Korea’s Real Estate Market: Are We Overreacting to Skyrocketing Property Prices?

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The most popular conversation topic in Korea these days is not North Korea’s nuclear program or the KORUS FTA, but the skyrocketing real estate prices. The real estate market has been the subject of interest since the late 1970s when the government transformed rice paddies and green fields in southern Seoul (Gangnam) into the first modern residential district in Korea. During the economic recession in the early 1980s, the government further expanded green fields in Gangnam in order to help revive the ailing economy. It focused on building residential buildings, good infrastructure, and reputable schools. The former agricultural land, then worth 300 won per pyong (3.3 square meters), has now become the nation’s most expensive area, worth around 30 million won per pyong. The price of land in Gangnam has thus soared 100,000 fold in nearly three decades, making the original land owners very wealthy.

Historically, real estate has been the safest and most lucrative investment vehicle in Korea. It is the asset that has been taxed the least and the most likely to rise in value. As a result, the average Korean household has up to 90% of its total assets in real estate. Soon after the financial crisis of 1997, however, Koreans witnessed home prices declining as much as 45%. With interest rates hovering at record-low levels and the stock market offering uncertain return, wealthy people took advantage of housing prices and poured their money into property. At the same time, the government relaxed control of financial markets. The financial institutions welcomed the opportunity and diversified their lending, making it easier for individuals to obtain a mortgage. Although this made it easier for ordinary citizens to own homes, it also opened the door to speculation.

Growing Bubble in Housing Market

Korea experienced a “lending bubble” in the mid-1990s spurred by the heavily indebted and over-extended *chaebol.* Following recovery from the 1998 recession, the country went through a “credit card bubble” in the early 2000s, with household debt reaching 62% of GDP at the end of 2003. Today, the nation is talking about a “real estate bubble” as apartments in the metropolitan area are priced around 40% above their intrinsic value. According to an online real estate information provider, one in four apartments in Seoul are now worth more than 600 million won ($630,000), and nearly 87% of apartments in the affluent Gangnam area are priced over 600 million won. The number of apartments worth at least 1 billion won numbered 50,845 in August 2005, but the number almost doubled to 109,166 in November 2006. A 3,600 square foot apartment in Gangnam Tower Palace cost 2.7 billion won ($2.6 million) in November 2002 when the complex was built, but was changing hands for 4.15 billion won ($4 million) in October 2005, a 66% increase in three years. The skyrocketing apartment prices have encouraged debt-financed buyers to continue the buying spree, which is pushing prices still higher. The Bank of Korea reported that the amount of loans extended to individuals using homes as collateral jumped from 86 trillion won in 2001 to 209 trillion won at the end of October 2006.

Rising property prices have also created a wider disparity between the haves and have-nots. Real estate prices in the richest neighborhoods skyrocketed 300% in three years, while prices in the poorer areas remained either flat or declined in value during the same period.

Asset- Inflation: Case of Japan

It appears that Korea is now undergoing a period similar to what Japan experienced in the 1980s and early 1990s. In Japan’s case, banks aggressively offered mortgages to companies and individuals at low interest rates, encouraging them to purchase more properties. At the same time, the property tax rate was low while taxation of profits from the sale of real estate was high, encouraging homeowners to hold properties rather than to sell. This resulted in a decreasing supply in the real estate market, and, arguably, a bubble in prices. Japan’s bubble burst suddenly when the government initiated strong regulation of the real estate market and mortgage loans. When the bubble collapsed in the early 1990s, the nation saw the “value” of the equivalent of $962 billion evaporate. It took Japan more than a decade to recover from the economic slump.

Some critics say that Korea’s recent real estate market frenzy is reminiscent of Japan in 1980s and fear that Korea may be following the same path. Other experts and government officials, however, downplay the possibility of a property bubble and say that Korea’s case is different from that of Japan. Unlike the situation in Japan where companies joined individuals in the aggressive buying spree, private investors are the major buyers in Korea, making the size of individual investments small. In contrast with Japan, Korea has seen apartment prices rise sharply in specific areas, such as Gangnam and redevelopment districts, so that the bubble concern is not nationwide but limited to particular areas in metropolitan Seoul.

Government Intervention to Curb Housing Prices

Believing that the rise in housing prices was triggered more by speculation than by real demand, the government stepped in to curb the price rise and crack down on speculation. Since President Roh Moo-hyun took office in 2003, the government has taken measures on seven occasions to curb demand for high priced real estate, but unsuccessfully. In fact, real estate prices rose each time the government announced a new set of measure to stabilize property prices. Average apartment prices in Seoul have risen 36%, while prices in Gangnam have increased nearly 70% since the government vowed to fight against real estate speculation. Despite the concern that more drastic measures could impede the economic recovery in the short term, the government continued to apply stronger and more comprehensive anti-speculation measures. It tried to curb demand for real estate, especially among wealthy people, by raising taxes. In August 2005, the government decided to raise capital-gains taxes on people who own two houses to a flat rate of 50% from the previous 9% and 36%. Those with three or more homes in designated Speculation Zones may have to pay up to 82% in capital gains taxes, an increase from the 60% rate. The plan was to be implemented in 2007, after a 1–2 year grace period, to encourage the owners to dispose of their extra homes. Furthermore, the government toughened lending policies by lowering loan-to-value (LTV) and debt-to-income (DTI) ratios, making it more difficult for people to obtain loans to buy homes.

The government unveiled yet another set of measures in November 2006—to build more homes instead of curbing demand. It plans to build 1.64 million houses in and around Seoul by 2010. Many experts welcomed that the government is starting to pay attention to the supply side of the housing market. However, the general public is skeptical that the government’s new anti-speculation policy will work. According to a nationwide survey of 605 people, more than 62% said they were pessimistic about the effectiveness of the new measure, while only 27% were optimistic. To lower prices without disturbing the housing market, the government decided to re-apply a price ceiling on apartments provided by private builders. The government lifted regulations on the prices of apartments provided by private builders in 1998. Private builders then began using luxurious materials for new apartments, pushing up the prices of neighboring apartments. By cutting construction costs, the prices of new apartments could fall as much as 30% from the current level.

Shifting policy direction is a difficult task. Although the positive impact of President Roh’s eighth round of measures may not be recognized immediately, many analysts agree that the new anti-speculation measures are appropriate and desirable. A stable real estate market is a prerequisite for the economic well-being of the nation. If property values were to decline by 20–30%, approximately 800 trillion won, equivalent to 100% of Korea’s GDP, would evaporate. A sharp fall in property prices would likely have a devastating impact on Korea’s economy, potentially bringing about the most serious financial crisis since 1997.