2.0 LITERATURE REVIEW

The spread of the 1997 regional crisis to Malaysia was reflected, initially, in sharp falls in Malaysia share prices and the external value of the Ringgit. Foreign investors bailed out of Malaysia stock market and sold the Ringgit. This has slashed share prices on the KLSE while forcing the Ringgit all time lows. The stock market and the currency were spiralling downwards in such an alarming manner that their value bore no relationship to the country economic fundamentals. The Ringgit had depreciated 27 per cent from its year earlier level (1996), while the KLCI was down 30 per cent since 1 July 1997 (Evelyn Shyamala Devadason, 1998)\textsuperscript{8}. The regional financial crisis has had a much more severe impact on economy activity than expected. Sharp decline in business and consumer confidence, both resulting contributed to decrease in assets prices including property prices, led to a pronounced contraction spending by early 1998. The slump in spending and asset value also led to severe difficulties in the financial and property industry. In view of this we have to look at the foreign researchers' and local researchers' point of view to examine the relationship of the share market performance, interest rate movement and property market and how the above two indicators will have an impact on Klang Valley property market.
2.1 INTEREST RATE AND PROPERTY MARKET

The availability of housing credit is a crucial determinant of the housing demand. The credit terms will transform a demand into an effective demand for house buyers. Furthermore, many household cannot buy houses with their own money because housing is an expensive good. This is more serious for the low income buyers (Lansley, 1979). In the house purchase market, interest rate plays an important role. Whereby higher interest rate on housing loans will increase cost of borrowing which increase the monthly loan repayment. Gelfond (1966) examined the relative importance of the interest rate, the length of loan repayment period and the loan-to-value ratio for sample of 1500 household in the state of Pennsylania. Gelfond concluded that the down payment requirement was quantitatively the most important factor restricting households in their quest for housing of their choice.

In England, similar lending policies resulted in the household liquidity position becoming an important determinant of demand. On the supply side, property developer relied heavily upon the ability for the firms to raise their funds. Property developer, therefore, have to borrow money from the bank to finance construction cost and can only repay the credit when they have sold the house. When interest rates are low, credit is easy, house building proceed at a steady to rapid rate. Demand is usually also buoyant as mortgage interest rates are also low and money are readily available.

On the other hand, when interest rates are high, credit is difficult to obtain, house building proceed at slow rate. According to Guttentag, in England, it has been suggested that the main constraint of the rate of housing buying starting at the time (in 1977) is not the supply of land or labor, but the supply of credit (finance). In the

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USA, most recent writers on the housing function have recognized that house is sensitive to credit conditions and have singled out interest rate variable is the major short term determinant of residential construction (Guttentag, 1961).  

Interest rate – the cost of money – plays a crucial role in the investment of stocks, bonds, mutual funds, and other money market account. Interest rates also impact on the cost of mortgage, credit card, and auto loans. When the demand for money exceed supply, interest rate rises, and when supply exceed demand, interest rates decline (Eugene F. Brigham & Louis C. Goperski, 1997). Interest rates have two effects on corporate profits. Firstly, because interest is a cost, the higher the rate of interest, the lower are firm’s profits, other things held constant. Secondly, interest rates affect the level of economic activity, and economic activity affects corporate profits.

During the recession period, Bank Negara Malaysia ("BNM") reduced Bank’s intervention rate. This reflects the increased liquidity in the financial system. This enables the bank to lower the intervention and Base Lending Rate. The lower the intervention rate, the lower will be the cost of borrowing money, which can help accelerate property growth. Conversely, during property boom period, BNM reacted to curb over heating property market by raising intervention rate and direct the bank to cut back loan growth to curb speculative activities. Consequently, the higher the intervention rate, the higher the cost of borrowing money, which can help to slow down the property growth (NST, 29-11-99).

The direction of change in the interest rate will affect the economic and financial decision of businesses and individuals to consume or to invest. Indeed, interest rate is a crucial variable in determining the property prices (Syed Ahmad Idid, 1993). The housing sector, as everyone knows, relies heavily on borrowed money from financial institutions. A credit slowdown, therefore, has serious repercussions. The two main forms of finances required are bridging finance and end financing. The

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latter is particularly long term and consequently is sensitive to both availability of funds and interest rates (Chew Ann Teck, 1982)\textsuperscript{16}.

R. Thilainathan (1997) stated that financing is by far the most important among the factors supporting the housing industry. Financing support the housing industry in the two ways – facilities property development for the developers and house ownership for house buyers. Hence, should overall credit continue to expand further, then there should be more opportunities for financing the property sector. Conversely, any detraction could proportionately reduce the lending capacity and trigger a downward spiral in the property industry\textsuperscript{17}.

2.2 SHARE MARKET PERFORMANCE AND PROPERTY MARKET

According to Evelyn Shayamala Devadason (1998) \(^{16}\), the falling of Kuala Lumpur Composite Index (KLCI) and share prices have had two-pronged effect on the economy. First, it has brought about a negative wealth effect on individual, resulting in a drop in consumer spending. Second, the drop in consumer spending is apparent in the car, property markets and in the tourism industry. The volume of property transactions has also been reduced.

The stock market performance, interest rate and current rate of economic growth have been identified as the three foremost factors affecting the performance of property sector. This has been recorded in a recent property opinion survey (WTW: 1997 & 1998) which also reflects a general decline in the real property cycle \(^{20}\).

Pursuant to Colliers International (1998), the property market in general was 'optimistic' for the first half of 1997 until the regional and currency turmoil started in July 1997. By December 22, the KLSE Composite Index had plunged as much as 47% from 1,078.90 on July 1 1997 to 569.83 on December 1997. The free fall wiped out close to RM 400 billion in market capitalization. The turn of event has been caught many by surprise. This had led the government take some measure to prevent drastic fall in property market. Despite all the efforts taken, the market continued to cool down. In fact, it has been dampened by the uncertainties in the national economic growth situation during the year. Toward end of 1997, buyers were generally expecting property prices to cut by 50%, whilst most owners were reluctant out close to RM400 billion in market capitalization. Whilst the ringgit depreciated by about 55% against US Dollar in just six months \(^{21}\).

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\(^{16}\) Evelyn Shayamala Devadason (1998), OPICT, pp 66-68.
The drastic and sudden turnaround in Asia’s fortunes resulted in:-

- Massive retrenchments, leading to a rise in unemployment rates to record level
- Massive pullout of foreign funds, as investor fell prey to the herd mentality
- Increased business failures and bankruptcies as corporate and individuals were no longer able to service their debts, especially those whose foreign loans have ballooned due to local currencies against the US dollar
- Tight liquidity and hefty rises in interest rates as the banking system grappled with rising Non Performing Loan ("NPL"). This further worsened the situation as businesses were starved of credit to continue their normal operations
- Substantial losses as investors had their fingers burnt by the drastic drop in stock prices
- Social unrest and political instability leading to replacement of the leaders of three countries (South Korea, Thailand and Indonesia)

All these led to a loss of confidence resulting in a significant reduction in consumer spending. The once booming Asian property market were quickly overwhelmed by the poor sentiments and credit squeeze. Although signs of overbuilding and an impending slowdown were evident way back in 1996, the way the property markets retreated in 1997 and 1998 were totally unexpected and caught property developers, bankers and investors totally unexpected (Tang & Teoh, 1999)\(^{22}\).

2.3 OVERVIEW OF PROPERTY MARKET

After a slight dip in 1969 due to the May 13 incidents, the property market recovered and was stable until 1973. The unprecedented increase and buoyant stock market brought in a property boom during 1973 to 1976 period. Property prices doubled during this period. From 1976 to 1978 there was stabilization in property prices. Another property boom took place from 1979 to 1983 caused by the relaxation of housing loan eligibility, low interest rate and a more liberal lending policy by the banks. By 1984 the economy was badly affected and the property market nose-dived. By 187 property value dropped by as much as 50 per cent in some areas. The industrial sector led the recovery of property market in 1998 and for the next four years until 1993 and growth was slow and tentative. The great boom in the stock market in 1993 and the steady growth in economy led to unprecedented property prices. By early 1997 prices of property had peaked at record levels. Steps had to be taken by the government and developer to address this alarming growth in property prices. In 1995, the government came out with a comprehensive set of guidelines on regulating foreigners buying property in Malaysia to ensure that only property costing more than RM250,000 was available to the foreigner. The Real Property Gains Tax (RPGT) was raised from 20 per cent to 30 percent for gains made within the year. The sliding scale of RPGT enjoyed by the foreigners was scrapped and replaced with a flat rate of 30 per cent on all gains regardless of the period of ownership. Furthermore, a levy of RM100,000 was imposed on all foreigners who purchased property.\textsuperscript{23}

The Bank Negara Malaysia ("BNM"), during this period also advised local bank lending not exceeding 60 per cent of the property prices of the house. In the face of increasing property prices, in April 1997, the BNM issued a directive to cap the excessive lending towards the property sector at 20 per cent and the equity sector at 15 per cent of all lending. BNM also directed all banks not to lend to property exceeding RM150,000. These actions had a very strong negative effect on the

growth of the property sector and property transaction and price dwindled. (See table on characteristic of the boom and bust periods)

Following the 1997 Asia economic crisis, in Malaysia, the attack on the ringgit and the crash of the stock market from a high of 1300 points to a low of 320 points, have sent strong signals to the property market. During the last three month of 1997 and first three months for 1998, the volume of transactions decreased. Property prices also fell. However, as the property market normally has a twelve month lag time, the actual effect of economic crisis will only translate into the property market by the end of 1998. The significant decline in sales reflected both the smaller amount transacted as well as the domination of lower valued products during the period as property developers shifted away from higher-end properties which suffered weaker demand. Reacting to changes in market forces, most property developers shifted from high-end products that suffered weaker demand to develop more affordable housing. The sharp decline in demand for high-end units resulted in an oversupply situation. The situation was aggravated by the supply of high-end condominiums (above RM250,000) coming on stream in 1998 (Govindran, 1999) 24.

The 1997 and 1998 Asia Economic crisis has affected certain industries more severely than others. The housing and property sector was among the worst hit. In 1998, the construction sector contracted by 25.4%, compared to a +9.5% in 1997. The initial tight monetary and fiscal policy stance aggravated the situation. The value of residential property transactions fell by 36% to RM 13.9 billion in 1998 (1997 +15.2%). The number of residential transactions fell by 30% to 122,881 units. The characteristics evident in the property market during previous boom and bust in Malaysia25. They are tabulated as shown in table 2.0 below.

### Table 2.0: Characteristics of The Boom and Bust Periods

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<td><strong>High GDP growth</strong></td>
<td>Negative GDP growth</td>
<td>GDP growth rate is estimated at *% for 1997 and forecast at 7% for 1996. 1996 growth rate was at 8.2%. In 1985, GDP growth was negative at 1.1% but improved to a marginal growth of 1.2% in 1986.</td>
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<td><strong>Lower deficit in the balance of payment</strong></td>
<td>Increasing trade deficits in balance of payment</td>
<td>The country's current account deficit was reduced from 9% of the GDP in 1996 to 5% in 1997. Malaysia potentially rising trade deficit gap, being of utmost concern amongst foreign investors and fund managers, has triggered off negative sentiments to an unwarranted level to trade.</td>
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<td><strong>Low Inflation rate</strong></td>
<td>Increasing inflation rate</td>
<td>Inflation rate stood at 3% prior to July 1997, down from 3.5% in 1996. During the period of the run-up to the mid 80s recession, inflation was at highest in 1981, at 9.7%.</td>
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<td><strong>Increasing income levels and higher affordability, low unemployment</strong></td>
<td>High unemployment rate</td>
<td>Unemployment rate had been reducing ever since the economic recovery in 1988 from the last recession. The current rate stands at 2.5% from a high of 8.7% in 1987.</td>
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<td>Higher volume and value of property transactions</td>
<td>Low volume and value of property transaction</td>
<td>The highest jump in volume of transactions occurred between the period 1988-90, an increase of around 23%. However, the years 1991-1993 saw less than 5% increase in volume compared to preceding year. Volume of transactions increased again between 1994-95 but at a rate of 16% only and 7.5% for 1995-96. The period of 1997-98 is expected to record fewer number of transactions partly because of the lackluster stock market, which has a rather direct impact of property industry amongst other factors such as interest rate, employment/income levels, business and consumer confidence.</td>
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<td>Higher confidence level amongst buyers</td>
<td>Buyers adopt wait and see attitude (reluctant to commit to long term investments)</td>
<td>Medium cost housing projects (those price below RM150,000) are expected to continue to enjoy strong demand. However, this will still be susceptible to the interest rate level prevailing. Already, buyers are adopting a wait and see attitude with regard to up-market residential properties.</td>
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<td>Steady growth of prices and rentals of properties (1994-1996)</td>
<td>Declining prices and rentals of properties and foreclosures (all time low prices in 1987)</td>
<td>Prices and rentals are stable currently but are expected to retreat further should the current economic uncertainty in South East Asia region prolong, which may result in increasing sums of non-performing property loans by banking sector, hence leading to inevitable foreclosures.</td>
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<td>Development project in all sectors were generally &quot;mega&quot; in scale</td>
<td>Slowdown in the development and construction sectors</td>
<td>The deferment / slowdown of several mega projects such as Bakun project, the Northern Region International Airport in Kedah, Highways linking the highlands, KL Linear city and Putrajaya (Phase 2) may trigger off a slowdown in construction sector, resulting in a lower contribution to the GDP. Note: the construction sector has been identified as a key catalyst to GDP growth besides manufacturing and services.</td>
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<td>Many players in the industry, including non-property based companies</td>
<td>Closure of small development and construction companies</td>
<td>Plantation owners, contractors, biscuit manufacturers, and even poultry reraers are amongst some of the companies which diversified into the property development business in recent years. To date, no reports of abandoned projects and winding-up of property companies have been reported. Should interest rates move up, thus increasing their holding costs of recently acquired properties, smaller, less diversified and in-experienced property companies face the risk of being dropped from the property scene.</td>
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<td>Higher volume of applications for land conversion</td>
<td>Reduced volume of land conversion application</td>
<td>The pace of applications for conversion of land from agricultural to building and the number of privatization projects awarded have slow down of late compared to during the early 90s.</td>
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<td>Increase in number of public listed companies in KLSE</td>
<td>Quite treading and public listing activities on the KLSE</td>
<td>An approximately 505 increase in the number of public listed companies was observed between 1993-1996. The KLSE composite Index then reached a high of almost 1300 points. It has fallen by approximately 38% at present.</td>
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