Households’ investment dilemma

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National savings in Bangladesh is estimated to be about 30% of

gross domestic product (GDP) and it has been growing steadily over time. Out of this total, gross domestic savings, which is the savings generated domestically out of domestically generated economic activity, is about 20% of GDP and the remainder is on account of inflow of workers’ remittances which accounts for more than 10% of GDP in recent years. There is no clear breakdown between household and corporate/business savings in Bangladesh, although it is generally believed that household savings account for bulk of our national savings. Household savings are intermediated through the financial system to investments in a broad range of economic activities all across the economy. Such savings, on the one hand drive the future growth of the domestic economy through funding of new investment and on the other hand, for the households provide the much needed provision for future income at the end of their productive career/life and/or leaving wealth for the future generation.

Although allocation of savings to higher yielding instruments/investments is very important for any household, their options are rather limited. For the most part household savings are directed to a few old-fashioned investment instruments: financial instruments like various forms of term deposits with banks or non-bank institutions (like National Savings Bonds); investments in stocks; and investment in real estate and land. In the absence of long-term savings instruments in the form of institutional pension funds, household savings in Bangladesh have been primarily through these three forms. For developing economies and financial systems, this type of allocation of savings is nothing unusual and in fact quite common. As a matter of fact, most households in Bangladesh start with financial savings through bank deposits, sometimes allocating a part of that to invest in stocks or buying a piece of land. As more financial savings were accumulated, people used to allocate a large part of that for constructing a house for the family.

The stable and predictable pattern of savings and its utilization had gone through a major shift in recent years as the stock market and real estate and land prices skyrocketed and formed stock market and real estate market bubbles. Many households have been lured to invest in Multi Level Marketing (MLM) for unreasonably high returns, which primarily invest in land. As stock and real estate prices surged, significantly large proportions of savings were allocated to these two sectors fueling further the asset price bubbles. In the recent bubble episode, stock prices went up by more than 10 fold or 1000% in less than 8 years and market capitalization of the DSE registered stocks increased from 5.5% of GDP in December 2005 to 47% of GDP in December, 2010 at its most recent peak. Price of apartments also recorded a similar trend: new apartments in posh areas of Dhaka (like Baridhara and Gulshan) which used to be sold at Tk 3,000-4,000 per square foot jumped to Tk. 20,000-30,000 per square foot within a period of five years. The bubble phenomenon has not been only limited to urban real estates, it simultaneously spread to almost all types of land across Bangladesh. As only a few lands are transacted in a locality, buyers’ interest shifted to the limited supply pushing up land prices throughout the country. Massive speculative investments by MLM companies and others in land also helped fuel the fire. One decimal of agricultural land in my own village, which used to be sold for Tk. 4,000 per decimal (equivalent to Tk. 0.4 million per acre), over the last five years has increased to Tk. 30,000 per decimal (Tk. 3.0 million per acre).

The massive shift in the rate of return across different types of savings/investment by households, have encouraged them to move away from longer maturity savings instruments and towards the real estate, land and stock market. This behaviour has been rational up to a point and early investors have been highly rewarded for their timely investment decisions. However, as asset price surges of this sort cannot last for long, we have already observed the meltdown in stock prices since early 2011. Unlike the stock market crash following a bubble, a real estate “crash” is usually a slow process, because the real estate market is less liquid than the stock market. One the one hand, many real estate companies have been offering deep discounts to woo the potential apartment buyers, sales are reported to be down by at least 40%. On the other hand, many unaware investors are still living on the perception that real estate and land prices will continue the bull run for a long time, if not for ever, and are making investment at highly inflated prices. Like most investors who buy at the peak prices, these are the investors who would pay dearly for their mistakes.

Under normal circumstances with steady but slow increase in real estate prices, there is a relationship between the house/apartment price and the rental amount that can be received from the same property. Generally monthly rent should be 1.0% of the implicit sale price of the house. In the case of Bangladesh, we are way short of that criterion at the moment. Currently a very well-finished new apartment measuring 3,300 square feet in Gulshan will rent for not more than Tk. 175,000-200,000 per month. The same apartment at the moment would sell for Tk. 20-25,000 per square foot, costing Taka 66-82 million plus registration cost, which is also not insignificant. The rental income to house price ratio will be only 0.27%-0.24% compared with 1.0% considered to be threshold internationally. Even with the lower cost of Tk. 66 million, the amount of foregone interest per month would be Tk. 660,000 per month at 12% rate of interest. There will probably be depreciation of the property over time as well leading to incurring of maintenance costs.

Some people may argue that since in most cases buyers use the property for self accommodation and with inflation house prices will eventually exceed the purchase price, it is always a good time to buy a real estate property. This argument often used by sales group could very well lead to bailing out the sellers at the expense of investors. Let me give an example of a land transaction offer that I recently faced. One of my close persons brought me an offer that they have negotiated with a private land developer in Purbachal to buy each katha of land (1/60th of an acre) for Tk. 1.3 million while the quoted price was Tk. 1.5 million. I also considered it as a good offer, but also observed that land price may not go up any time in the near future and housing and land cycles generally last for five to seven years. Plots in these housing developments are not expected to be developed before 10 years and everybody is buying the plots as investment for future or for speculation. If land prices, following the record bull run in recent years do not increase in the next five years, which is a highly likely scenario, I would be able to buy 50%-60% more land with the same amount of money invested in the money market and still be able to make gains from future investments. The same reasoning applies to buying of apartments. In our earlier example of Gulshan apartment, if the apartment price does not go up for five years following the recently ended bull run, an investor will save at least Tk. 36-40 million in interest earned over the same period. As a tenant the saver will be paying rent for the same or a similar high end apartment and still save an additional Tk. 36-40 million over the five-year period.

Another argument used in defense of real estate investment in Bangladesh is that it is the most densely populated country in the world, and the scarcity of land underpins housing valuations. But as the chart below illustrates, Hong Kong property prices fell during 1997-2000 by 60% in the aftermath of the Asian Financial Crisis. It took 14 years for the total Hong Kong housing index to climb back to the level it reached in 1997.

Japan, another country where buildable land is scarce, also recorded a massive decline in house price of 80% over the past two decades. The bubble economy in Japan during 1988-90, when Japanese land and share prices more than doubled, was one of the most remarkable examples of financial speculation in modern times; in absolute terms, it was possibly the largest speculative event in the history of the world. The peak of the bubble economy lasted only about two years; the bubble popped in 1990. Between 1990 and 1992 the Nikkei 225 average lost over sixty per cent of its value, and land prices plummeted by about fifty per cent. More recently, real estate prices in Bombay declined by 30% in nominal terms and declined by almost 50% in Dubai. In major Chinese cities apartment prices already declined by 30% and further corrections are underway. All of these economies are much stronger than Bangladesh and have much higher savings rates to afford housing along with strong demographic pressures for new accommodation. But the important issue is: when real estate prices are well beyond the earning potential and the investment cannot be justified by economic fundamentals, a major correction does always happen.

The issue is where should the savers put their money in the coming months? Stocks had been overpriced and valuation went beyond what it should have been. Following the major correction, stocks are now fairly priced and stock market is a good place for long term investment but not for short term gains. While the real estate market correction has just started, based on the experience of other countries, investors should not come to this market now and wait till the correction is over. All investors in MLM and so-called Housing Cooperatives should get out of their pyramid-type investment schemes and be aware that with an end in the land market bull-run, many of these investments or pyramid schemes will become illiquid and bankrupt.

In the near term, the most considered way forward for investors is to park their savings in the money market. Currently, there is a liquidity crunch in the money market, which is partly attributable to a lack of investors’ interest in the money market as returns on land/real estate and in stock markets have been unusually high in recent years. MLM companies are also reportedly giving returns up to 60% per annum to lure households and shifted billions of takas to those activities. Banks are competing for deposits and demand for credit is high in the economy, creating an upward pressure on deposit rates. Given the volatility in the stock market, the over-valuation and ongoing correction of real estate and land prices and the inevitable collapse of MLM pyramid schemes, households would be better served to park their savings in the money market and earn reasonably good rates of return along with preservation of capital. Bangladesh Bank, on its part, should allow the banks to offer competitive interest rates on deposits and build up their deposit base to enhance liquidity in the banking system.

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