THE REAL ESTATE MARKET AND DOMESTIC CONSTRUCTION INDUSTRY IN 1999

by Sun-Dock Kim(sdkim@hri.co.kr)
& Hong-Rae Cho(hrjo@hri.co.kr)

Trends in 1998

The real estate market in Korea was battered badly during the first year of the IMF era. As of last November, average land prices and house prices had fallen 13.4% and 12.7%, respectively. This is the biggest fall in real estate prices since the 1970s, and the first time the average real estate price had dropped in the 1990s. Two basic reasons explain this phenomenon. First, on the demand side, purchasing power in terms of liquidity drastically decreased. Market interest rates once jumped to as high as 30%, while individuals suffered from decreased disposable income. A second reason was on the supply side. The wave of bankruptcies and ensuing restructuring in the corporate sector forced Korean businesses to flood the market with a huge amount of real estate which they once possessed for the purpose of pure future investment or as collaterals to banks. The situation in construction industry in 1998 was not so different from that of the real estate market. Due to a sharp decrease in the disposable income of Korea's middle class and the frozen facility investment, the private sector's domestic construction orders declined by more than 60% in 1998. Meanwhile, facing significant budget constraints, the government failed to stop the abrupt decrease in construction demand. As a result, public sector's orders also declined 7.0~8.0% as well.

But the rate of decline in real estate prices has remarkably diminished since the third quarter of 1998, mainly due to much lower interest rates and the government's policies to stimulate demand. Assuming that the government's policy stance continues to be expansionary, many experts expect that the real estate market and domestic construction industry will be among the first places to show symptoms of recovery. In fact, several precursors have begun emerging from late 1998.

- Land prices and residential housing prices, which fell steadily earlier in 1998, stabilized after the third quarter.
- The rate of unsold houses started falling after July of 1998.
- The number of bankruptcies among construction companies is declining.

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Forecast in 1999

The government is expected to implement policies to boost the real estate market, or at least, the overall macroeconomic policy will help to boost the real estate market eventually. The background behind this can be explained in two ways. The domestic construction industry and the real estate market are closely related to each other. In order to boost the aggregate demand for the entire economy, it is essential to revitalize the real estate market, and thus to revive the sluggish small-size domestic construction companies. Another reason is the worries over the asset-deflation. From the second half of the last year, many experts have been worrying over a possible vicious cycle stemming from asset deflation. The general

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downward trend not only in financial asset prices but in real estate prices could cause a further decrease in effective demand in the economy. Much worse, it could hinder the smooth restructuring process in both the banking and corporate sectors. The stimulus policy for the real estate market will include lifting some regulations, such as green-belt regulations, strengthening support for the consumer financing of real estate purchases, and lowering the domestic interest rates.

In addition, the market circumstances are expected to turn favorable. The new housing supply for 1998 has decreased by more than 40% and much of current construction has been stopped or delayed. The housing market situation, therefore, will worsen by early 2000, a situation which the government would like to avoid. Also, a housing mortgage system or an asset-backed securitization system will be introduced in 1999, which will greatly increase investment in real estate. Meanwhile, there is an important precondition for a substantial recovery in the real estate market; namely, without a recovery in the real economy, it is hard to expect a booming real estate market. At the same time, the ongoing corporate and financial restructuring might harness a quick recovery in the market. In spite of these potential negative factors, it is expected that the real estate market and the domestic construction industry will definitely turn around sometime in the second half of the year. As the economy starts to recover and the effects of liberalizing real estate regulations materialize, prices will begin to rise at a faster rate starting in 2000. Construction orders, as a whole, will post a 6% rise. The public sector will show 4% growth due to the relieved government budget deficit limit. In the private sector, housing construction will lead the growth while the commercial construction will still remain sluggish throughout the year. Private construction order will grow 10% in 1999.

Introduction of Mortgage Backed Securities

The introduction of MBS (Mortgage Backed Securities) will be the most remarkable change in Korea's housing financial market. The current finance mechanism for the housing market before MBSs was mainly based on several public funds which were established and managed by the government or on loans from the Housing & Commercial Bank. These sources, however, were relatively limited in terms of size, and other commercial banks were not capable of enlarging their businesses to the housing market for the middle income class. In addition, after the IMF program began, the increasing rate of consumer bankruptcies has led to an over-supply in the housing market comprising medium-size houses, apartments, and other kinds of real estate. Furthermore, every bank has become extra-conscious about their asset structures in order to keep their BIS ratios above 8%. The introduction of MBSs, however, is expected to lessen many of these negative factors. The MBS system will facilitate cash flows among house buyers, banks, MBS issuers, and MBS buyers (investors). Under this mechanism, commercial banks will be able to extend their housing loans. At the same time, it will develop newer demand which was dormant under the traditional finance mechanism. On the supply side of the housing market, there will be much less room for the government's intervention. As a result, the average price level in the housing market is expected to become much more stabilized than before. VIP