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Real Estate and the Asian Crisis

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This paper suggests that activities in the real estate markets in Southeast and East Asian economies were an important contributing force to the financial crises of 1997 in the Asian economies. The analysis relies upon unpublished data reported contemporaneously by financial institutions and market watchers to document the extent of the imbalances in the real property market that were evident to informed observers at the time of the financial collapse. The analysis argues that a series of reforms in the regulation of the property market and the treatment of real property loans by financial institutions are necessary to prevent the recurrence of the kind of speculative bubble that contributed to the financial crises in Asia. Given the recentness of the crisis, the nature of the data, and the absence of definitive statistical sources, the results are tentative, but they are certainly consistent with a financial collapse whose proximate cause was unchecked activity in the property market.

Key Words: Asian financial crisis; speculative bubbles; property markets.
Journal of Economic Literature Classification Numbers: E3, G2.

I. INTRODUCTION

The linkage between the real estate market and the general conditions of the economy has been studied extensively. However, most academic research is focused on the ways in which economic fundamentals affect property prices or the ways in which expectations about fundamentals affect property markets. (See Mankiw and Weil, 1989, for a celebrated example of this research.)[2] Research also compares the importance of economic fundamentals, relative to the importance of history, in affecting outcomes in the real estate market. (See Quigley, 1999, for recent evidence.)

Economic models arising from this line of research are capable of generating

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[2]For another conspicuous example, the recent textbook by DiPasquale and Wheaton (1996) devotes a full chapter to explicating the linkage between fundamentals and expectations about fundamentals to property markets.

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patterns of price change over time in property markets in response to variations in economic conditions and to exogenous shocks. (See, for example, DiPasquale and Wheaton, 1992, or Case and Shiller, 1988.) There has, however, been much less attention given to the opposite line of causation—the potential for exogenous changes in property markets to affect the subsequent economic performance of the economy.

This paper explores this latter line of causation with special reference to the collapse of the Southeast and East Asian economies in the late 1990s. We consider the potential effects of bubbles in the property market upon the broader economy and present some evidence suggesting that conditions in the real estate market played a major role in the rapid meltdown in Asian economies[3] beginning in 1997. Given the lags in official statistics, especially in the developing world, most of the evidence presented below comes from private sources or from financial observers. Thus, the evidence is hardly definitive; nevertheless, the argument may be a cause for real concern.

The concluding part of the paper presents some implications for policy—especially policy with respect to the real property market—which arise from this perspective.

II. BUBBLES AND PROPERTY MARKETS

Bubbles in financial markets and in real asset markets are not new—as investors in Britain's South Sea Company in the 1720s and as real estate developers in Texas in the 1980s could attest. Garber (1990) reviews a diverse set of historically significant speculations—runups and subsequent crashes in prices—suggesting a variety of ways in which investor behavior can lead to a bubble in asset prices which subsequently bursts.

The first and most straightforward of his examples is that of an entrepreneur who incorrectly (or falsely) claims that a venture will pay great future dividends. Subsequent investors base their decisions upon these perceptions of market fundamentals. This situation—asymmetric information in which one player has an incentive to dissemble—may yield a runup in asset prices if this player is successful.

The second example is that of an entrepreneur who uses some of the capital deposited by early investors to pay high dividends, confirming the prospective returns to subsequent investors in the (so-called Ponzi) scheme.

[3]The Asian economies are as diverse as the European economies, so any generalization is hazardous. Since this paper was originally presented in Tokyo in 1998, an important set of case studies has been published (Mera and Renaud, 2000). For the most part, those detailed accounts are consistent with the generalizations reported here. The significant exception is Korea. Kim argues cogently that Korea's real estate collapse "could not" have been a major cause of its economic crisis (Kim, 2000, p. 100).