The Emerging Crisis in Real Estate*

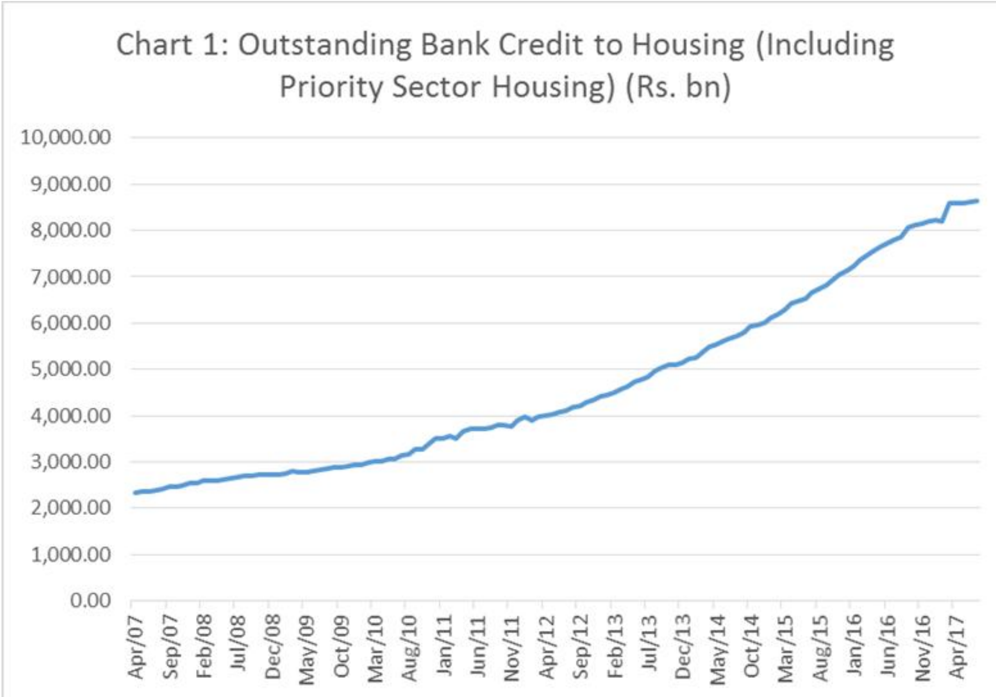
C.P. Chandrasekhar and Jayati Ghosh

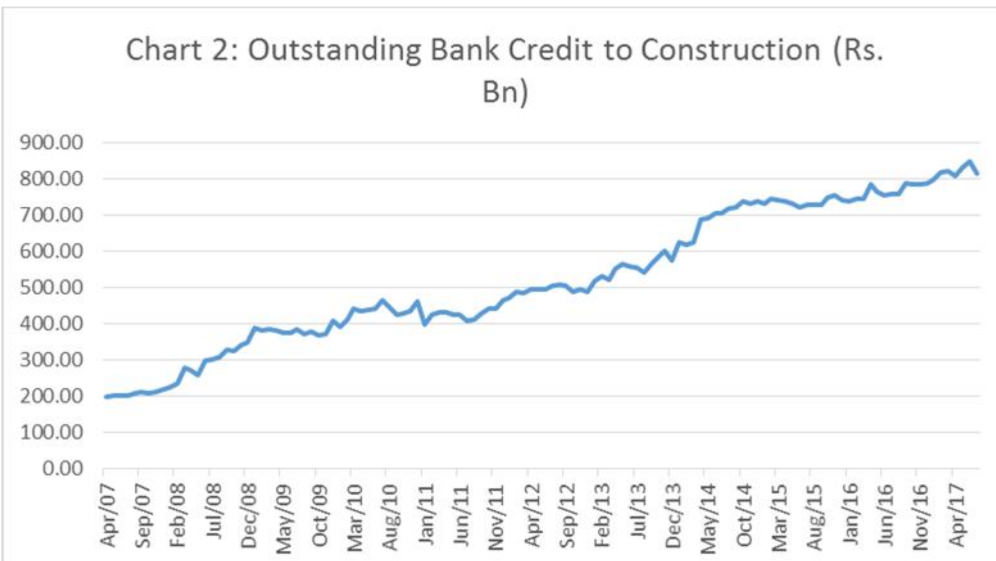
The Reserve Bank of India' sdecision to push banks to clean their balance sheets by recognizing non-performing assets, resolving bad debts of large defaulters, and, failing that, taking them to bankruptcy court for liquidation, has focused attention on the crisis in a few sectors. Among those, besides power, steel and textiles, is the real estate sector, consisting of housing, commercial real estate and hospitality assets. Firms like Unitech, Jaypee Infratech and Amrapalli are being pursued by banks, and home buyers who had paid them advances but not received their houses have turned to the courts. They fear they would lose out in case of liquidation because home buyers' claims will be considered only after those of secured creditors like the banks have been settled. The fate of these firms reflects the fact that the industry is facing a crisis, despite persisting demand for housing.

The real estate story is of special interest because the post-liberalization evolution of this sector reveals quite starkly the characteristics and contradictions of post-reform growth. An overriding objective of neoliberal reform is to get (domestic and foreign) private investment to drive economic growth by providing it the right environment and offering it the appropriate incentives. But in a market economy, while supply side initiatives may help nudge into activity a private sector afflicted with inertia, those initiatives would work only if the fruits of such activity find a market. So even if it is not among the stated objectives of reform, a parallel thrust of policy must be that of stimulating demand.

This is challenging for a policy frame that refrains from using autonomous state expenditure as the principal stimulus to growth. The belief is that this is not necessary and should be avoided when tax and other concessions are used to incentivize private investment, since increased public expenditure would lead to large deficits that defeat the purpose of fiscal reform. It must also be avoided because it goes against the grain of a growth strategy that seeks to give primacy to the private sector.

This implies that demand must come from the private sector. Some of this comes from derived demand, as is true of commercial real estate. When business is doing well, demand for office space rises. Nothing illustrates this better than the rapid expansion of steel and glass-fronted structures in the major metropolitan cities to accompany the export-led boom in the software and information technology-enabled services sectors. As compared with this, the component of the real estate sector that was waiting to explode due to consumer demand was the personal housing market. Based on the Census 2011, the total number of households in urban India was placed at 81.1 million in 2012, while the urban housing shortage in that year was estimated at 18.78 million. That is, close to a quarter (23.2 per cent) of households in urban India needed new houses because they were homeless or lived in dilapidated or over-congested accommodation.



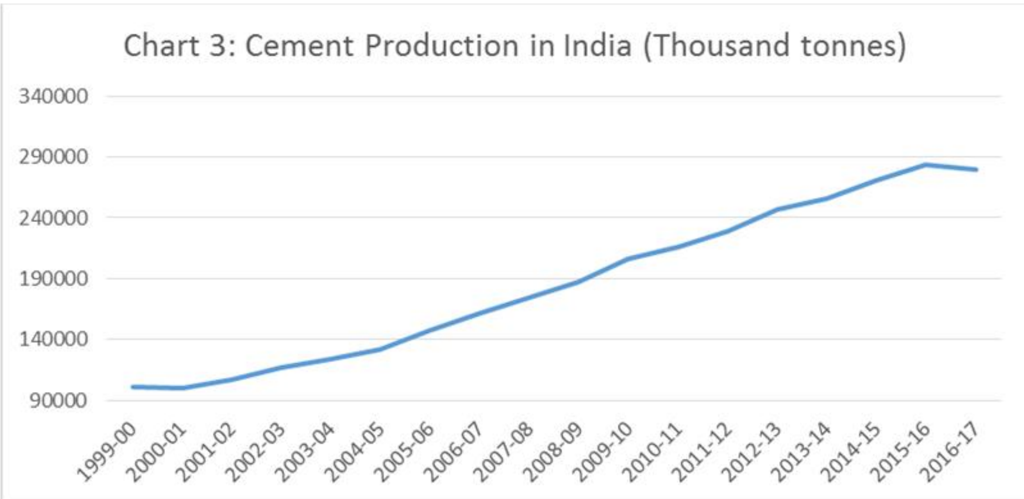


But this is only indicative of the fact that the "technical" demand for housing in a rapidly urbanizing economy with a high share of youth in the population is bound to be high. The challenge for the reformers was to convert this technical demand into effective demand. The opportunity to do this came from two sources, especially from the early 2000s. The first was the rapid buildup of liquidity in the economy, resulting from a combination of an easy money policy and a sharp increase in foreign capital inflows. The second was financial liberalization that allowed banks to hugely expand credit based on that liquidity, even if it entailed substantial increases in exposure to certain sectors.

One area that benefited from this credit splurge was real estate. The growth of housing loans gathered momentum at the end of 1990s and remained at extremely high levels right up to 2006-07, before the global crisis. As a result, the share of housing finance in total credit rose from 5 per cent in 2001-02 to 12 per cent in 2006-07. What is interesting is that despite the effects of the global financial crisis in 2007-08, the expansion of credit to both housing and the overall construction sector remained high till very recently (Charts 1 and 2).

The increase in housing investments is often attributed to the low level of penetration of the mortgage market in India, standing at 7 per cent in 2006, as compared to 12 per cent in China, 17 per cent in Thailand, 26 per cent in Korea, 29 per cent in Malaysia and as much as 80 and 86 per cent respectively in the US and UK respectively. But these differential penetration rates have to be seen in the light of differentials in per capita income and the degree of income inequality, both of which do not favour a significantly large mortgage market in India. So it was the willingness of the banks to lend without collateral to a larger universe of borrowers that generated the boom. As a result of the increased exposure to debt, a number of realty firms are in default and some are facing bankruptcy.

A similar boom was seen in the infrastructural area, which also received large loans from the banking system. Before the 2000s banks were wary of lending to this area because of the long maturity, low liquidity and higher risk involved in loans to this sector. Partly because banks dropped that reticence and hugely increased lending to a few large borrowers in this sector, they are now finding themselves burdened with large non-performing assets (NPAs). This is what has set off the bad debt resolution process based on the recently announced Insolvency and Bankruptcy Code.



Within the real estate sector, it is developers rather than home buyers who seem to be defaulting on payments. Competition between developers led to massive accumulation of land, as they built up land banks as a strategic weapon against one another. Borrowing for this purpose and land development meant that the interest burden accumulated by developers was huge, and in excess of what could be met by the development and marketing of house properties and commercial floor space. So leading developers have also stopped servicing debt and have become part of the NPA problem. The impact on construction is reflected in the deceleration and recent decline in cement production (Chart 3), which is a commonly used proxy for real estate growth.

One fallout of this NPA problem is that banks are less willing to lend, as they work on cleaning up their balance sheets and finding funds to recapitalise themselves. This has affected even the housing sector, where defaults have been far less than in areas like construction. Here too, while credit and demand for housing are still growing, they are fast losing momentum. Thus, trapped between rising interest and other costs and faltering demand that affects prices, the real estate sector is experiencing a severe version of the crisis stemming from the inability of the system to sustain growth driven by private debt-financed spending.

*** This article was originally published in the Business Line on September 25, 2017.**