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MARKETPLACE SHLOMO MAITAL

WHEN THE BUBBLE BURSTS

Catching up to Hong Kong: Since 2007 the price of flats in Tel Aviv has risen 76.4 percent
NIR ELIAS / REUTERS

Soaring property prices are like riding a tiger – if prices continue to rise, it's bad; if they fall, it's bad, very bad

"WE SHALL not cease from exploration," wrote Anglo-American poet T.S. Eliot, "and the end of all our exploring will be to arrive where we started and know the place for the first time."

After a trip to mainland China and Hong Kong, I returned to Israel to see with fresh eyes the soaring cost of housing and Finance Minister Yair Lapid's plan to deal with it by exempting flats from the 18 percent Value Added Tax (VAT). Under the plan, first-time home buyers who have served in the IDF will be exempt from VAT charged on new flats priced at 1.6 million shekels ($460,000) or less.

If Lapid were a firefighter, he would battle blazes by pouring gasoline on them. The VAT exemption will have the same effect. Lapid's wrongheaded policy, approved by the Housing Cabinet on March 24, has been utterly rejected by all the experts, including Bank of Israel Governor Karnit Flug and highly respected Finance Ministry Chief Economist Dr. Michael Sarel, who quit because of it. All

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to no avail; it will soon become law.

Why won't the VAT exemption slash housing prices by 18 percent? And if this won't work, what will?

Let's begin with the numbers. According to the Housing Ministry, since 2007 the price of flats in Tel Aviv has risen 76.4 percent. Nationwide, the cost of housing has risen 57 percent. Since 2008, Tel Aviv rents have gone up 65 percent (nationwide 52 percent).

Since 2006, Israel's property price increase has been the highest of all the 34 OECD (developed) nations. Soaring property prices are driven partly by capital inflows into Israel, which hit a record high of $7.22 billion in the last quarter of 2013 – some of that money bought properties.

These numbers are alarming for at least two reasons.

First, the experience of the US, Japan, UK, and other countries shows that inflated real estate prices eventually collapse and, when they do, bring down the entire economy. This could happen to Israel, too, and some experts think it will. Mortgages and real estate loans comprise about 40 percent of local banks' assets. Moreover, some 90 percent of new mortgages have variable interest rates. When interest rates rise, as they will, people will struggle to pay their mortgages and some may default. This is precisely what burst America's housing bubble in 2008. The property bubble has helped fuel a stock market bubble. The Tel Aviv 25 stock index has tripled in the past decade, driven by banking and real estate.

Second, soaring housing prices make it impossible for many young couples to buy a home or even rent one. Between 1996 and 2008, it took 100 average monthly salaries (about eight years) to buy an average apartment. This key number was stable. But, today, it takes 130 monthly salaries to buy an average flat, or more than a decade. This puts Israel very close to the world's most unaffordable city, Hong Kong, where 156 monthly salaries buy an average flat.

According to the business daily Globes, Israelis need 191 average salaries to buy a spacious five-room apartment, double the OECD average of 96 monthly salaries. Therefore, many of the Generation Y couples could well despair and leave Israel, taking their energy, skills and creativity with them.

Why don't young people buy or rent cheaper flats on the periphery? Simply because they prefer Tel Aviv where there are jobs, culture, entertainment, night life and other young people.

My Technion colleague Prof. Amnon Frenkel studied this issue, and in published research found that hi-tech and finance workers with "culture-oriented lifestyles" prefer to rent small apartments (which are all they can afford) in central city locations. I understand this well. My son lives in north Tel Aviv with his wife and two-year-old daughter. Tel Aviv is a vibrant, dynamic city, one of the best places in the world to live – and, also, one of the most expensive.

FINANCE MINISTER YAIR LAPID'S PLAN TO DEAL WITH HOUSING COSTS HAS BEEN UTTERLY REJECTED BY ALL THE EXPERTS

There is a long list of reasons why the VAT exemption is doomed to fail. Governor Flug uses Economics 101 (a course Minister Lapid never took) to explain why. If you lower the price of flats, you increase demand. If you increase demand in the short run, without boosting supply, prices rise, especially when demand is price insensitive as it seems to be for flats. The only long-term solution to soaring housing prices is to boost supply.

Flug doubts regulatory officials can monitor flat prices to prevent builders from pocketing the VAT, instead of passing it on as lower prices. "In the absence of price supervision, a large part of the benefits will not be enjoyed by home buyers," Flug has said.

I spoke with a lawyer, Gil Gan-Mor, a member of the Affordable Housing Coalition, which also opposes the VAT exemption. He told me the exemption will mainly help wealthier home buyers and comes at the expense of low-income buyers whose distress and needs are much greater. The cost of the VAT exemption is about NIS 3.5 billion ($1 billion), he said. What social services may be cut to pay for it?

Gan-Mor and the Affordable Housing Coalition want to see a broad range of policies adopted, including a law to require a fraction of all new housing (including that built on private land) to be priced in a range feasible for low-income families; a revitalization of public housing, including some in existing neighborhoods; an increase in rent subsidies for the needy; and urban renewal, in favor of affordable housing, reversing the trend toward "gentrification" and costly high-rise flats for only the wealthy.

I pointed out to Gan-Mor that under the existing Law for National Housing, a quarter of all new housing built under this law must be "affordable" (low price, for low-income families). Yet, not a single new building license has been issued by the National Housing Committees that administer the law. Gan-Mor says the government is evading implementing what the Knesset has passed. His coalition has two petitions before the Supreme Court though no ruling has been handed down yet.

Perhaps no group understands property and housing prices better than property assessors – those who make their living by evaluating what land and real estate are worth. The Land Assessors Association Chair Ohad Danos wrote a brief to the Justice and Finance Ministries, which authored the VAT-exemption law, stating flatly that "the [VAT exemption] proposal will not bring a reduction in housing prices."

Danos also blasted another provision of the law that limits the VAT exemption for those who did not serve in the IDF (i.e., Arab citizens and ultra-Orthodox) to apartments priced at NIS600,000 or less. "It is unworthy," he wrote, "that legislation should include a fiction," because almost nowhere are there apartments available at that price. The law is baldly, and perhaps illegally, discriminatory and may be struck down by the Supreme Court for that reason.

If we took T. S. Eliot's advice and explored the world, what can Israel learn from other countries that have grappled with property bubbles? Here is a brief survey.

SINGAPORE: New York Times reporter Shaila Dewan has written that soaring housing prices are a worldwide problem. "The developed world's wealthiest cities are facing housing crises so acute," she reported, "that not only low-income workers but also the middle and creative classes find them increasingly difficult places to afford. There was not a single home on the market in San Francisco that would be affordable on a teacher's salary and in many cities renting is even more expensive."

But, she noted, there is one city that has managed to surmount this problem – Singapore. There, "more than 80 percent of

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the [5.3 million] population lives in public housing designed with walkability, ethnic diversity and green space in mind."

Israel long ago abandoned public housing. Is it time to revive it?

NEW YORK: New Mayor Bill de Blasio, who succeeded the popular Michael Bloomberg, promised in his winning campaign to build 100,000 affordable apartments. Many will be high-rise.

Can high-density high-rise housing help solve the problem of soaring land prices? Technion Prof. Rachelle Alterman, an expert on urban planning, land use and law, thinks not. She told the daily Haaretz last year that she considers residential towers "terrible disasters" and, in 2009, published research ("Faulty Towers") on such towers' flaws, especially those designed for the middle-class market. But other experts disagree, including the American urban planner, Virginia Tech Prof. Peter Katz, who thinks high-density housing built around transit is a desirable solution.

LONDON: This city, like Israel, has seen a huge influx of foreign capital, much of it going into property. London has 72 sterling (pound) billionaires, more than any other city in the world. Their unlimited cash has driven property prices into the stratosphere.

Dewan reported that London will need 800,000 new housing units by 2021 to meet new and existing demand. In London, where he is currently on sabbatical leave, Frenkel tells me that entrepreneurs who launch new housing projects must allot, by law, one-fifth of all new units to affordable housing for low-income families. But, in practice, Frenkel says, this law is tough to enforce and no more than 10 percent of new units in London are "affordable." I'd be delighted if Tel Aviv could achieve even that 10 percent.

HONG KONG: Daily Telegraph reporter Harry Wilson gave us cause to worry about this amazing city's well-being. A record 54 million tourists came to Hong Kong last year, most from mainland China. Hong Kong's property prices have more than doubled since 2008 because of the city's ultra-low interest rates, tight supply and abundant credit from banks. But Wilson quoted Credit Suisse banker Victor Wang, based in Hong Kong, who notes that the "[Hong Kong] financial sector is several times the size of the economy," raising the specter of a crisis "that could be unleashed if China's credit bubbles were to burst."

"Hong Kong is in for a roller coaster ride," Wilson wrote. Could this be true of Israel, as well?

Hong Kong's property prices have been driven upward by an influx of money from mainland China – not unlike Israel, where capital inflows have gone partly into housing. Both the Chinese and Hong Kong governments have imposed tough regulations on these inflows.

SINCE 2006, ISRAEL'S PROPERTY PRICE INCREASE HAS BEEN THE HIGHEST OF ALL THE 34 OECD NATIONS

In 2012, Hong Kong's Financial Secretary John Tsang imposed a 15 percent added duty on non-permanent resident and corporate buyers of Hong Kong property. In other words, Hong Kong chooses to cool demand of foreigners rather than further heat up demand, as Lapid proposes.

Perhaps Israel too should limit property purchases of those who do not live here. The presence of many empty flats together with those who desperately need housing is a travesty. I spoke about this with Rafi Aharoni, an Israeli and prominent Hong Kong business leader. This is what he told me:

"When I arrived in Israel for Passover, I went to visit my daughter in Jerusalem. I learned that she was the only tenant in her building. The whole 10-15 story building is completely empty of tenants! Most or all of these tenants bought these apartments for investment only, not to live in.

"Because of the ridiculous price of apartments, the young generation simply cannot afford to buy a home. These are people born and raised here who sometimes give their lives for the State of Israel. In my opinion, every time there is a wave of anti-Semitism in the world, another 10,000 to 30,000 units will be sold in Israel and the price will go up again. In order to bring the price of property down, non-Israeli citizens should have to pay extra stamp duty, perhaps 20-30 percent."

In one sense, Israel's soaring property prices are like riding a tiger – there is no good way to get off. If prices continue to rise, it's bad; if they fall, it's bad, very bad. Each way, Israel loses.

Jesse Colombo, a contributor to Forbes magazine, predicted the 2008 global financial crisis and, today, warns of the consequences of falling property prices. "Here is what to expect when Israel's economic bubble truly bursts. The property bubble will pop, causing prices to fall. Banks will experience losses on their mortgage portfolios. The tech bubble will pop both in Israel and the US causing a wave of start-up failures (particularly app and social media start-ups). Technology and banking stock prices are likely to fall the hardest, which will drag the overall stock market lower. Economic growth will go into reverse. Unemployment will rise."

If Colombo is, heaven forbid, right, flattening the cost of flats by a VAT exemption may be futile and counterproductive, but perhaps that is a good thing. Bad policy may achieve good results because, if flat prices really did fall steeply, the resulting wave of selling could be truly disastrous.

Recently, the State Comptroller blasted the Netanyahu government for excessive unfunded travel, noting that trips by ministers rose 60 percent compared to the previous government, with many of those trips paid for by external sponsors. I'm very happy that ministers travel a lot. They should, as T.S. Eliot advises, "not cease from exploration." But when the ministers go abroad, do they truly seek to study how other countries struggle with the same tough problems facing Israel? Do they truly learn, and bring home in their suitcases creative new policy ideas, along with duty-free Jack Daniels? Do they return home to see Israel for the first time?

New data show that economic growth in the first quarter of 2014 slowed to only 2.1 percent (annual rate), as both consumer spending and business investment declined, and exports slumped due to the strong shekel. It may be that the slumping economy itself will cool housing prices rather than the VAT exemption.

We must hope and trust that when the cost of flats is flattened, our jobs, incomes, bank accounts, and pensions are not flattened too. ■

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