Economic Challenges to Housing Finance

by Dr. Theo Waigel

THE INTERRELATIONSHIP BETWEEN POLITICS, ECONOMICS, AND HOUSING FINANCE

Housing finance stands at the crossroads of savings and investment and, therefore, is at the very heart of economic development. It is thus a stabilizing element in the world's increasingly volatile financial markets; hence, the importance of housing finance to economic policy.

On the other hand, housing finance depends in large measure on national and international economic trends and political decisions. Interest rates, price stability, growth, savings, capital flows and exchange rates are all vital to housing finance. That is why it is so important to consider how economic trends and developments could impact or stimulate housing finance in the future.

Housing and Housing Finance as Challenges of the Future

There are important reasons why housing finance should not rank behind other challenges of the future. Everyone talks about the technologies of the future, about innovative services and about transport and communications infrastructure. But how and where people will live in the future is every bit as important for the cohesion and stability of our societies.

The availability of adequate and good quality housing serves above all to safeguard prosperity and as a provision for old age. No debate on the difficult problems of the aging of western industrial societies and intergenerational imbalance should overlook the housing issue.

But for the newly industrialized countries of the south, and the transition countries of the east as well, the provision of adequate housing is a difficult issue and crucial to political stability. Therefore, it is worth making every effort at the national level and in international cooperation to make things as easy as possible for the housing finance sector.

Future Trends in the Financial Market

Housing finance is a part of financial market activity and therefore fairly heavily affected by what is going on in financial centers around the globe. Undoubtedly, housing finance institutions like it best when as little as possible is going on. As financial agents for long-term capital investment in the real economy, they benefit most from steady, uninterrupted development.

I believe the chances of a spell of calmer weather over the financial markets are, overall, good. This assessment is based on the following trends in particular:

- Most of the large industrial countries are charting a steady course toward eliminating budget imbalances.
- Inflation–fueled by struggles for redistribution within society and excessive government borrowing—is continuing to decline.
- Decision-makers in both the state and private sectors have learned their lessons from past crises and are reacting more flexibly and effectively to recognizable imbalances.

In the meantime, we have experienced a wide range of crisis scenarios. First, there was the typical 1980s crisis scenario, the result of countries running up excessive debts and of the exodus of capital, which brought severe turmoil to the world's financial markets. Then, more recently, we had the "East Asia" type of crisis caused by excessive and uncontrolled private foreign borrowing.

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A suitable way had to be found of dealing with each of these crises in the financial markets. In the first case, it was a matter of tackling excessive national indebtedness with consolidation and growth policies to restore creditor confidence. In the most recent growth crisis of the Eastern Asian "Tigers," on the other hand, the response has been a shake-up in the relationship between banks and state, and better banking supervision.

Developing Stabilization Strategies

But there are also common goals and guidelines for achieving stable financial market development. These have been more closely analyzed and described in the last few months. I should mention in the first instance, greater transparency, the installation of early warning systems, and a clearer division of responsibility for returns and risks between the state and the private sector.

All effort must be directed toward avoiding mistakes in forecasting future trends and speculation-fueled booms—the dreaded "bubbles." It is never healthy in the long run if investors all rush headlong into the same type of investment or into the same region. In the housing market the result is vacant properties and a slump in prices. And on stock markets and exchange markets, it leads to sudden price falls with panic selling, asset losses and serious consequences for the real economy.

Speculative rises are often triggered by governments sending out the wrong signals: excessive demands by certain regions or industries, or the promise of fixed exchange rates or overly expansionary monetary and fiscal policies leading to boom-like surges. All this can be avoided with steady financial, economic and monetary policies that are designed above all to achieve continuity and reliability.

Favorable Conditions for Stabilization

Current global economic trends are conducive to such policies in a number of respects. That was reaffirmed convincingly in the latest report of the International Monetary Fund to its autumn meeting in Washington.

- Some of the East Asian "Tiger" economies appear to have recovered from the shocks in the financial markets. After some initial difficulties, the right instruments have been found, especially in South Korea and Malaysia. There has been a shakeout in the banking sector. Foreign trade imbalances have been reduced, mainly by drastically cutting imports against a background of low exchange rates. The outflow of capital has thus been halted and, in some cases, actually reversed.

- Having suffered an additional buffeting from the East Asia crisis, Japan too has regained its footing in the first half of 1999, though mainly as a result of government pump-priming programs. Here, too, the shakeup of the banking system is making headway. As the recovery of the American savings and loans associations has shown, however, this sort of process needs time if it is to take place without undue loss of national economic resources.

The East Asian crisis dented economic activity in Europe, as it led to a decline in Asian countries' imports, in some cases by double-digit figures. Then there was the general collapse of Russia's imports. All in all, growth ground to a halt in the major European economies in late 1998 and early 1999.

But the crucial thing was that Europe's financial and capital markets hardly flinched. Not a single bank got into serious trouble as a result of having to write off trade investments in Russia and East Asia; and at the same time, the influx of flight capital led to highly favorable credit terms in Europe.

The newly created Euro Zone thus passed its first big test. Even the Kosovo war did nothing to shake the European financial market. And so the last of Germany's Euro-critics, who until then had been fairly vociferous, have just about fallen silent. The Euro is already proving to be a factor in the stability and stronger growth that has started to take hold in the European core countries in recent months.

Financial trend watchers and observers of the real economy are all eager to see what will happen in the United States. Predictions for the U.S. have ranged from a serious decline in growth and accelerating labor costs with rising inflation to the collapse of stock markets and a dramatic devaluation of the U.S. dollar on account of the high foreign trade deficit. But none of the predictions has, so far, come true:

- The real economy continues to move ahead strongly with enormous productivity gains.

- Inflation is negligible.

- Stock markets are booming.

- The trade imbalance has made little impression on the currency market speculators.

The year 2000 could see a dream configuration of the global economy. Slightly moderated growth in the U.S. combined with renewed economic activity in Europe and a reinvigorated East Asian region could noticeably reduce any remaining trade imbalances. Europe, Japan and East Asia could bring unemployment back down, and the inflationary pressures in the United

States would remain more under control. Moreover, a U.S. economy growing more slowly would suck in fewer exports, thereby reassuring the exchange markets as far as the real economy is concerned.

Economic, financial and monetary policy can, in that sort of situation, achieve a great deal provided above all that mistakes are avoided. Instead of throwing caution to the wind, "Greenspan policy" has called for navigating carefully and so holding in check the tide of speculation. The Council of the European Central Bank is also on the right path here, though perhaps not yet quite as professionally as the U.S. Federal Reserve.

Between Inflation and Deflation

Today, the eyes of the world are on the Federal Open Market Committee of the U.S. Federal Reserve. A further small rise in interest rates is possible to nip inflationary expectations in the bud. But price rise pressures in the United States, as elsewhere in the world, are marginal compared with what they were.

There has not been a situation for decades in which most of the larger industrial countries have had an inflation rate in the range of only 1.0% to 2.5%. Allowing for the fact that the official rates are probably overstated by between 0.5% and 1.0%, we have near price stability almost everywhere.

It used to be said that housing investment and housing finance benefited from high inflation—the "flight into real assets." Today, we are experiencing for the first time, in Germany at least, a gradual recovery in housing demand in a very low inflation environment. Low interest rates, combined with low inflation, make it easier for the housing investor to launch a project. That far outweighs the argument of subsequent capital appreciation driven by inflation, because the subsequent increase in value is uncertain; and what's more, it presupposes that the terms of financing are such as to make the investment actually look feasible in the first place.

Of course, it would be damaging if general price stability were to topple into a deflationary spiral, as many people have feared over the last 12 months. Deflation means a wait-and-see approach on the part of investors and a flight into cash. History has brought home to us very graphically the tragic consequences of such trends for growth, employment and political stability.

Even before the latest commodity price increases, however, it was clear that the deflationary pressures had been greatly exaggerated. Two arguments in particular point to this conclusion:

- Declining wages and salaries are the precondition of a truly deflationary process. Any such decline can be virtually ruled out, given the state of the labor market and the undiminished power of trade unions in many countries.
- The world's central banks have learned a great deal and would take forceful action to combat any deflationary tendencies.

As far back as 1987, the crisis in the financial markets was met with such a powerful injection of money that some commentators later thought it had been too much of a good thing. Even during the crisis in East Asia, there was no shortage of central bank money. The fact that credit was nevertheless tight in a few places, for example, Japan, had more to do with the banks' consolidation strategy and their need to make value adjustments than with inactivity on the part of the central banks.

THE OUTLOOK FOR INTEREST RATES

The period of precautionary interest rate cuts is past. Even the European Central Bank has started to talk in terms of a bias toward increases in the interest rate. Professional ECB policy watchers are now only divided as to whether the moderate rate rise will come in the late autumn or not until spring.

Even in a stable global economy, financial markets will experience the ebb and flow of interest rates. But I am sure the margin of fluctuation will narrow.

The greatly reduced risk of inflation largely obviates the need for the otherwise customary inflation premium. That means that the interest rate levels overall, and as an average over several years, may be lower than they have been for the last three decades.

The monetary policy of the large, globally influential central banks is on a learning curve as well. No more stop-go monetary policies, but instead, cautious countermeasures taken at an early stage to attack inflationary pressures at the source. The European Monetary Union will make a vital contribution to the simplification and stability of monetary policy. In the future, monetary policy in Europe will be able to concentrate on the goal of price stability without, at the same time, having to keep one eye on exchange rates.

Another factor that makes it unlikely that interest rates will soar to former heights is the convergence of economic trends in the trio of regions mentioned earlier. Slower credit expansion in the U.S. squares nicely with Europe's growing borrowing requirement. Thus, interest rates in Europe and the United States can converge at a relatively modest level.

Stabilizing and Boosting Savings

Even at comparatively moderate rates of interest, saving can and must be encouraged. Housing finance has an important part to play here. As far back as the mid-1990s, we ministers of finance, together with central bank presidents, took a hard look at the problem of low levels of savings. The propensity to save of private households has seen a marked decline over the last few decades in almost all of the major industrial countries—most of all in the United States. This trend may have been exaggerated by statistical factors, but it does reflect changes in the conditions for personal savings.

The inflationary spells of the 1970s and 1980s have persuaded many households to prefer present consumption to future security. Another important factor is that many households can nowadays more easily obtain personal loans. Consequently, saving up for major personal investments—from a car to a house—is becoming ever less important. Lastly, with better social security systems in place, people are tending to provide less for their future needs. Since state social security systems are funded on a redistributive basis in most countries, a large proportion of accumulated capital is lost without anything to take its place.

The decline in personal savings has been going on for many years against a background of widening gaps in government finances. The investment and employment shortfall in Germany, France, Italy and other major industrial countries is largely a result of this interplay between declining personal capital formation and rising government claims on the savings deposits still available.

There is no getting around the fundamental link between, and basic congruence of, savings and investment. However sophisticated and however globalized financial markets may be, they cannot make up for a general shortage of capital. Loan financing would be inflationary and hence unsustainable in the long term without savings, its counterpart in the real economy.

It is up to the state institutions and private sector financial intermediaries alike to halt the decline in capital formation.

Pension reform is the main challenge in the state sector. The demographic problems facing the advanced industrial countries will not be resolved unless an increasing proportion of pensions is funded on an invested basis. Today's well-stocked and active generations must save and provide for the future, so that however society is constituted in years to come, people can maintain their living standards on a sound economic basis.

Housing Finance's Contribution to Provision for Old Age

Savings and loan associations (called Bausparkassen in Germany) and similar financial institutions will account for a growing share of pension provision on an invested basis. Although the current debate on reform has revolved around savings in investment funds or pension funds on a voluntary or state-organized basis, residential property is—and always has been—an equally important form of provision for old age. People who live out the last years of their lives rent-free in their own home have provided at least as well for their old age as people who draw their pensions from the capital market.

Housing finance companies must promote this concept by constantly updating their range of products and adapting them to the rising demand of private households. Increasingly, enlightened citizens are coming to regard a home of their own as a financial investment, like buying stocks and shares or other types of investment. The housing finance sector must react with flexible and time-variable instruments, both at the savings stage and at the financing stage. It is plain that these new paths are already being trodden the world over.

THE OUTLOOK

Housing finance is, I believe, taking on a special and growing significance in the transition and newly industrialized countries. For people there, better living conditions are the crucial expression of economic prosperity. If the market-type economic system is to continue its triumphant progress throughout the world, it must show that it can produce better results than any of the alternatives. Capital must flow to where it is needed most, not as a result of central planning but of the free play of market forces. If the financial markets can do this with minimum friction and if they can save people from disappointment, they will be making an important contribution to prosperous and peaceful co-existence in the world.

Above all, they must build confidence, because confidence is the essential capital in all financial transactions, far more important than any advertising or public relations campaign, however brilliant.

Benjamin Franklin once remarked that anyone who said you could get wealthy except by hard work and thrift was a cheat and a rogue.

"Wealth" may not be the right word in modern usage for what most of us aspire to. Yet property, and especially housing, does afford us a wealth of scope for personal development and a wealth of security. Therefore, I want to see strong financial institutions, which in the interests of their customers enable as many people as possible to become property owners.