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## **Understanding Speculation in Housing Forwards**

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The method used by developers to sell housing units in advance of their completion date has recently come under public scrutiny as a result of intense speculative activity that has at times threatened public order. Recent proposals to regulate such sales seek to curb speculative activity and ensure fairness in the market.

The major public concerns center around two issues. First, triad members wishing to turn a quick profit often use strong-arm tactics to jump the queue, making it difficult for law-abiding buyers to acquire the units directly from the developer. Second, final users who wait in queues on the announced date of public sale often find that many of the choice units have already been privately sold ahead of time to property agents or speculators. Many buyers are therefore compelled to pay a considerable premium in order to acquire their units from property agents and speculators. Speculative activities are being blamed for creating such a situation.

While these concerns have a long history, the recent upsurge of property prices in the small- and medium-size-unit residential market has renewed calls for regulating the sales of these units so as to curb speculation and to ensure fairness in the market. There is considerable agreement that queue-jumping by triad members is a public order problem and should be resolved through more vigorous law enforcement measures. This can be combined with measures to deter queue-jumping. A more controversial issue concerns the need to curb speculation.

### **Misguided Proposals to Curb Speculation**

From an economic point of view, it is not clear why speculation should be curbed. Speculation is economically desirable because it spreads risk. It can occur only when there are differences among people in their attitudes toward risk and their assessment of future prospects. So long as banks remain prudent in making mortgage loans, there is really no rationale for regulating a purely voluntary exchange arrangement unless there is a clear case of market failure.

According to some commentators, a case for regulation can be made in that the sale of new residential units in the form of housing futures has an element of market failure. They argue that developers possess location-specific monopoly power, especially in large developments. Such powers are enhanced by the fact that housing units are not homogeneous. The monopoly argument cannot be ruled out in principle, but is it empirically plausible? To exercise such monopoly power, developers have to possess a mechanism that would allow them to sell the units to their respective highest bidders. In other words, price discrimination must be present. This can only be achieved through auctions because developers cannot possess information as to who is the highest bidder for each unit in advance. But the fact that developers have chosen not to use auctions as a means to sell their units is *prima facie* evidence that price discrimination cannot be the explanation.

It has been alleged that auctions have not been adopted by developers because they are costly to administer. It is not immediately obvious that there is much empirical merit in this claim. But even if this were the case, the monopoly argument still breaks down because it implies that price discrimination is too costly to implement. Since monopoly power cannot be effectively exercised, there is no case for regulation on such grounds.

It is interesting to note that if auctions were adopted, short-term housing speculation would be reduced because the units would then be held by those with the highest bid. These are more likely to be final users than property agents and speculators because a competitive bidding process is likely to reduce significantly the scope for making speculative profits. This means that if price discrimination could be effectively employed, then the incentive to engage in speculation would be reduced significantly. In other words, speculation takes place only when monopoly power, if it exists, is not exercised.

Another popular proposal favored by many is to introduce a capital gains tax aimed specifically at reducing housing speculation. Such a proposal is redundant since the existing inland revenue code provides for taxing short-term trading profits. Since such profits are often not reported, the real problem is the effectiveness of law enforcement measures. This difficulty will not be removed by the introduction of a capital gains tax. Furthermore, short-term speculation is not likely to be deterred when sentiments are bullish without a very high tax rate on capital gains, which would be highly distortionary and hard to justify in view of our fairly low income tax rates. It may also be difficult to justify a capital gains tax on transactions in housing futures alone.

### **Nature of Housing Speculation**

The puzzling issue that remains to be explained is why do developers choose to sell their

units the way they do? Why do they choose to sell some of their units to property agents and speculators in advance of the announced date of sale? Why do they choose to make prospective buyers wait in queues? Why don't they use auctions, which are more likely to maximize their expected gains?

One explanation is that while developers can make a reasonably accurate forecast of the average market price, it is impossible for them to know the highest bid for every unit. If developers are less efficient at searching out the highest bid for every unit, then one would expect property agents and speculators, who are more efficient in this type of search activity, to perform such a function. But such an explanation fails to explain why developers are keen to sell many of their units to property agents and speculators, often in advance. Since developers cannot gain from a better matching of units to final users, why do they care whether the units are sold to property agents, speculators, or final users? The explanation is also unconvincing because unless auctions are too costly to administer, developers will have an incentive to use them to force buyers to reveal their bids for every unit, and capture the gains that would otherwise accrue to property agents and speculators.

The selling of new residential units in advance of their completion date is in principle no different from the selling of a futures contract. Like all futures markets, it is not always easy to distinguish between speculators and final users. But housing futures have two important distinguishing features. First, residential units are necessarily heterogeneous. Second, the final users are typically homeowners or small landlords. These two elements imply that there is a non-trivial problem of matching units to final users. Consequently, speculation in housing involves not only the spreading of risk but also the matching of the units to final users. Property agents and speculators who trade in housing futures perform dual functions.

These unique characteristics create the need for a special set of arrangements in order for the market in housing futures to function. It is important to establish at the very outset the incentive for developers to sell some of their units to property agents and speculators rather than to final users.

Developers often choose to sell the units in a single development in a number of stages. Clearly the price one is willing to bid for a unit depends to a large extent on its expected future value. This value will change over time as more information becomes available and will alter the price that one is willing to bid for a unit either upwards or downwards. A developer would try to pick the best time to sell his units, but he can never be completely certain when that is. An optimal strategy would be to space out his sales over time so as to balance risk against expected return, but there is a limit dictated by relevant cost-benefit considerations on the frequency of conducting such sales.

Property agents and speculators have a comparative advantage over developers in searching for a prospective buyer for a unit because they are in a better position to fine tune both the price and the timing of each sale. This advantage allows property agents and speculators to be comfortable with bearing more risk than the developer is willing to. It also means that the price of acquiring a unit from property agents and speculators will be higher because they have to bear more risk.

Property agents and speculators will prefer to acquire prime units from developers. Since they have to sell the units to final users at prices above the initial sales prices set by developers, it would not be in their interest to acquire non-prime units from the developers and sell them to final users at prices that will not be very different from those of some of the prime units available directly from developers.

This explains why, in the period following the initial sale of new units by developers, the increase in prices on different units occurs at an uneven rate. The prices of prime units tend to rise proportionately more than non-prime units in the same development. Incidentally, this explanation also makes it clear that developers are not systematically making poor forecasts of housing prices, as the evidence would superficially suggest.

The final user is faced with three choices: (a) to purchase a prime unit from a property agent immediately, (b) to purchase a non-prime unit from the developer, or (c) to postpone his purchase until some future date. In making his choice, he is aware that many prime units are held by property agents and speculators who would not sell unless a premium is paid now. This information alters his assessment of the value of the non-prime units available from the developer. It induces him to increase his bid for these units, which will raise the probability that the non-prime units will be taken up.

By selling the prime units to property agents and speculators, the developer has increased the probability that all of the units will be sold within a short period of time. He is able to do this because, by selling some of the units to property agents and speculators, he has temporarily withheld some of the units from the final users. The developer has created a situation in which property agents and speculators will help him space out the sale of the units to final users. The risk of picking the right time to sell the right number of units has been partly shifted to property agents and speculators, who are in a better position to fine tune that decision.

Sometimes developers sell a large block of units to a single investor at a discount with a provision that the investor will not resell the units in smaller parcels for a pre-determined period of time. The discount represents a compensation to the investor for taking higher risks.

The restriction on reselling these units in smaller parcels ensures that the investor will be taking higher risks, for otherwise there will be no reason to give the discount in the first place. The discount is clearly given with the view that the units would not end up in the hands of small final users too quickly.

By selling some of the units to property agents and speculators in advance, the developer has induced others to take on the risk of picking the right time to sell. Property agents and speculators may be more willing to bear such risk than developers, not necessarily because they are less risk averse, but because they are better searchers for final users than the developers. The most intriguing aspect of the arrangement is that the developer is able to capture part of the gains from allowing others to help him space out his sales more efficiently over time. This occurs because the probability that all the units can be sold quickly has been increased. This translates into a higher expected revenue after adjusting for risk. Note also that the developer would have little incentive to sell to property agents and speculators if it were not possible for him to improve his own situation.

### **Superiority of the Present Method**

Consider the difference between auctions and the present method from the point of view of the developer and the final user. Auctions have the advantage of extracting the highest revenue for the developer given the information available to all parties at the time of the auction. The disadvantage is that many of the units that are put up for auctioning are likely to end up with final users. This means that the extent to which the sale to final users can be spaced out over time is limited. The developer therefore has to assume a higher risk of picking the right moment to conduct the auction.

Naturally, developers will want to be compensated for taking on more risk than they prefer if they are compelled to adopt auctioning as the mechanism for selling the units. In a sense, developers can expect to get a higher total revenue through auctioning because they have to take higher risks. Since the present method has been chosen by developers over auctioning, it represents a superior arrangement, not because it brings in more expected revenue, but because it optimizes between return and risk.

From the final users point of view, they are not worse off either under the present method. If search activity is highly efficient, then the expected amount they have to pay the developer under auctioning may not be significantly different from what they have to pay now, which includes payments to both the developer and property agents and speculators. They may be better off if the developer picked a bad time to conduct the auctioning, and worse off if the developer picked a good time. The risk to the final user and to the developer are both

increased under auctioning. Under auctioning, the final user has less scope to decide when to buy the unit because fewer such units will be available from property agents and speculators. An alternative to auctioning is to operate a lottery so that whoever comes first will have the first pick of the units offered by the developer. This may reduce the probability that the prime units will end up in the hands of property agents and speculators, depending on how the lottery is operated. Lotteries will reduce the amount of speculation if more units end up in the hands of final users, but it is unlikely to be as effective as auctions in this respect. If developers are not prevented from selling the units to property agents and speculators in advance of the lottery, then the lotteries will have very little fundamental difference when compared with the present method unless restrictions are imposed on subsequent sales.

The important point about the market for housing futures is that it exists in order to diversify risks for both developers and final users. This is beneficial to developers because it reduces the risk of selling most of the units to final users at a bad time. It also benefits users because it protects them from having to buy most of the units at a good time. For this to work, a significant number of units has to be held by property agents and speculators, who perform the dual function of assuming risk and searching for the final user. Measures to curb speculation in housing futures is basically a contradiction in terms. If all the units can be placed directly with final users, then why bother with a futures market? It is natural for final users to complain that they are often unable to purchase the units directly from developers when the sentiments are bullish, but then they have no obligation to buy the units from developers when the sentiments are bearish.

The method devised by developers to sell housing units in Hong Kong is quite unique. It is not clear whether this is due to the innovativeness of local developers or whether it is the product of the higher risks they have to bear in developing property in Hong Kong. What is clear is that there is no compelling reason to believe that there is a case of market failure. Speculative activities improve economic efficiency. Let us hope that a better appreciation of the mechanism behind these arrangements will lead to a more enlightened view about the desirability of regulating the market for housing futures.

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