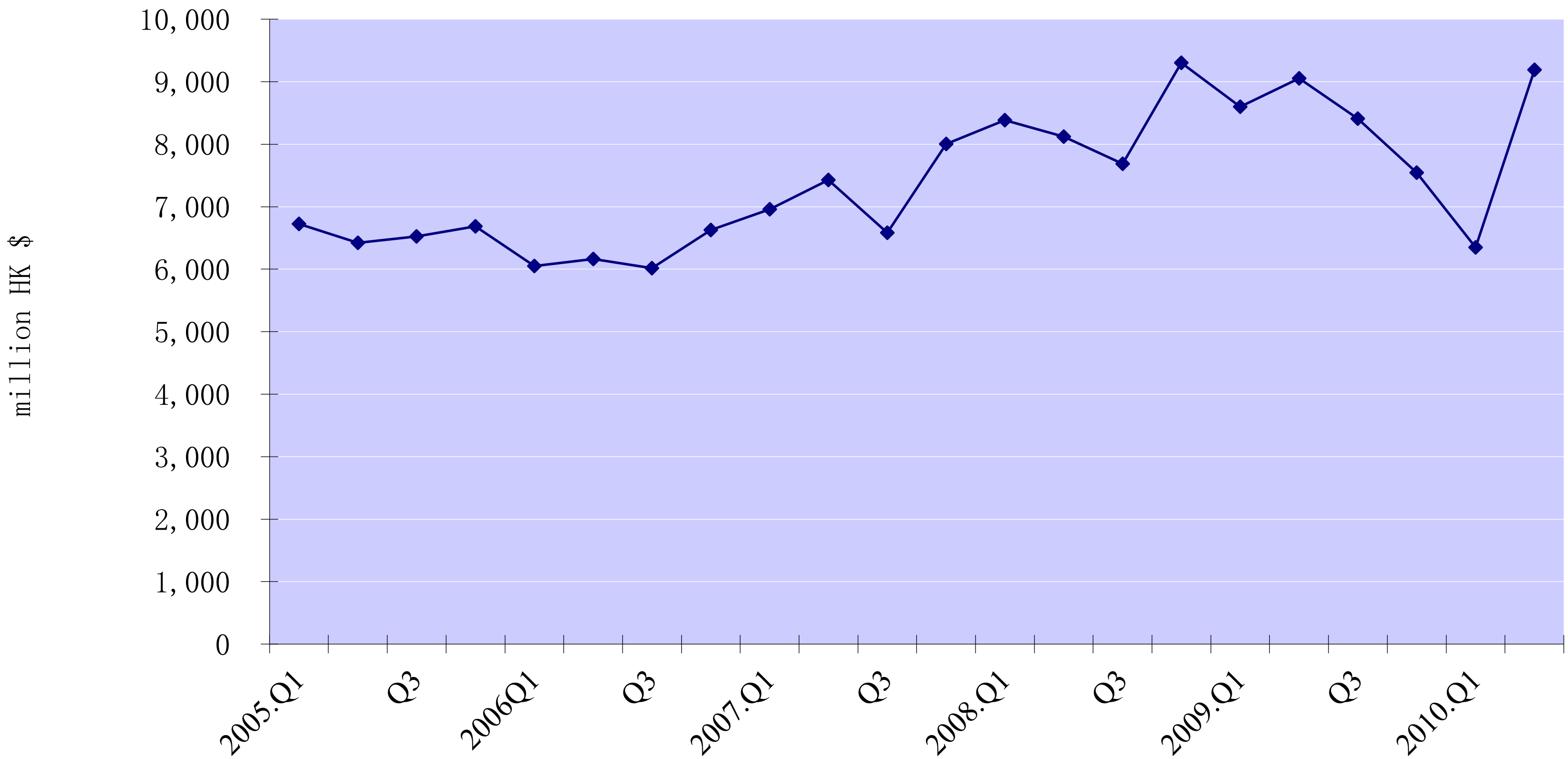
Two key concerns in China

- **Stability of housing market**
  - China needs to avoid property bubble
    - Concerns about link between property speculation and rmb speculation
    - Measures already being taken
      - Increased downpayment
      - Higher interest rates for second home
      - Suspend mortgages for 3rd home/some non-residents; in some places, restrictions on second homes
  - Additional problem in China: land sales as a source of local revenue
  - Most countries have found it difficult to manage
    - Lending policies (bank regulations affecting supply; consumer regulation affecting mortgages)
    - Tax policies
      - Property tax
      - Capital gains tax

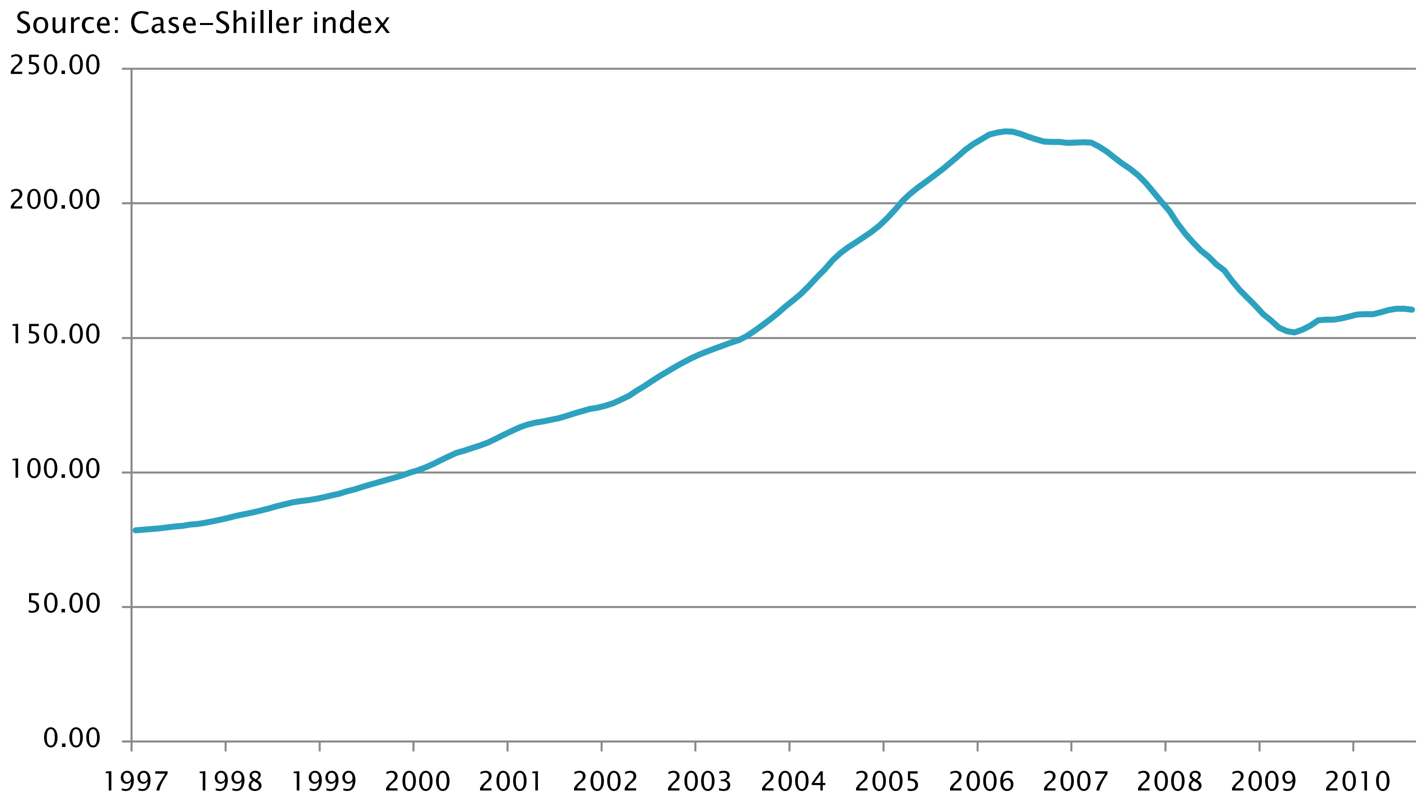
Comparisons of Real Estate: U.S. house construction



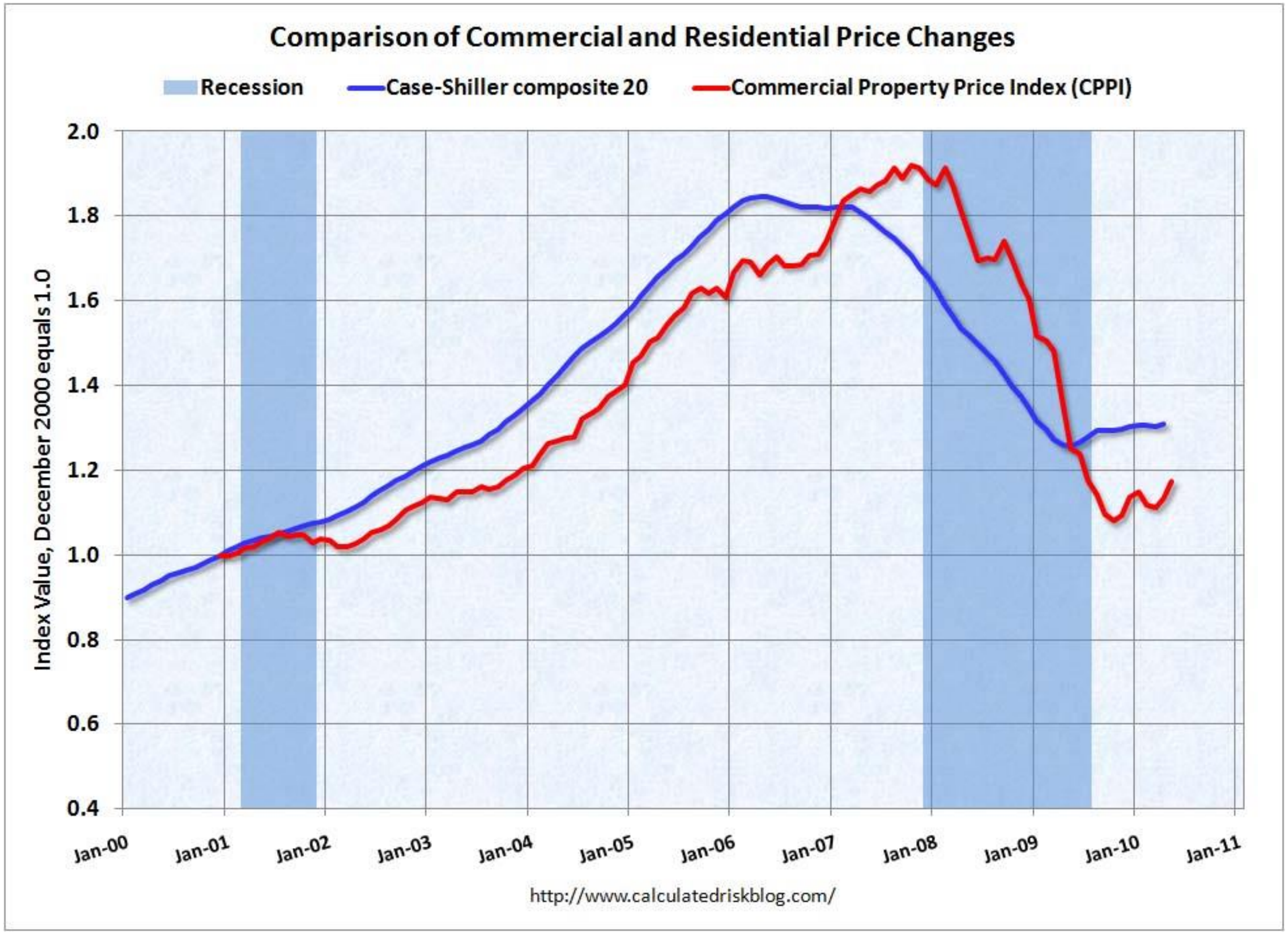
Comparisons of Real Estate: Hong Kong real estate construction



Comparisons of Real Estate: U.S. house prices



Comparisons of real estate



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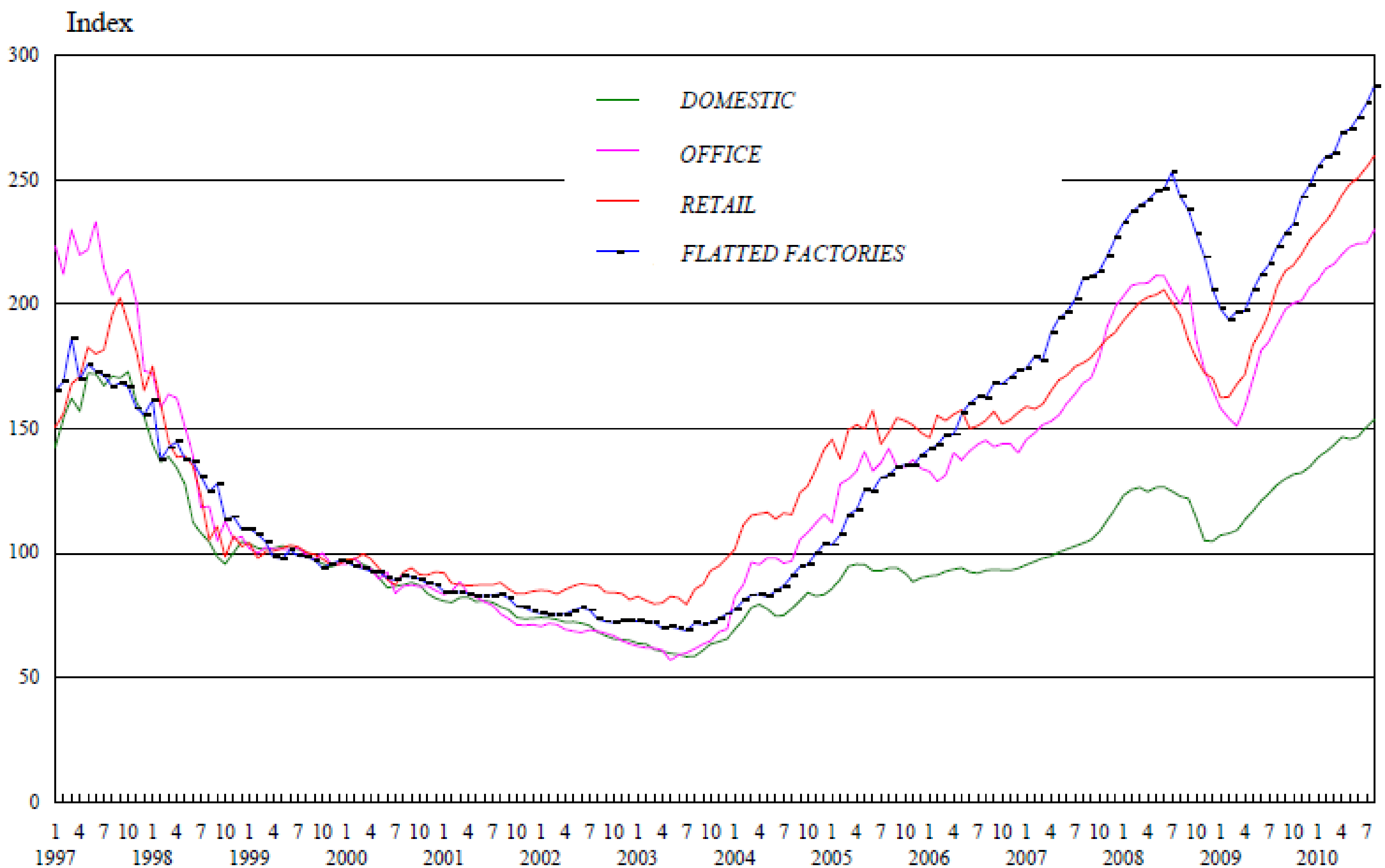
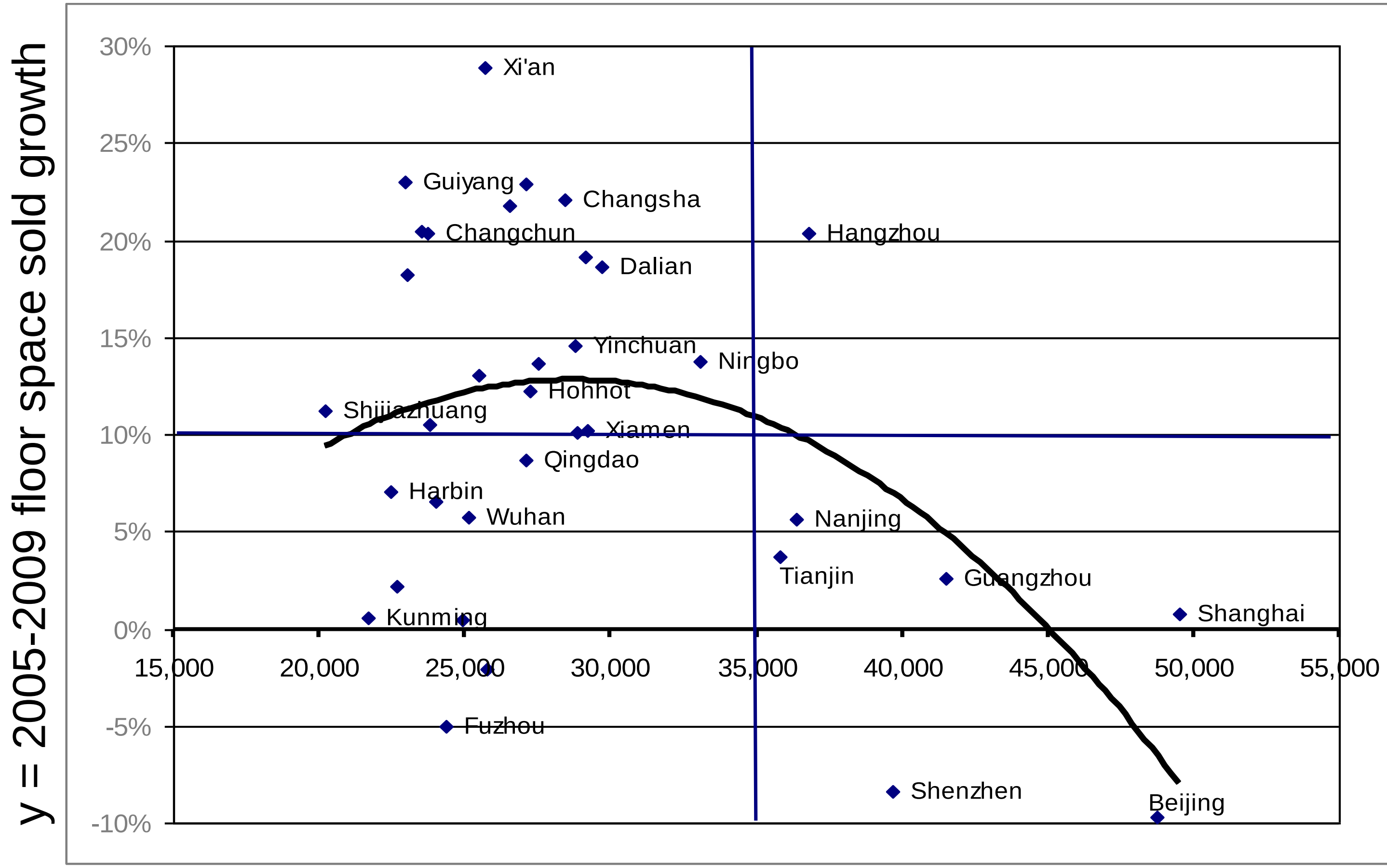


China's income level and housing demand growth



x = 2005-2009 average annual wage, RMB

- **Underlying economics mean that real estate investment is likely to be a major driver of growth**
  - But the pattern of investment may be markedly different
    - Much of investment in residential real estate will be for upgrading quality
      - Making cities more livable
    - More public housing
    - Increased incomes/changing lifestyles will necessitate investments in commercial real estate

Changing demands

- **Fiscal and environmental concerns**, learning lessons of past, likely to mean that government support, regulatory framework, may change
  - Worries about excessive subsidies through tax system to real estate
  - Worries about preferential treatment of leverage
  - Worries about bubbles leading to taxes and banking regulations to stabilize investment
- Large fiscal deficits may mean that **real interest rates** after the recovery may be high
  - For now, long term interest rates in West at record lows
  - Real estate may become a hedge against inflation

Concluding Comments

- We have pulled back from the brink of disaster
- But the world faces important uncertainties
  - Most likely prospect remains Europe and US mired in a slow and unsteady recovery
  - Financial system slow recovery
  - Strong growth only in Asia
    - Not just "more consumption": the planet will not survive if everyone attempts to imitate US profligate style
    - But more investment
- Real estate will be vital for improving living standards and sustaining the economy
  - But it will have to work hard to avoid boom bust pattern
  - And to ensure environmental sustainability