EUROPEAN HOUSINGREVIEW

FEBRUARY 2009

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INTRODUCTION

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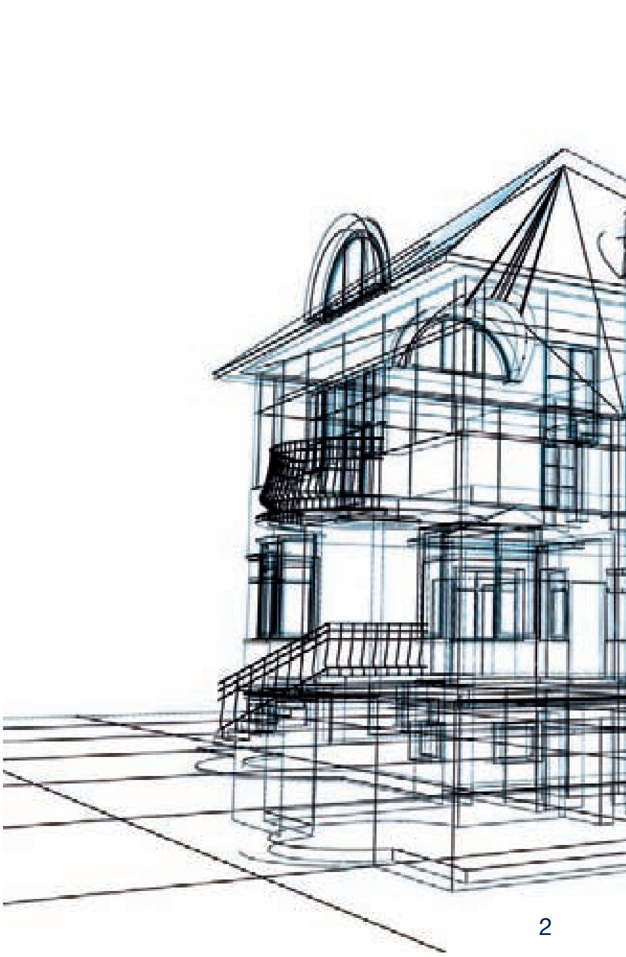

ABOUT THE AUTHOR

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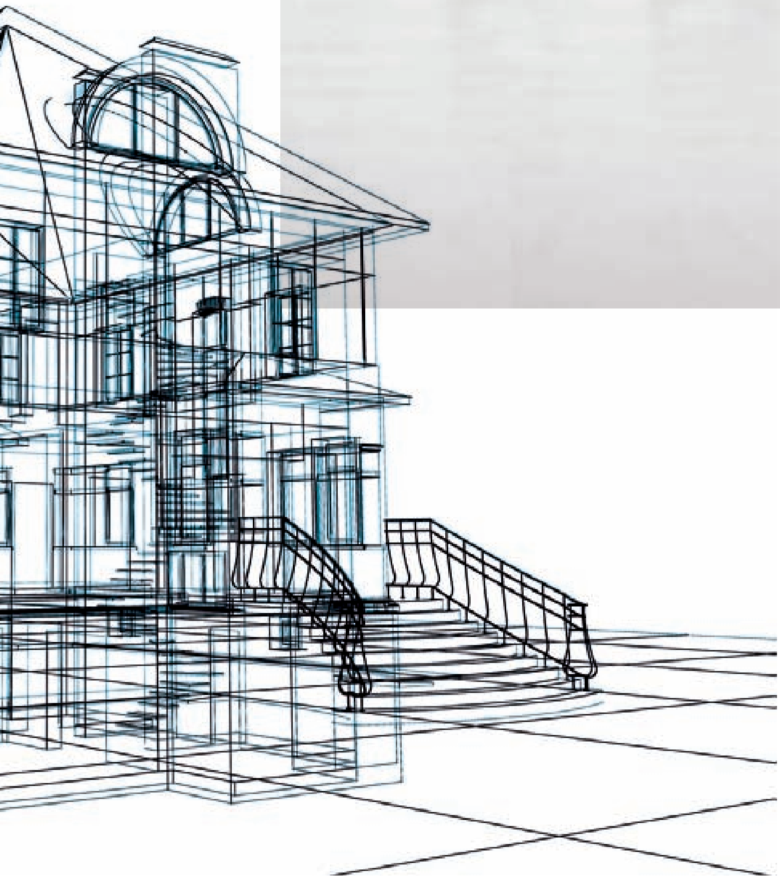

While every effort has been made to ensure that the data and other information in this report are accurate, some errors may remain. In addition, it should be remembered that information in this field is variable in content and quality. The purpose of the Review is to provide information, analysis and background to Europe's housing markets and housing provision systems. It is not intended for use directly either in market forecasting or for investment decision purposes. The full report is available at **www.rics.org/ehr.**

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PREFACE

Preface

Interest in EU housing markets has expanded considerably in recent years. This report provides information on housing in individual countries and comparative housing market analysis across the European Union.

This Review aims to

- Offer coverage of EU housing and mortgage finance systems
- Examine housing markets in a comparative pan-European way
- Give informed interpretations of data and events
- Create quick reference information on housing and related topics, such as the economy
- Provide an understanding of the current state of EU housing markets
- Enable evaluation of the growth of homeownership in the EU
- Consider the role played by rental housing
- Comment on housing markets in the context of macroeconomic and demographic influences
- Outline important policy change

The format adopted is to provide a number of introductory comparative chapters, presenting an overview of recent developments and raising topical issues. They are followed by specific country reports on a chapter by chapter basis. These reports explain, where possible, the broad structure of a country's housing system, examine macroeconomic, financial, policy and other influences on housing demand and supply and evaluate current market conditions.

Given the expansion of the EU in 2007 to 27 member states, it is not feasible to provide individual chapters on all countries. Instead, after the initial pan-European analysis, 11 countries are examined in detail. The policy is to include all of the four largest economies, plus a variety of others from around the EU.

Emphasis is put on residential markets at the national level. Where of particular significance regional issues are considered, but it is beyond the scope of this study to undertake detailed regional and city analyses.

Housing markets are continually changing and there is a danger that information becomes out of date quickly. This report was completed in the last weeks of 2008 and, so, obviously cannot comment on or describe any events occurring later than that. Headline price data were updated in the second week of February 2009.

While effort has been made to ensure that the data and other information in this report are accurate, some errors may remain. In addition, it should be remembered that information in this field is variable in content and quality. The purpose of the Review is to provide information, analysis and background to Europe's housing markets and housing provision systems. It is not intended for use directly either in market forecasting or for investment decision purposes.

Secondary sources were predominantly used but many estimates and manipulations of data were undertaken by the author. For simplicity, however, only the sources of independent data used are cited in the Figures and Tables.

This is the eleventh year since the first Review was published. The author should like to express his gratitude for continued support of the Royal Institution of Chartered Surveyors over the years and, in particular, for the helpfulness of RICS Head of Research, Stephen Brown and RICS Chief Economist, Simon Rubinsohn.

Markets stagnate and decline

Gloom spread to all of Europe's housing markets in 2008. By year end prices were either stagnant or down. In fact, in real terms, prices were falling everywhere by the end of the year, given that inflation had been quite high in several countries and averaged 1.6% for the EU as a whole by the end of 2008.

There were some substantial turnarounds from market experience in 2007. Scandinavia, central and eastern Europe and some parts of the Mediterranean, such as Cyprus, were still experiencing prices surges in 2007 but no longer in 2008, with the sharpest reversals in the Baltic States.

Not even the countries that previously did not experience house price booms are immune from the housing market squeeze. Most notably, prices in Austria and Germany are drifting down. The reason, of course, is that they are being buffeted by the same events as the markets in other countries.

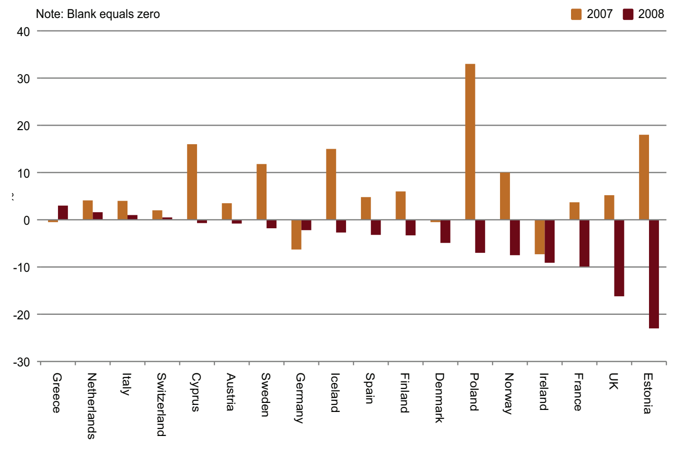
Geography seems to matter. The Nordic countries apart from Sweden, Spain, Ireland and the UK, and recent EU member states from central and eastern Europe seem to have had a particularly tough time in 2008. For most other countries, prices seem flat or falling slightly in real terms. This seems to offer the hope that they will miss out on severe downswings. It is hard to say but the signs in the closing months of the year were that progressively more European housing markets were seeing a slump in buyer interest and severely limited ability to raise finance for purchase.

The twin shocks of first commodity price booms that pushed up interest rates and dented economic growth, followed by a credit crunch of unprecedented scale in modern times has affected the whole of Europe and its housing markets. The prospects for 2009 are of a further weakening of housing markets, price falls may accelerate in quite a few countries and become more apparent throughout the whole of Europe in 2009.

The decline in housing markets is being further influenced by the scale of the economic recession in Europe. The IMF forecast in January 2009 that the euro areas' economy would decline by 2% and the UK's by 2.8% during 2009, though hopefully with a levelling off in 2010. Such gloom may well be amplified in housing markets, which look set for a prolonged downswing at least as great as that of the early 1990s.

The recovery may also be a slow one because of the core importance of long-term finance for healthy housing market activity. The financial system has been battered because of mortgage finance, and the riskiness of holding mortgage debt for investors and lenders rises as house prices fall. Such feedback effects between housing markets and financial systems suggest that restoring confidence in housing finance systems is going to take a long time.

Figure 1: House prices in Europe



Note: Blank equals zero

House price data are of variable quality, coverage and timeliness.

Sources: National Statistics Offices; Central Banks; Housing Ministries; FNAIM, France; Hypoport, Germany; ESRI-Permanent tsb, Ireland; Scenari Immobiliari, Italy; BPE, Estonia; BuySell, Cyprus; REAS, Poland. Denmark and Greece to 2q only; Austria and Sweden to 3q.

CHAPTER 1: HOUSING MARKET DEVELOPMENTS IN EUROPE

Watch that price!

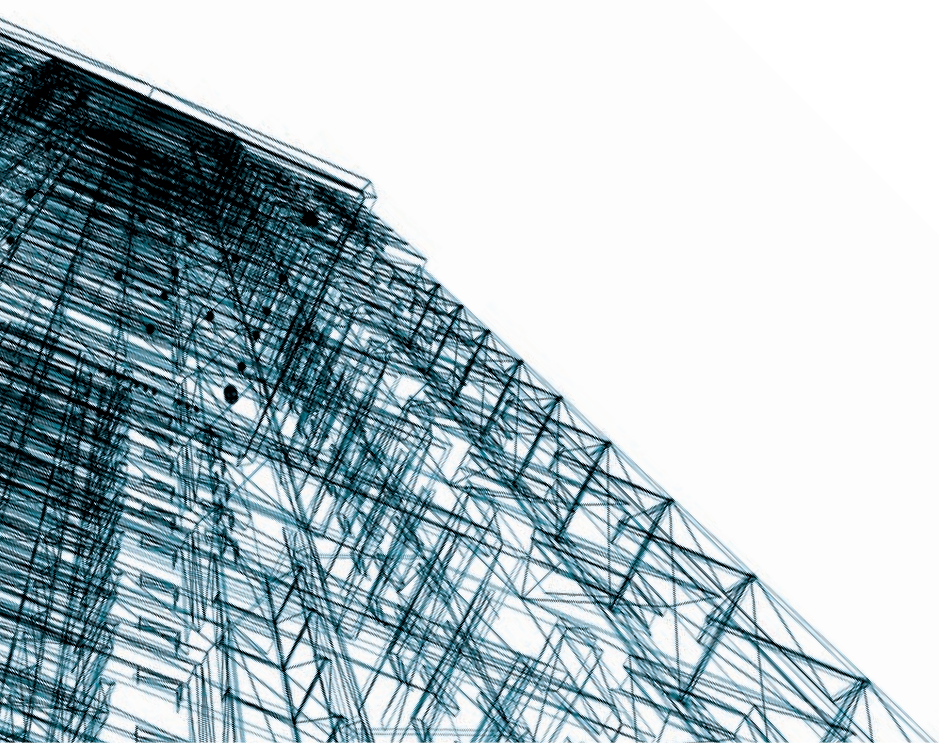
The main difference in posted price information across Europe is that there were clear groups of countries already going through a cycle of substantial prices falls in 2008, whereas others were not. However, there are difficulties in interpreting the information for data reasons as well as because of factors relating to distinct housing market dynamics between countries themselves.

The first issue relates to the time at which price data are published. In past years, the author of this review has made year end forecasts for each country to enable cross-country consistency. These forecasts could be made with reasonable confidence as they were only for a few months and so were generally accurate representations of actual price changes. The tumultuous events of 2008 have made such an exercise more prone to forecasting errors and, so, it has not been done this year. Price dynamics were changing so rapidly during the last quarter of 2008, driven by the heightened impact of the credit crunch and its consequences for mortgage availability and consumer price expectations. A consequence is that such differences in dates was far more important than it would normally have been, especially as the winter months are usually quiet ones in housing markets.

This means that the reported data in Figure 1 may relate to different times within 2008. For a handful of countries the data are actually end of year ones but several are third quarter information and others for one of the last three months of the year. The least timely data are for Denmark, Greece and Belgium. Consequently, prices in some of the late reporting countries were most likely to be lower at the end of the year than is shown.

With regard to the content of house price data, there is no standardised way of reporting house price information across Europe. So, it varies considerably in terms of its representativeness, timeliness, market spread and accuracy. There may be nothing inherently wrong with the different price indices in terms of their own definitions – they are what they are - but they have to be interpreted carefully, as indicators of actual price changes in housing markets as a whole especially when making short-run cross-country comparisons of price change.

Many of the issues are known to data experts.
The exercise to produce reliable and consistent house price information across the EU apparently progresses but the day when last month's price information for each EU country can easily be downloaded from Eurostat still remains a distant prospect. In the meantime, it is important to be aware that some countries' indices in effect smooth price changes in relation to others and some exaggerate them. Quite what are the comparative effects depends on market dynamics and the stage of the house price cycle.



CHAPTER 1: HOUSING MARKET DEVELOPMENTS IN EUROPE

Another factor is that house price data are reported with different lags from the point of sale. When the buyer and seller agree on a price for a property, it can be several months or longer before the transaction enters a house price index estimate. Some European house price indices are based on asking prices, so in those indices prices have not been agreed. What is more in falling market final prices are likely to be lower than the ones that the seller is hoping for. Other indices are based on mortgage data at various stages of the mortgage negotiation process. Some derive data from the dynamics of the legal side of property exchange. Others are based on the time at which properties are recorded in a land registry. Even within each of these stages, the time at which the price is recorded and entered into a database can vary significantly between countries. For example, Spanish institutions appear to be particularly slow at recording prices, while the length of time to complete the property transaction fully is notably lengthy in England. The overall implication is that the prices recorded across countries at specific points in time are highlighting market conditions at different times.

Another feature relates to the mix of properties being recorded in prices indices and traded on markets. Some house price indices are not composite weighted ones of all market transactions but, instead, refer only to specific parts of the market. For instance, Scandinavian indices separate out particular house types and generally the dominant category of single family housing is reported. Yet, in these countries, apartment markets are currently faring worse than single family ones. The situation is similar in Germany where the values of terraced homes are often reported as the house 'price', excluding weaker apartment price changes.

Further complications are added because some indices relate to the prices of dwelling units, whereas others as per square metre. The sizes of properties can change over time and the unit indices do not necessarily pick this up, even when 'quality-adjusted'. Other indices may refer to solely new build apartment markets and to only particular cities rather than to countries as a whole. This is common for central and eastern European countries' price indices and makes their behaviour particularly volatile.

When markets turn down the builders of new homes frequently do not adjust asking prices for a long period of time on schemes they are currently building out. Instead, they are prepared to negotiate over price and offer non-price inducements to persuade buyers to buy. When new building is particularly important, recorded prices may lag true market developments. New building has been high in Ireland and Spain and, though both indices record agreed rather than asking prices, there is no knowing what extra elements were added to the product bundle as the market started to soften, so the extent of price changes is likely to be under-recorded.

The reported price indices for many central and eastern European countries may simply be the asking prices, such as with Poland. Actual market prices are likely to be less than those during a downturn because of improved quality offers and the fact that the negotiated price will typically be less than the asking one because of the strengthened bargaining power of buyers in such situations.

Finally, the best quality properties tend to be sold more quickly when sales are slow, while the worst languish until sellers accept reality and cut prices to realistic levels. Recorded prices as a result move slower than those struck in actual quality-adjusted deals.

This long list of the differences between house price measures suggests a couple of rules-of-thumb. First, if one country's house prices seem to be changing faster than another's check what is being measured. Second, when interpreting data on a comparative basis, the direction of change may be as important as its scale because of such data differences. Only with hindsight, when a better picture has been gathered over a longer time period, will a clearer understanding emerge of what cross-country differences actually were and, even then, the world of house prices indices remains at best one of approximations.

CHAPTER 2: SHORT – RUN DYNAMICS IN EUROPEAN HOUSING MARKETS

Introduction

European housing markets are in decline after a long period of boom in most of them. They are being subjected to an unprecedented series of events associated with turmoil in financial markets and rapid economic slowing, leading to recession and the prospect of a long period of recovery. The question arises of what will happen to housing markets during this period of crisis.

A common perception is that any country's housing dynamics can be plotted by recourse to past events in a fairly straightforward way. What goes up, must come down. So, the stronger the previous housing market boom, the greater the downward adjustment. This parable can be modified by reference to some understanding of what was happening to market fundamentals during the boom but the story is essentially the same. Price overshooting in a boom leads to 'correction' back to long-term equilibrium, with the risk of undershooting being greater than necessary price adjustments during the downswing.

On these arguments, it should be fairly straightforward to predict which countries will experience the greatest price falls. The ranking will essentially be correlated with the scale of the previous price rises. Such a ranked list of price rises during the boom is given for several European countries in Table 2.1.

Europe had some of the largest house price increases in the world. However, the scale of the rises varied – though this is partly due to differences in the ways in which prices are measured, as noted in Chapter 1. Not all countries shared in the boom, notably Germany, because its housing market cycle became different from much of the rest of Europe in the aftermath of reunification.

Appealing though the approach may be of predicting house price corrections by the scale of the previous upswing, there are other factors that have to be brought into consideration when examining short-term price adjustments. This is particularly the case because of the nature of the events stoking up current housing market problems. Most obviously, they are the scale of the current financial crisis and the extent of the economic downturn that has resulted in Europe. In addition, the timing of economic and housing market cycles is imperfect between countries – some tend to lead, while others lag. Supply side and other institutional factors matter as well. Finally, the policy stances of governments and central banks are important. Taken together these factors suggest that the current downturn in housing markets is going to be more pervasive across Europe than just concentrated in a minority of previous super-boom countries.

Table 2.1: The price consequences of the boom, changes in real house prices 1996-2006

Ireland	188
UK	118
Sweden	107
Spain	102
France	99
Denmark	96
Netherland	88
Finland	85
Germany	-14

Source: OECD

CHAPTER 2: SHORT – RUN DYNAMICS IN EUROPEAN HOUSING MARKETS

European housing markets are prone to volatility

Past events show that many European countries' housing markets have experienced significant slumps before. In fact, the record of major downturns where real prices fell by more than 15% has been worse for Europe than elsewhere.

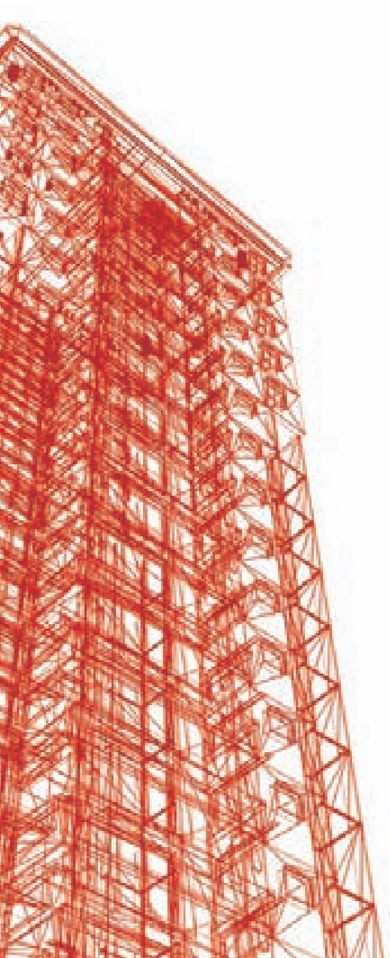
Some data on real house prices are shown for the years between 1970 and 2005 in Table 2.2 for 18 advanced economies. Two-thirds of the European countries surveyed there had two major crashes between 1970 and 2005, while Australia and the USA had none and others only one. Moreover, European countries had big price falls when they happened, with 9 of the 12 countries listed in Table 2.2 having real falls of more than a third in at least one downturn over the 35 year period.

These data suggest that Europe has been prone to sharp house price fluctuations in the past. This volatility took place in an era of economic instability, combined with high but varying rates of general price inflation. But current circumstances are the result of an equally great shock and the current credit crunch may well have even more dramatic consequences than those earlier events.

Table 2.2: Real house price falls 1970-2005

	Number	Max. % fall
Finland	2	50
Switzerland	2	41
Sweden	2	38
Denmark	2	37
Italy	2	35
UK	2	34
Spain	2	32
France	2	18
Netherlands	1	50
Norway	1	41
Ireland	1	27
Germany	1	15
Korea	**1**	**48**
New Zealand	**1**	**38**
Japan	**1**	**31**
Canada	**1**	**21**
Australia	**0**	**15**
USA	**0**	**14**

Source: OECD



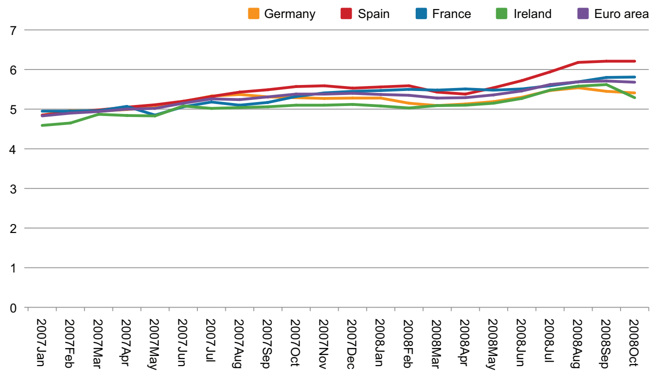
CHAPTER 2: SHORT – RUN DYNAMICS IN EUROPEAN HOUSING MARKETS

Mortgage interest rates

The recent house price boom was associated with falling interest rates and easing mortgage credit terms. But the interest rate cycle bottomed out in 2005 and had been rising again. The commodity price increases of 2006 and 2007 pushed up inflation and encouraged European central banks to continue raising interest rates even after the credit crunch had started. The European Central Bank (ECB) raised rates in June 2007, again in July 2008, and only began cutting them in October 2008. The Bank of England's rate peaked in July 2007, but it did not really begin to cut interest rates aggressively until October 2008. Other European central banks also maintained anti-inflation policies until late in 2008.

The outcome for mortgage interest rates was that they were rising prior to the credit crunch and were already slowing housing markets. The credit squeeze was then associated with continuing rises in interest rates until the final months of 2008 (Figure 2.1).

Figure 2.1: Average mortgage interest rates in Europe Jan 2007-Nov 2008



Source: ECB

Increases in mortgage rates during 2008 were not only related to monetary policy but also to capital market problems and to the growing spreads required by lenders. Spain in particular experienced a widening of spreads during 4q 2008. Consequently, Europe's housing markets were being depressed by rising mortgage costs throughout 2007 and 2008.

Inflation and reference interest rates are both forecast to fall substantially during 2009. However, it is unlikely that mortgage rates will decline by such large amounts. Because of the downturn housing markets are becoming more risky, so lenders will want to increase their margins. Moreover, there is far less competition for mortgage business.

Countries reliant on fixed interest mortgages will face the likelihood that many existing homeowners will face sharp increases in real mortgage payments as inflation falls. Many owner occupiers have taken out or refinanced their mortgages over the past few years at interest rates of five to six per cent in many European countries with traditions of mortgages with an initial interest rate fixation of five or more years. Furthermore, because of current credit shortages, they will face few opportunities to refinance at more attractive rates, even when they can do so without pre-payment penalties.

Another interest rate issue relates to the widespread use of foreign currency mortgages in certain European housing markets. During the earlier years of relatively low interest rates borrowing was done in currencies such as the euro and Swiss francs because financial liberalisation had made the option possible in third party countries. The practice was particularly prevalent in CEE countries, as the later chapters on Poland and Hungary show. But foreign currency lending was also attractive in second homes markets. For example, British buyers of holiday homes in France and Spain could take advantage of cheaper euro than sterling-denominated mortgages. As the euro strengthened during 2008, such borrowers have been strongly squeezed. Exchange rate volatility is likely to continue, creating uncertainty as well as potential hardship and default amongst those with such foreign currency denominated loans.

The build up of mortgage debt

Indebtedness increased substantially during the housing boom across Europe. As economies and housing markets falter, the burden and risks associated with that debt become ever more apparent. What is more, unsecure consumer lending rose alongside mortgage debt secured on residential property in many countries.

Meaningful comparative inferences about the relative scale of indebtedness are complicated because statistical definitions and practices vary across individual countries as well as being due to variations arising through real differences in long-term debt holding characteristics. For example, Switzerland has a very high mortgage debt to GDP ratio but is rarely regarded as a country at threat from such a characteristic and it has one of the lowest homeownership ratios in the world.

Even so, the scale of relative differences in debt holdings across Europe is substantial, as can be seen from the ratio of mortgage debt to GDP shown in the second column of Table 2.3. Yet other features are pertinent when examining the scale of mortgage debt. Mortgage indebtedness tends to be greater in owner occupation than in rental housing. This is because more own equity tends to be used by investors to purchase rental property and because most rental investments are long-term holdings where much of the initial debt would have already been paid off. Even in the UK, after its buy-to-let investment boom, the debt-to-value ratio in the private rented sector was only around 25%. In addition, within homeownership significant numbers own their homes outright. So, high levels of indebtedness are concentrated amongst a relatively small group of households.

It is also instructive to compare mortgage-to-GDP ratios at the peak of the previous boom in 1990 with those in 2006 near the peak of the last one. In most European countries, the ratio is higher this time round but in some the increase is particularly dramatic, namely the Netherlands, Ireland, Spain, Denmark and the UK. Denmark and the Netherlands have the highest mortgage debt-to-GDP ratios and relatively small shares of owner occupation at the same time.

Table 2.3: Mortgage debt levels, growth and the relative importance of owner occupation

Rank	Mortgage debt as % GDP 2006	% share of owner occupation	Rank	Mortgage debt as % GDP: 2006 minus 1990 shares
Denmark	101	55	Netherlands	62
Netherlands	98	56	Ireland	52
UK	83	69	Spain	44
Ireland	70	79	Denmark	44
Spain	58	82	UK	30
Sweden	55	55	Belgium	17
Norway	52	80	Germany	16
Germany	51	43	France	14
Finland	44	63	Italy	13
Belgium	36	68	Finland	12
France	32	57	Sweden	4
Austria	24	51	Norway	3
Italy	19	73	Austria	n/a
USA	**76**	**70**	**USA**	**32**

Source: IMF, national statistics agencies

The consequences of the credit crunch

The credit crunch led to the freezing up of access to capital markets for providers of mortgages. They also faced more expensive interbank lending and periodic restrictions in its availability. These difficulties have been compounded by the loss, or rescue, of some previously major players in mortgage markets: most notably in Britain but also in the Benelux countries, Germany and to a lesser degree elsewhere. Others have been reluctant so far to expand their lending in order to replace those lost, or much reduced, market shares.

The infusion of capital by governments into their respective financial institutions during 2008 minimised the risk of a major financial collapse but further encouraged banks to limit lending in order to get back on an independent and less penal footing as quickly as possible. From October 2008, interest rates have been falling rapidly but, so far, they have been unsuccessful in reviving mortgage markets or economic activity and may not do so for some time to come.

The sudden shrinkage in mortgage lending has been without precedent. Unsurprisingly, lenders with limited funds have prioritised the most profitable parts of the market. In the circumstances of enhanced risks of default, often in a context of substantial house price falls, or at least their prospect, they are those borrowers with the least chance of defaulting. Those in categories deemed to have greater default risk are being charged higher interest rates or, more typically, denied credit altogether.

While it may be the case that risk was mispriced during the earlier credit boom, it is not clear whether the current developments simply reflect the return to better pricing or a flight to safety in which many potential borrowers are squeezed out altogether until markets settle down again. As this is happening all around Europe, every housing market is being affected to some degree by a sudden contraction of demand. However, some markets have been hit more than others, as the country specific chapters in this report show.

Access to capital markets has been an important conduit for mortgage funding in many countries in recent years. But the ability to raise new funds or to refinance existing loans has been greatly restricted since 2007, either for the residential mortgage-backed securities (RMBS) or for covered bonds. Overall, five European countries had particularly significant recourse to capital markets. Ranked in terms of the value of their outstanding debt, they are Spain, the UK, Denmark, Germany and the Netherlands (Table 2.4). Other countries also have important indirect linkages which end up funding house purchases through debt issuance by financial institutions and government.

For some countries, the RMBS market ended up providing within the space of a relatively few years substantial proportions of mortgage funding. The UK relied on RMBS for 40% of funding in 2007 and for the Netherlands the proportion was 25%. Mortgage lenders in the UK were by far the most active issuers of RMBS this side of the Atlantic. Amazingly, given the relative size of its housing market, UK lenders were responsible for over half of the total European issuance of RMBS. The rest was concentrated in a handful of other countries as well: notably Spain, the Netherlands and Italy (Table 2.4). Spain has also been a major user of more traditional covered bonds, where lenders have more guarantees from issuers than with RMBS. In covered bonds, Spain was the second-ranked country in outstanding volume to Denmark, followed by Germany and the Netherlands. By contrast, the UK share had been small, though growing.

The fortunes of mortgage lending in European countries with heavy reliance on capital markets have varied since the onset of the credit crunch. The Danish mortgage system has managed to function reasonably well, according to the chairman of the Association of Danish Mortgage Banks, with lending levels in 2008 on a par with previous years[1]. (However, this has not stopped an accelerating decline in Danish house prices, which are expected to fall by at least 20% during the downturn.)

By contrast, the virtual closure of the RMBS market was the prime cause of the collapse of so many UK mortgage lenders in 2007 and 2008. Of the top 10 UK mortgage lenders in 2007, which between them then had 78% of the market, the ones that were most exposed to the RMBS market failed to survive beyond the autumn of 2008. Lenders with a total market share of 36% in 2007 were subsequently either nationalised or forced into takeovers. Mortgage issuance dropped dramatically in the wake of such problems.

[1] *'Danish mortgage lending has withstood the financial crisis', Peter Engberg Jensen, chairman for the Association of Danish Mortgage Banks and Group Chief Executive, Nykredit Realkredit A/S, 11/20/2008.*

Table 2.4: Residential mortgages and capital markets: outstanding balances

€ billion, outstanding amounts 2008 q3

	RMBS	Covered Bonds	Totals	% share of total
Austria	2.3	4.1	6.4	**0.4**
Denmark	0.3	335.8	336.1	**21.5**
France	14.2	63.6	77.8	**5.0**
Germany	5.2	206.5	211.7	**13.5**
Ireland	14.5	13.6	28.1	**1.8**
Italy	47.8	0	47.8	**3.1**
Netherlands	104.7	15.7	120.4	**7.7**
Spain	108.6	267	375.6	**24.0**
UK	280	82	362	**23.1**
TOTAL	**577.6**	**988.3**	**1565.9**	**100.0**

RMBS = Residential mortgage back securities

Source: Adapted from Crosby, Mortgage finance, Final Report and Recommendations, HM Treasury, London, 2008

In the euro area, experience in most countries was more like that of Denmark with mortgage finance holding up for most of 2008 and even expanding significantly in recent member countries, such as Cyprus and Slovenia (Figure 2.2). An important reason for the difference is that the ECB had been prepared to take mortgage-backed securities since the beginning of the credit crunch as collateral in liquidity operations with only a small penalty cost. In contrast, the Bank of England only reluctantly accepted such debt from October 2008 and at higher cost. The result is that almost all of the hundreds of billions of mortgage securitisations in the euro area in 2008 ended up being held by the central bank[2]. German banks were the largest users of ECB facilities and banks in other member states have been active users as well: such as the Netherlands, Spain and Ireland. Belgium experienced the greatest fall in mortgage availability and, like the UK, had to have a mortgage provider rescued: the country's previously largest bank, Fortis Bank.

Mortgage debt continued to expand rapidly for most of 2008 in the majority of CEE countries. Much of it still utilised foreign-currency loans, despite mounting exchange rate risks. However, the renewed intensity of the financial crisis in autumn 2008 severely curtailed additional lending and increased exchange rate volatility.

With regard to 2009, the difficulties of mortgage markets are likely to remain and the uncertainties are great. As a result, prospects will continue to be influenced by the nature and degree of market interventions by the financial authorities.

The economic slowdown

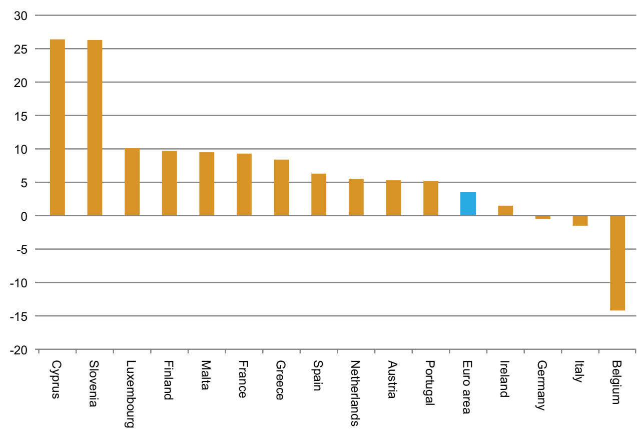
By the end of 2008 much of Europe was in recession, with forecasts for economic growth revised downwards. The resurgence of the euro further hit export markets compounding losses from reduced housebuilding and elsewhere.

The impact of the economy on the housing market is obviously substantial. It affects income growth, unemployment prospects and consumer expectations. As recession has hit so much of Europe severely and almost simultaneously, the downward spiral of housing markets slowing economies and faltering economies further slowing housing markets has been pervasive.

Typically, regional and national economies have timing differences over precisely when they enter and leave recession. This effect is likely to resurface in the next upswing, so that various parts of Europe will revive quicker than others and their housing markets with them.

[2] *Crosby Report, ibid.*

Figure 2.2: Outstanding loands for house purchase, euro countries, October 2008



Source: ECB

Supply-side issues

Supply responses during the boom years varied considerably across Europe (Table 2.5). Such variations in supply not only influence how prices react during upswings but also the trajectory of housing markets in subsequent downturns.

When supply is unresponsive to changes in price, much of any variation in demand is going to be borne by changes in prices. This means that countries and regions within them that have lower supply elasticities can expect greater variations in prices over the cycle and the principle is symmetrical, with prices falling more in downswings as well as rising more in upturns. Two countries were identified in last year's European Housing Review as having especially poor supply responses: the UK and the Netherlands. Consequently they are currently vulnerable to this supply side effect. Higher than average economic growth city regions also tend to have low supply elasticities even when the European country in which they are situated as a whole has better supply responsiveness. As result, some of the housing markets in the major growth regions of Europe may experience similar inelastic supply effects. CEE housing markets also exhibit the same characteristic.

Price responsive supply sides, though obviously preferable over the long-term, can also generate adjustment problems during downturns. In this case, the issue is supply overhang. If builders fail to forecast the coming slowdown, they will overbuild, leading to a glut of unsold properties which will encourage prices to undershoot long-term values significantly. If the reduction in demand is large and persistent enough, it may be the case that even properties built and occupied in recent years will experience significant vacancies and hard-to-sell periods. Many German cities have experienced this phenomenon in recent years. Spain and Ireland's building booms are leading to similar excess supply in them, even though building rates are currently being curtailed. The major cities in CEE currently face the same type of problem. In their case, a surge of new supply emerged just as demand evaporated.

Another European wide issue has been the construction of large numbers of city-centre and inner city apartment blocks, often with the encouragement and subsidies of policy makers and planners keen to see urban regeneration and high density living. The consumer base for such highly-priced, relatively small properties of this type is generally limited, as it relies on affluent strata of young, childless people. Overbuilding was apparent before the onset of the credit crunch in many of these markets but they have been decimated since its onset because of investors, homeowners and mortgage providers' recognition that prices are likely to fall substantially in such districts. Copenhagen is experiencing a classic case and others are occurring in the regional city centres of the UK. However, the phenomenon is Europe wide.

Table 2.5: Comparative changes in housebuilding

Country*	% change in housebuilding 2001-2006	Dwellings per per 1000 inhabitants 2004
Spain	101	13
Sweden	94	3
Ireland	78	19
Denmark	78	5
France	37	6
UK	21	3
Finland	11	6
Netherlands	-1	4
Germany	-24	3

*Ranked from the highest to the lowest real housing price change

Source: National statistics offices

CHAPTER 3: EUROPEAN PRIVATE RENT CONTROLS – SOCIAL GOAL OR OWN GOAL?

Introduction

All across Europe, there are regulatory controls on rental property. They relate to rents, occupancy and quality. Some are fairly uncontroversial, such as conformity to fire regulations and contract enforcement. Yet they stretch well beyond such matters. In some countries, tenant occupancy rights are very strong. For example, it is extremely difficult to evict tenants, such as in Germany. In others, contracts are long-term and it can be obligatory for landlords to renew them if the tenant so desires, as in Italy. Elsewhere, minimum standards are set. The Irish have just banned accommodation that does not have its own self-contained toilet and washing facilities, so the traditional bedsit is on its way out. But, perhaps, most importantly in terms of the way in which the rental market operates is the existence of rent control, where the rent of a dwelling either set for everyone or for existing tenants and can only be changed according to strict rules.

The idea of rent control is to limit rent increases either permanently or for a period of time. The claim is that such practices are good because they benefit and protect tenants. The landlord may lose out because they cannot charge the highest price for their property, though some rent control policies aim specifically to be 'fair' to them.

Rent control under this benevolent view is a classic example of the softer type of capitalism that makes Europe a better place. But is this actually the case? The alternative is that rent control, even its softer forms, imposes real costs on many for the gain of the few. The real losers may be many who want to rent; all housing consumers; and society in general.

It is not possible here to go through all the types of rent control existing in Europe because there are so many of them, nor can all of the issues be covered. Further details can be found in country specific chapters. Instead, the aim is to illustrate some principles that suggest that Europe may be better off with less rent regulation.

The standard criticisms of rent control

Rent controls are unpopular in economic theory on the grounds that they:

- raise housing demand
- reduce new supply
- lower maintenance and other aspects of housing quality
- create adverse neighbourhood effects via the cumulative impact of rundown properties
- raise rents in non-controlled segments of the market
- lower tenant mobility
- allocate housing inefficiently amongst housing consumers
- encourage the growth of other housing tenures at the expense of renting.

The basic model from which such conclusions are derived is commonplace and found in most introductory economics textbooks and is supported by virtually all economists. It analyses a situation where a ceiling is put on rent levels per dwelling unit at a level below the market clearing amount.

When rent control is introduced, the lower decreed rent dissuades investors from supplying rental property, through cuts in new supply and via reductions in maintenance inputs and other landlord service influences on quality. In this context, it is worth noting the difference between housing units – physical dwellings – and the flow of services derived from dwellings, which are related to quality, space and other characteristics of housing. Rent control may fix the price of housing units but does not control the price of housing services, which adjust downwards per housing unit. Maintenance declines in quality may seem to be long-drawn out because built structures take time to deteriorate, especially if they are relatively new. However, US empirical studies suggest that the impact may be quite quick as reductions in painting and the quality of internal fixtures represent a substantial proportion of landlords' maintenance expenditures and there is a need for fairly continuous input of them.

The implication of less maintenance is that the capital value of the housing stock is slowly eaten up. Neighbourhoods take on a rundown look and more affluent households quit them, encouraging the emergence of problem localities.

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Housing shortages grow as the sum of two effects. When rent control is introduced, pre-existing demand is no longer met because of the ensuing supply cutbacks. At the same time, the new lower rents encourage additional demand. So, overall perceived housing shortages may grow significantly beyond what they were before the introduction of controls. If there are parts of the rental market that remain uncontrolled, the loss of supply in the controlled sector will also lead to increased demand there, raising rents.

Tenants in below market price housing are less mobile, because if they move they are unlikely to find another rent controlled property because of prevailing shortages of them and will be reluctant to pay higher housing costs and, so, are locked into their current tenancy. Moreover, the benefit they derive as a sitting tenant has only to match the controlled rent level rather than the market rent clearing level.

Associated with the lack of tenant mobility are the distributional implications of rent control. Overall, the loss of housing supply resulting from the imposition of rent control leads to a global social loss and also a redistribution of the remaining benefits between landlords and tenants and between existing and potential consumers of specific rental dwellings.

Moreover, it cannot be assumed that the remaining controlled tenancies are allocated to those people with the highest willingness to pay for them. Instead, given the security of tenure stipulations that are generally associated with rent control measures, sitting tenants are the prime beneficiaries. Their willingness-to-pay need not be the highest and is even less likely to be so over time. Instead, more-recently formed households and others that are willing to pay more than existing households are likely to grow in number but they cannot gain access to the homes they would like. Nor can existing tenants trade amongst themselves to maximise their collective benefit from the controlled housing stock.

The lower cost of their properties additionally encourages existing tenants to consume more housing than they would otherwise have done and, therefore, be more reluctant to move than they would have been before (say, when children leave home). Consequently, misallocation amongst households of the controlled housing stock removes a significant share of potential consumers' benefits and may easily reduce them below the original free market level.

These distributional points are important, because it is often believed that rent control redistributes 'unreasonable profits' away from landlords to the benefit of tenants. But landlords do not have to be landlords and will only be in the sector as long as they earn a return. If the returns to landlords rise above those on equivalent investments elsewhere more landlords will invest. If they fall, landlords will quit the sector, which is why the supply of housing falls with rent control. Locking controlled dwellings in the rental sector by imposing security of tenure controls means that landlords face a one-off loss in the capital value of their property, which will now be worth more in another use, say, by being sold to owner occupiers. Again, over time the sector will shrink.

A better way to look at the situation than to see it in terms of a division between landlords and tenants is to recognise that the role of the price mechanism in competitive markets is to allocate resources to their best uses. Under rent control, the reduced supply of housing and the inability to allocate the remaining amount to those most willing to pay the most for it means that in reality the redistribution arising from rent control is predominantly between households. There is also no reason to expect that those tenants that benefit actually have characteristics that would normally be candidates for redistribution policies. Many of those that have gained from rent control in New York and Los Angeles, in Paris, Stockholm and Copenhagen, for example, have been shown to be relatively well-off.

What happens to the housing demand that is no longer satisfied by the rental housing now under rent control? One possibility has already been noted: it shifts to uncontrolled rental sectors, raising rents and lowering housing standards there, because property is more expensive. But it also spills over into other housing tenures. More people may move into owner occupation than would otherwise have done so. For example, young people may have to bear the burden of down payments and mortgage debt at an earlier stage in their lives that they would have wished.

The ramifications of restricting the size of the private rented sector on the overall nature of housing provision and public expenditure can be large. In many developing countries, rent control has encouraged the growth of informal housing and squatter settlements; through an inability to invest profitably in formal rental housing. Where government can afford to subsidise housing, pressures for governments to alleviate housing shortages also tend to grow. In Europe, it is no surprise that the expansion of social housing, as subsidised housing provided by government and non-profits, occurred in a number of European countries at times when strict rent control existed in the private rented sector, because that led to a collapse of good quality private supply.

Weaker forms of rent control

The standard model of rent control above fixed rents for everyone at a below market level and then examined what the implications would be. There is another type of rent control, which is very common in Europe, whereby when a tenant moves into a dwelling the rent is freely negotiated between the landlord and the tenant i.e. it is fixed at the prevailing market level. However, after that rent increases for sitting tenants are limited by some prescribed formula and tenants have security of tenure. The formula used is typically linked to the general rate of inflation, which means that the real level of rents is fixed no matter by how much market rents rise. The security of tenure stipulations for sitting tenants vary between countries but can last from a few years upwards to the life of the tenant, or a tenancy may even be able to be passed onto relatives.

The scale of the effects of this type of rent control depends on the difference between sitting tenants' rent levels and prevailing market rents. If they are small, the effects will be limited. In situations where rents and property prices are rising fast, the impact is substantial. Local areas may become more popular, or demand in the market as a whole may rise. Without rent control, rents for everyone would rise as demand grows. With it, the demand surge does not generate consequent rises in rents for existing tenants. This is a quite a strong form of rent control in such situations, as it segments existing tenants away from general demand and supply pressures. The outcomes then begin to approximate those analysed earlier: less availability of rental property and gains to existing tenants at the expense of potential new ones.

A justification for this type of rent control is that the landlord is given a 'fair return', while the tenant is sheltered from future real rent uncertainty by effectively banning increases not related to direct service provision i.e. direct landlord costs, including dwelling improvements. This type of rent control has many admirers and is the most common type in Europe. However, there are clear distributional implications, which tend to be ignored by proponents. In particular, the additional demand that causes the potential rise in rents relates to the housing demand of those not already sitting tenants. They completely lose out from the policy because they can no longer effectively bid for accommodation, which the legislation 'reserves' for incumbents. Moreover, ignored are the opportunity costs of landlords, which may induce them to supply lower amounts of housing than they would have done in a free market context.

Another outcome under this type of rent control is a particular pattern of rent adjustment. With perfect foresight about the time a tenant is going to stay and perfect forecasts of future rents, landlords would ask for and new tenants would accept rents that match the discounted flow of rent in a free market over the time of the tenancy minus the permitted increases in rents during the tenancy. When rents in general are rising, initial asking rents would be higher than market rents in a free sector because the rent control measure means that landlords will front-load rents. In a competitive market, landlords will not earn excess returns through this strategy, because average landlord net returns are influenced by the flow of investment into the rental sector, which will continue until it equals the risk-weighted prevailing return on all investments.

Apart from the altered pattern of rent payments, the overall effect of such rent control legislation in the perfect foresight context on housebuilding, trend rent levels and maintenance standards is limited. This is primarily because landlords have set rents that incorporate all potential tenant rent reduction gains occurring during the course of the controlled tenancy. But, at the same time, the point of having the legislation itself is considerably diminished as well.

In the more general situation of uncertainty, the impact is less clear than in the world of perfect foresight. Obviously, because they live in the real world, tenants only demand rent control legislation in situations of uncertainty rather than perfect foresight. But the principle that landlords will try and compensate themselves for any potential loss of return by front-loading the rents agreed with new tenants still prevails. For example, research has found that tenants living in such rent control properties in New York initially paid higher rents than those in the free market sector but tended to stay longer and enjoy increasingly lower than market rents as the lengths of their tenancies increased.

The more landlords bear the costs of uncertainty over future real rent increases and inflation and the less they know about the length of time a tenant is going to stay, the higher initial rents are likely to be set in order to compensate them for any potential loss of return. As a corollary, less housing will also be supplied on the rental market.

Landlords also have incentives to prefer tenants that stay a shorter period of time, because then they are no longer locked in inflation only upwards adjustments. They will consequently tend to discriminate against households with a higher probability of staying for a long time. Typically, younger, childless households are likely to stay for a shorter time; while other types of household may find it particularly difficult to find new accommodation because of landlord fears that they will stay for a long time. This fear will also become self-justifying if all landlords behave in the same way because such tenants will move less frequently.

However, landlords do get benefits from some long-term tenants, so there is degree of trade-off in terms of ideal strategies for them. Good tenants pay their rent, get on with neighbours and keep properties in good condition and thereby lower landlord costs and risks.

Long staying tenants may also find themselves in a situation common in more traditional forms of rent control, with declining quality for the same nominal rent because landlords cut back on maintenance. This situation, for example, was found in a study of Los Angeles. When apartments become vacant under second generation rent control, landlords have an incentive to undertake maintenance to ensure that they obtain the best rent from a new tenant but they have the opposite incentive of neglecting maintenance during a tenancy. Therefore, tenants may gain most from rent stabilisation in the early years of a rental contract when the cash benefits from rent stabilisation outweigh the loss of quality through maintenance cutbacks.

Rent policies in Europe

This section briefly illustrates existing private sector rent control programmes in Europe. Some countries have a multiplicity of regulations, so only the main ones are considered. The aim of this section is not to be comprehensive but rather to illustrate the types of programme that exist.

1. **Denmark:** A cost-based system with a low value put on properties so that rents are considerably below market levels, especially in more expensive areas.

2. **Sweden:** The system of rent setting requires that there are local negotiations between tenant organisations and private landlord organisations. Rent levels have to be comparable with those in social housing and private tenants can appeal to a rent tribunal if they are not. As social rents bear little relation to market rents, private ones do not either.

3. **Netherlands:** The government sets annually what rent rises are permitted, currently related to annual general price inflation. Rental units are assigned a quality rating per square metre and the rent is fixed according to that. This procedure applies equally across both social and privately rented housing, apart from a small ‘luxury’ sector where rent setting is free of restrictions.

4. **France:** Rents may be freely agreed in leases for new and renovated dwellings and then subsequent rent increases are linked to an official reference index, known by the acronym IRL - Indice de Référence des Loyers.

5. **Germany:** Rents are freely negotiated at the time when households rent dwellings. After that, controls apply and rises are linked to inflation or to rent levels in comparable dwellings with rents fixed in a stipulated period of earlier years – typically four. Therefore, rents alter by an amount determined by the sheer weight of existing tenancies rather than by the relatively smaller number of current market transactions. Any permitted increase is also smoothed because adjustment can only be implemented up to a maximum of 20% extra on the rent for three years.

6. **Italy:** There is free negotiation of initial rents and after that rents can only be raised by 75% of the cost of living index annually. Landlords have to commit to four year contracts, with the possibility of the tenant exercising the right to another four years' renewal under the same terms. Security of tenure ceases after that date, although eviction procedures through Italian courts are lengthy and uncertain in outcome.
7. **Switzerland:** Initial rents are negotiated at market levels and then they rise by annual inflation or a similar reference index.

It can be seen that the main differences between the types of rent control in the various countries relate to whether initial rents are broadly market based or not; how they change over time; and whether new tenancies or only existing tenancies are affected. The Danish, Netherlands and Swedish systems lead to deep discounts against potential market rents for all renters.

In the other systems, the discount depends on the length of the tenancy and the permitted rent increase. Rents will be below market levels depending on the extent to which rent market rents would be rising. The greatest deviation for market rents will occur in countries where tenancies last for a long time and the rules permit only limited annual changes in rents. The effect will also be greater in regions and cities with a high demand for rental property than lower ones. Amsterdam, Stockholm, Denmark and Paris are more likely to be affected than most other parts of their respective countries, for example.

The relevance of supply

The impact of rent controls depends on the responsiveness of supply to any increase in housing demand. As housing takes a while to develop and build, a sudden increase in housing demand is likely to push up house prices and rents. Then, if supply is responsive to the change, additional building should come on stream and lower house prices and rents again. The greater the responsiveness of supply, the closer rents will fall to their old values. This gives one justification for rent controls. They stop the rents of existing households temporarily overshooting their long-term values.

However, if supply is unresponsive, rents will rise and remain higher than they would have done in a free market context because existing tenants will not face any rent increases and, so, will consume the amount of housing they would at the old rather than the new higher prices.

Cases of responsive and unresponsive supply can be seen around Europe. Rents have been falling slowly in many parts of Germany for a number of years. This suggests that supply has been highly responsive to demand changes. Rent controls in such contexts are not binding, because landlords have to cut rents to find new tenants. Similar situations can be found in many parts of Austria and Switzerland. Rent control becomes virtually irrelevant and may actually sustain rather than reduce rents.

Paris represents the opposite end of the spectrum. Supply responses have been poor there, so rents have been rising on a permanent basis. Yet, existing tenants are sheltered from the effect by the rent laws. Instead, the consequences of growing housing shortage are borne by new arrivals to the Paris housing market, who find rents high and accommodation difficult to find. The situation from a social perspective is exacerbated by the fact that many new arrivals are immigrants. Rent controls have therefore contributed to a major crisis of a lack of affordable housing. The same could be argued for major cities in Italy, Portugal and Spain.

Rent controls and mobility

It was argued above that rent controls diminish mobility amongst existing tenants, because if they move they lose the benefit of a below market rent. This then harms mobility in general because less rental property in high demand areas is put onto market. As pointed out earlier, a number of studies across the world have demonstrated this effect.

However, there is another outcome as well, related to the point made earlier that landlords are more likely to select as their tenants people that move within a short space of time to avoid incurring the drawbacks of having long-lasting tenants when legislation limits the rents of existing tenants. Young, highly mobile, people become the ideal tenant and, if the selection effect is substantial, cities where rental housing is high have elevated resident turnover and relatively narrow ranges of population.

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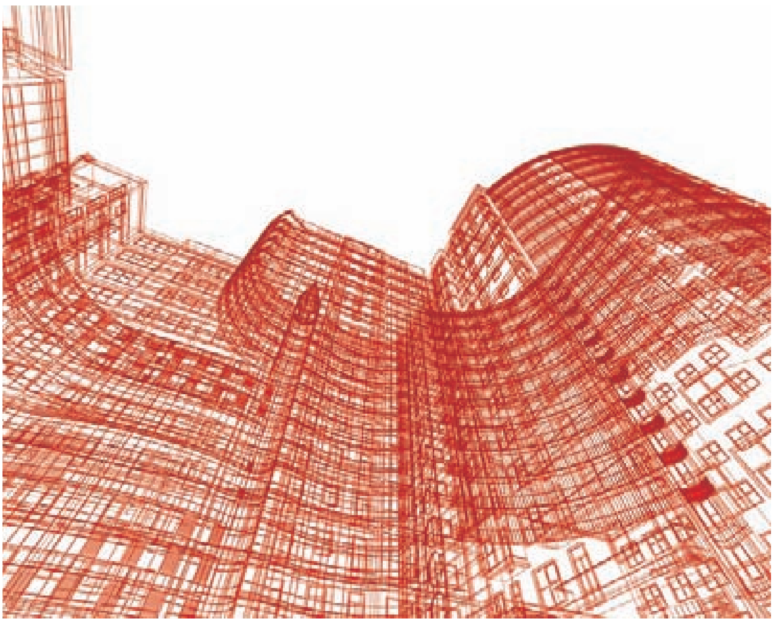
Therefore, overall there are two opposing tendencies within the private rented housing stock. Under existing tenant rent control, part of the rental stock houses long-term never-going-to-move tenants and another, growing part accommodates highly mobile people. It is hard to disentangle the effects of rent control from other social and economic influences on urban living patterns. However, it does seem to be the case that cities with high proportions of private renters and existing tenant rent controls in place do have high residence turnovers and large proportions of mobile, single person households, such as in Berlin and Munich, where around half of the population lives as singles.

Neither type of tenant behaviour is useful in the context of improving labour mobility, which is often argued to be a benefit of having a significant private rented sector.

A lack of empirical evidence

A number of statements have been made about the implications of rent control in this chapter. Much of the empirical evidence for them is based on evidence from the USA. When undertaking research on rent control policies, it soon becomes apparent that there is little empirical research for Europe. This seems surprising for such a major legislative programme spread across Europe, absorbing significant amounts of legislative and enforcement effort, with major implications for housing provision, local and national economies and social cohesion.

Within this context, the onus is surely on the supporters of rent control policies to justify the general economic and social benefits of those policies. Logic and international evidence is generally against them.



The politics of rent controls

A feature of rent control is that the winners from the policy can clearly identify with the causes of their gains – lower rents and security of tenure – and often they are geographically concentrated, which makes it easier for them to organise politically. Tenant organisations are effective lobbyists in many European countries at local, national and even European levels.

The rhetoric of social justice and helping the poor against greedy landlords can be effectively employed by those supporting restrictions to promote their case politically, even if it is generally a poor representation of reality.In New York, for example, a variety of studies have shown that lower income and minority groups fare badly in gaining access to housing under rent control.

By contrast, the losers from rent control, apart from the directly affected landlords, are households that experience higher housing costs and those that cannot find adequate accommodation. They are a dispersed group, individual members of which may not even comprehend the linkages between rent control and their own housing problems. It is consequently far easier to introduce rent control measures and they will generally be popular in the short run; whereas it is hard to reverse such programmes.

CHAPTER 4: RECENT MARKET PERFORMANCE: COUNTRY SUMMARIES

Summaries

This chapter provides brief summaries of contemporary housing market conditions in each of the eleven countries surveyed in detailed country chapters. It aims to provide a snapshot view for those who do not wish to read each chapter in detail.

Cyprus

The sustained housing boom seems to be over, according to recent turnover and price information. Property registrations between October 2007 and October 2008 were 24% down according to the Property Valuers Association. The Real Estate Agents Association also suggested that sales were 40% down in coastal areas because of a decline in foreign buyers.

The housing market had been experiencing buoyant conditions. When Cyprus joined the EU a few years ago, a boost was given to both the economy and the housing market, which was reinforced by accession to the euro area in 2008. The housing market was very active and prices rose rapidly, reaching 20% towards in 4q 2007. However, in 2008 the asking prices for houses levelled off.

Housebuilding levels have been high. In fact, the country seems in recent years to have the highest housebuilding rate per 1,000 population in the EU, with the housing stock expanding by 30% in the past decade.

Though a slowing in the market is evident, the extent to which the general global economic slowdown will affect the housing market in 2009 is hard to predict. The central bank is confident that the economy as a whole and the financial system will both weather the crisis. But much depends on overseas interest in homes on the island and both the UK and Russia have been badly hit by the economic crisis and have seen their currencies slump against the euro.

A period of housing market retrenchment may now occur. Housebuilding is still at high levels, despite the slowdown, and so is likely to fall further. The government offered assistance to the construction industry in a late 2008 €52m stimulus package but, all the same, job losses are likely to be high.

France

The long boom in French house prices ground to a halt in the summer of 2007 and 2008 saw significant falls, according to FNAIM. By 4q 2008, the price of existing homes was down 10% on the year. The official INSEE existing house price index based on notaries' transactions, which tends to lag the FNAIM asking price index by 3-6 months, indicated that prices peaked in the first three months of 2008, signalling the end of boom, after which they fell slightly during the next six months.

Transactions of existing homes fell by estimated 30% in 2008, according to FNAIM, and the number of houses on the market waiting to be sold grew substantially. Housebuilding was also in retreat, after a marked surge in the final years of the boom. Housing starts declined by 15% in the first 10 months of 2008. The prospect for 2009 is for further falls in prices and output as the economy slows and downward pressures on the housing market mount.

The credit crunch initially had only a limited impact. Mortgage loans even grew by a tenth on an annualised basis in 2008 up to October, according to central bank data. Even so, mortgage interest rates rose throughout most of 2008 and lending conditions markedly tightened. Then the intensification of the credit crunch in autumn 2008 brought the crisis to the fore during the closing months of the year and severely affected housing market dynamics: directly in terms of mortgage lending and indirectly via its negative impact on the real economy and the resultant reduction in housing demand.

The government tried in the second half of 2008 through a variety of initiatives to stimulate housing demand and limit repossessions. The aim is to expand bank lending following the October crisis period. Whether those and other stimulus measures will succeed in halting housing market decline during 2009 remains uncertain. Revival may have to wait until 2010 at the earliest. A supply overhang, paradoxically increased by earlier government measures to expand supply, may delay recovery.

Prior to 2007, the French housing market had been one of the booming areas of Europe, with significant price rises occurring for a decade. In fact, real house prices doubled between 1996 and 2006. However, the rate of price growth actually peaked way before the onset of the credit crunch in the summer of 2004, at 16% a year, and following that price inflation gradually subsided. Such a trajectory still gives some hope for a housing market soft landing in 2009. Yet that prospect diminished in the last months of 2008 as a severe lack of mortgage finance took over the fortunes of the housing market.

In a country where long-term fixed rate mortgages predominate, the housing market is only indirectly affected by ECB interest rate changes. Instead, developments in long-term interest rates are of greater importance. The restoration of normal conditions in capital markets as well as to inter-bank lending will consequently be necessary conditions for any noticeable revival in the housing market.

Germany

House prices fell by 2.2% in 2008, according to estimates based on the Hypoport German House Price Index for existing houses. New building permits also declined to some extent by about 2%; while mortgages rose by around 2%. So, the market showed signs of weakening after several years of being broadly static.

The credit crunch has not passed Germany by. Fears of bank runs in autumn 2008 forced the government to offer guarantees on bank deposits and financial sector bond issuers. Some institutions have also had to be rescued, such as the major mortgage lender Hypo Real Estate. Other banks had state injections of capital. Total state action amounted to €500bn. Inter-bank lending seized up and a committee of MPs overseeing the banking rescue reported in mid-December that the rescue had failed in its objective of freeing up credit availability again.

Though the German housing market may have missed out on the boom, that does not mean to say it is insulated from the bust, especially as the downswing is being driven by a common lack of credit and knock-on economic declines.

As elsewhere in the euro area, rising interest rates were increasing mortgage borrowing costs until late 2008. Interest costs were over a quarter higher in 3q 2007 than in 2005 and they continued to drift up through most of 2008 by roughly a further 50 basis points.

House prices and rents have been pretty much flat or gently rising and falling in nominal terms for over a decade now, while average prices in real terms have been falling. Given the state of the economy and relatively plentiful housing supply, except in a few city regions, the prognosis remains for only limited price change over the next few years. Previous experience and the current economic climate suggest that falling interest rates are unlikely to have much effect in stimulating housing demand in the near future.

A recent survey showed that the homeownership rate had dropped slightly from 43% in 2002 to 42% in 2006. Housebuilding rates are not expected to grow much over the next few years because of the relatively quiescent state of the housing market and comparatively poor demographics.

Hungary

Hungary has not had the rises in house prices experienced in some other central and eastern European countries in recent years. Prices did surge by 76% nationally between 1998 and 2001 and by even more in Budapest, with the greatest price growth concentrated in the new build market. But then price growth gradually petered out, with some revival between 2002 and 2004, as vote winning subsidies were withdrawn and fiscal austerity caused a sharp reduction in economic growth.

In fact, in real terms average house prices have been falling by around 4% a year over the past three years nationally, according to central bank sources – though there is no accurate house price measure. Transactions were also 10-15% down in 2008.

In nominal terms, the new build condominium market in Budapest, which is the sector that has been exhibiting the strongest price growth, recorded a 4% rise in 2008. However, given the country's relatively high inflation rate, such a rise meant a 1% fall took place in real terms. Existing house prices, for which transactions are greatest, saw no significant change in nominal prices at all.

The main causes of a subdued housing market in recent years have been the economic and public finance problems facing the country, which have limited consumers' spending power. However, housing supply was also growing relatively fast until 2007. This helped to moderate price pressure. During 2007 and most of 2008, housebuilding remained at relatively high levels. The existence of the credit shortages from autumn 2008 onwards is likely to result in sharply reduced building levels over the coming period.

Despite the country's general economic problems, the mortgage market boomed in 2006, 2007 and for much of 2008. This helped significantly to stimulate housing demand. More recent events since then indicate that mortgage borrowing is likely to be sharply curtailed in 2009. As in other parts of Europe, mortgage credit availability is likely to be the key driver of housing market activity in 2009 and beyond.

The intensification of the world financial crisis in autumn 2008 posed a considerable threat to the Hungarian financial system, but bank recapitalisation and assistance from the IMF and ECB steadied the situation. Nonetheless, lending to households has been drastically curtailed; with higher interest rates and tightening loan conditions. What is more, households have mainly been borrowing in foreign currencies. Although new loans of this type have virtually dried up, existing borrowers are now exposed to substantial exchange rate risks and the threat of higher repayment costs.

Anecdotal evidence suggests that the housing market has been nearly frozen since the autumn but it is hard to judge the overall impact because key events have been so recent, but the picture will become clearer as 2009 progresses. There is general optimism that, as there has been no recent price boom, the downward readjustment of prices will be slight. However, there are a number of uncertainties which may lead to more difficult times than that. Amongst the factors that may tip the housing market into deeper problems are the freezing of credit markets and the associated cessation in interbank lending; the scale of the foreign-exchange loan exposure of households; the size of recent household borrowing; and the potential depth of the current recession. Adverse developments in relation to any of them could lead to higher loan defaults and a worse housing market outcome in 2009 that is being hoped for.

Foreign currency loans rose to 60% of net household borrowing in 2008. This currently represents a significant exchange rate risk to households' finances and to the housing market in general.

Housebuilding peaked a number of years ago in 2004 during the then housing boom. Although it subsequently recovered somewhat, it was still almost 25% less than that peak in 2007 but building was maintained during 2008. However, the credit crunch is likely to affect the development industry badly and some firms may be forced to fold as a result.

A local property tax is being introduced in 2009. Its details are subject to local authority discretion, which means that its impact on the housing market is at present unclear.

Ireland

Year-on-year prices were down by 9% by December 2008, according to the ESRI/permanent tsb index. House prices had by then fallen by 15% from their early 2007 peak. The prospect for 2009 is for further price reductions as a major housing market correction continues.

Other indicators of market activity in 2008 also showed that the rate of decline is still substantial. Housebuilding was 53% down by year end from its peak in 2006. The number of mortgage loans had fallen by 48% in 3q 2008 from their level two years previously.

The change in price performance after 2007 marked a dramatic shift in market sentiment. The myth that house prices would never seriously fall in Ireland has been punctured. This could lead to a sea-change in attitudes that will probably affect purchaser and lender expectations for many years to come.

The collapse of the housing market helped to plunge the wider economy into deep recession, with GDP falling by almost 2% in 2008. This has led to a vicious cycle in which a declining economy further dampens the housing market that then lowers overall growth once more.

The EBS/DKM affordability index suggests that affordability will be back at early 2005 levels for first-time buyers by January 2009. Vacancies have also risen substantially in rental markets and rents have started to fall as well.

A severe overhang of housing supply is helping to precipitate further price decline. At the end of the boom, the country was producing a record level of housing output. It reached a remarkable 16% of GNP in 2006, whereas 3 to 4% is a more typical European figure. Unsold stocks remain high and output is likely to fall much further in 2009 as a result.

Irish households are now some of the most heavily indebted in the Europe. Mortgage lending reached 135% of personal disposable income in 2006. Consequently, there is a prospect of rising defaults and negative equity, especially amongst those that bought near the peak of the boom. However, defaults have been at extremely low levels, measured in the hundreds.

Continuing housing market decline is in prospect. It may be some years before sustained recovery occurs and, even then, price growth may remain feeble for far longer.

In the Budget Statement of October 2008, several measures were introduced in the hope that they would stimulate housing demand. However, the overall impact was modest with tax reductions in some areas offset by increases elsewhere.

Italy

Nationally prices in 2008 were flat – rising by only 1%, down from 5% in the previous year. Over the past decade, house prices have not risen by anything like those in many other EU countries: growing by about 40% in real terms between 1998 and 2007.

The number of sales dipped by 13% and, by then, they were 23% below the 2003 peak. Mortgage growth was negative in 2008 as well, after more than a decade of significant growth, suggesting that the credit crunch has been having an effect on the housing market. However, mortgages are far less important than they are in many other countries. Demand was also weakened by the fact that the economy had been in recession for much of 2008. Housing investment also fell, following several years of strong growth.

Housebuilding numbers tend to be difficult to forecast accurately because of the scale of building that takes place outside of the formal building control framework. This helps to keep housing supply relatively plentiful. Physical shortages seem to be greatest in the major cities of the centre and north.

One upside of the muted performance and limited use of mortgages in the housing market in recent years is that it is unlikely that the Italian housing market will experience substantial price falls, unless there is a dramatic economic collapse or severe problems in the financial system, neither of which seem likely at present. Instead, the prognosis is for further moderate declines in house prices and activity in 2009. However, given the state of the economy, the risks are clearly on the downside.

Netherlands

House price growth virtually ground to a halt in 2008 as the market continued to slow and there were tentative signs of falling prices in the last months of the year. According to Kadaster data, prices were up 1.6% in 4q 2008 on the previous year. Transactions data had shown more persistent weakness throughout the year, with a 13% fall in sales over the year to the third quarter.

As elsewhere, mounting economic gloom took its toll and optimism that the Netherlands housing market would avoid falling prices began to evaporate. The financial system was badly affected with the shock nationalisation in September of the Dutch part of Fortis Bank – which included Netherlands retail parts of the former ABN Amro Bank - and state injection of funds into other banks. These banks had been major mortgage lenders and mortgages have been far scarcer in the closing months of the year.

The troubles of the world economy have not spared the Netherlands. What is more, the country has one of the highest mortgage to GDP ratios in the world and a quarter of recent mortgage lending has been funded via special purpose vehicles, so that constriction of capital market lending will continue to have significant effects.

Housing supply remains extremely tight. Private housing completions were a quarter less in 2007 than they were in 1998 and the slowdown is reducing them further. A significant cause of price rises during the boom was an extremely tight supply side. This may easily translate into significant price falls during the downturn.

Poland

The marked boom in house prices that took place between 2005 and 2007 was well and truly over by late 2008. Residential markets languished for most of 2008 with subdued sales. Prices have been falling in all the major cities. By year end asking prices for new properties were down by 7%. In existing homes markets, the greatest falls have occurred amongst flats at poor locations and those built during the era of concrete panel technology.

By contrast, mortgage markets continued to expand for much of 2008 but after the intensification of the credit crunch in the last quarter the supply of mortgages shrank dramatically, precipitating a much greater slowing of the market than had been seen before. The likelihood of continued constraints on mortgage availability implies that prices will continue to slide in 2009.

The sheer scale of the mortgage boom of recent years, much of it at relatively high LTVs, poses significant risks for the housing market in the context of a slowing economy. Much mortgage borrowing has been in foreign currencies, which intensifies the risks especially as the national currency, along with those in other central and eastern European countries, has been on the slide, with investors withdrawing from previously buoyant equity and other investment markets.

An overhang of completed new properties has been growing and it could rise further as schemes continue to be finished. The supply of newly-completed flats for purchase in the six biggest cities grew by 56% in the first half of 2008 compared to the same period in 2007. This growth in properties for sale has arisen because of new completions and because investors have been putting up for sale properties they had earlier bought off-plan.

Supply has not been slowing in the face of a cooling market. In fact, completions in the market for sale were already 15% higher than for the whole of 2007 by the end of October, at over 52,000 dwellings. Output was slowing slightly in the final months of the year and is expected to fall significantly in 2009, as the housing market continues to decline and unsold stocks of new dwellings pile up. Projects already underway are difficult to stop, so output is likely to remain substantial until they are built out, unless they are abandoned. This means that even more stock will be coming onto the market for some time, adding further to excess supply. In the circumstances, the prospect of failures amongst developers is now high.

Spain

The housing market slowdown intensified during 2008, though recorded prices in the two official indices surprisingly showed only stagnation or moderate falls. The Housing Ministry information based on the property registry, which significantly lags market transactions, recorded a -3% year-on-year change in 4q 2008 and the new INE index based on data from notaries, shown a slight negative change in 2q 2008.

The country had one of the biggest housing market booms in Europe, so the expectation is for a more marked price correction, partly for domestic reasons but also because the second home market had been so strong and foreign buyers played such an important part in it. Now they are few and far between.

Property prices increased by 2.2 times in real terms between 1996 and 2006, housebuilding rates rose to record heights, and mortgage debt increased dramatically. Housing investment alone was 8% of GDP in 2006 and construction as a whole, much of it related to real estate, about 13% of GDP; while household debt reached 125% of personal disposable income in 2007 – three-quarters of it related to mortgages.

Non-price data were showing the extent of the market turnaround in 2008, which seemed to accelerate significantly from the third quarter onwards. Transactions were down by 30% year-on-year in 3q 2008. Housing starts were down by almost a half in June 2008 compared to the year before as developers dramatically cut back output. In contrast, completions were actually up by a third on the year because developments from the previous period of high output were still being built out. This continuing flow of new stock onto the market has been exacerbating an already significant supply overhang. What is more, Spain's housebuilding has been at extraordinarily high levels for a country of its size and even the mid-2008 level of starts was likely to be far higher than the market would absorb in the months to come. So, new supply will continue to put downward pressure on prices and further substantial falls in building are to be expected.

Spain was Europe's largest user of capital markets to fund mortgages. Around 30% of them utilised residential mortgage-back securities and the rest covered bonds. The impact of the credit crunch on mortgage availability has unsurprisingly been dramatic and mortgage lending had fallen almost 45% year-on-year by August 2008.

Worrying factors are the impact of the credit crunch on the availability of mortgages; the ability of the housebuilding industry to continue to cut back output in order to limit supply overhang; and the weakening of an economy that is contracting because of the scale of the reduction in housebuilding and the ending of a consumer boom.

The government has introduced some fiscal measures to revive the economy and offset the decline in the housing market but the scale of the downswing is such that any actions are only likely to moderate some effects rather than negate current housing market dynamics.

Second homes markets are obviously not only affected by developments in Spain but also by events in the originating country of purchasers. Many buyers in Spain have been from the UK, which is expected to have the worst recession amongst the major EU economies and, furthermore, sterling has slid substantially against the euro, significantly raising sterling-denominated Spanish house prices. Such factors further add to housing market woes in many parts of Spain, especially around the coast and on the islands.

Sweden

House prices have been growing much slower since the middle of 2007. In 3q 2008, they recorded a 4.7% annual rise, the fastest rise amongst the 17 countries surveyed here but the market was rapidly slowing in the last months of the year. The long Swedish house price boom finally seems to be over. Prices in some sectors and locations are already falling. For example, in the three months to October, 2008, the prices of flats fell by 6%. Other indices, such as that of Maklarstatistik, were also recording larger rates of price decline than were the official data. Properties on the market are experiencing a longer time before being sold, which is putting downward pressure on prices.

The boom had lasted from 1997 to 2007 with prices often rising annually by 10% or more, except in the aftermath of the early 2000s dot.com boom, which particularly affected the IT-oriented Swedish economy. Overall, real house price rose by 2.3 times over the period, which places Sweden in the top European league for price growth during the last boom.

Further evidence of a slowing market can be seen in 2008 monthly transaction data. Transactions were notably down compared to 2007 and prices even fell slightly in October, although the winter months are slow for housing markets. Housebuilding was also sharply down in 2008, especially since the summer with starts down by almost 60% on the previous year in 3q 2008. By contrast, mortgage growth in 2008 remained strong, up by 11% in value on the year to September, before facing greater problems from October.

Recent years of sustained borrowing now mean that Swedish households are relatively highly indebted, with a debt to disposable income ratio of around 150%. According to the central bank, that ratio has risen by almost 30% in past 4 years, mainly due to extra mortgage debt.

The previous housing market cycle in Sweden during the late 1980s and early 1990s saw a major price spike and a subsequent crash that forced the Swedish government to rescue its financial system. So, the country has already had relatively recent experience of events that are affecting many other countries today. In that last housing market downturn real house prices fell by 30% from their previous peak. The slump was blamed on earlier inappropriate macroeconomic policies and financial liberalisation and it is now widely argued that the lessons learned then should stop a repeat of such cataclysmic events. Yet, they highlight a potential for extreme housing market volatility – caused in part by the role that owner occupation has to play in a highly-regulated and renter-skewed housing system.

United Kingdom

After the longest and strongest house price boom on record, the housing market was badly hit by onset of the credit crunch in 2007 and the subsequent rapid turndown of the economy. The resultant cutback in mortgage finance rapidly sent the market into freefall. Mounting economic woes and expectations of substantial falls in house prices then helped to intensify the decline.

According to the Halifax house price index, by December 2008 house prices were 16% lower than a year earlier and back to the level they were three years before in summer 2005. The Land Registry price index suggested somewhat lower falls at 13.5% over the year up to October. Yet, whichever measure is used, prices clearly are falling rapidly.

Other housing market indicators highlighted a dramatic collapse in activity. Sales volumes were 64% down in August 2008 compared to the same month in the previous year, according to the Land Registry. The regular RICS housing market survey, a leading indicator, mapped the rapid decline. By November 2008, sales levels were at record lows, with only 10.6 completed sales per surveyor over the previous 3 months. Mortgage lending in November was less than half the level it was before the credit crunch started. Mortgage defaults began to rise, although from low levels, but there were fears that they would rise rapidly in 2009. The Council of Mortgage Lenders has forecast that mortgage arrears will more than double to 500,000 in 2009, with repossessions rising to 75,000 from 45,000 in 2008.

The new homes market was severely affected. Both the net balance of site visits and reservations were around 80% down by mid-summer 2008 on the previous year, according to the Home Builders Federation. Private housing starts in England in 3q 2008 were 55% down on the previous year.[1] Many sites have been mothballed, thousands of staff laid off and billions wiped off the value of housebuilders' shares.

The loss of mortgage supply was caused by the closure of the market for residential mortgage backed securities (RMBS), where UK banks had been the most active in Europe using them to finance 40% of mortgage lending, and by subsequent difficulties in inter-bank lending. The impact was most directly seen in the collapse of some major mortgage providers, their nationalisation or forced takeover by others. This was seen spectacularly in the announcement of the sale of HBOS - by far the country's largest mortgage lender with a fifth of the market prior to the credit crunch - to Lloyds TSB in September 2008 after the collapse of its share price and a threatened run on its deposits, almost exactly a year after the collapse of Northern Rock. Around the same time, the Bradford and Bingley was broken up between Santander and the state. Santander also took over Alliance and Leicester, while over the course of the previous year several specialist lenders had ceased to provide new mortgages.

Weakening housing market prospects made lenders cautious. Risk is being squeezed out of the mortgage market through high pricing or sheer unavailability. While it may be the case that risk was mispriced during the earlier credit boom, it is not clear whether the current developments simply reflect the return to better pricing or a flight to safety in which many potential borrowers are squeezed out altogether until markets settle down again.

The government announced a £500billion financial rescue plan early in October 2008 but this failed to halt the mortgage famine or to improve bank lending to either businesses or consumers. It was also by then considering guaranteeing mortgages as part of a package designed to restart the RMBS market. A substantial package of reflationary fiscal measures was announced in November, partly directly aimed at the housing market. Government and housebuilders also set up a joint scheme to provide interest free equity loans for first-time buyers of new housing.

In reality, it is hard to predict either prices or the length of the housing market slump, because so much depends on an increased availability of mortgage finance. The fear is that mortgage availability fails to revive for a long time. If that occurred, the downturn will be severe and prolonged. Much depends on how successful the authorities are in revitalising credit markets. The measures to date have had little expansionary effect, though undoubtedly they have avoided financial catastrophe.

[1] *CLG*

CHAPTER 5: CYPRUS

Overview

The sustained housing boom seems to be over, according to recent turnover and price information. Property registrations between October 2007 and October 2008 were 24% down according to the Property Valuers Association. The Real Estate Agents Association also suggested that sales were 40% down in coastal areas because of a decline in foreign buyers[1].

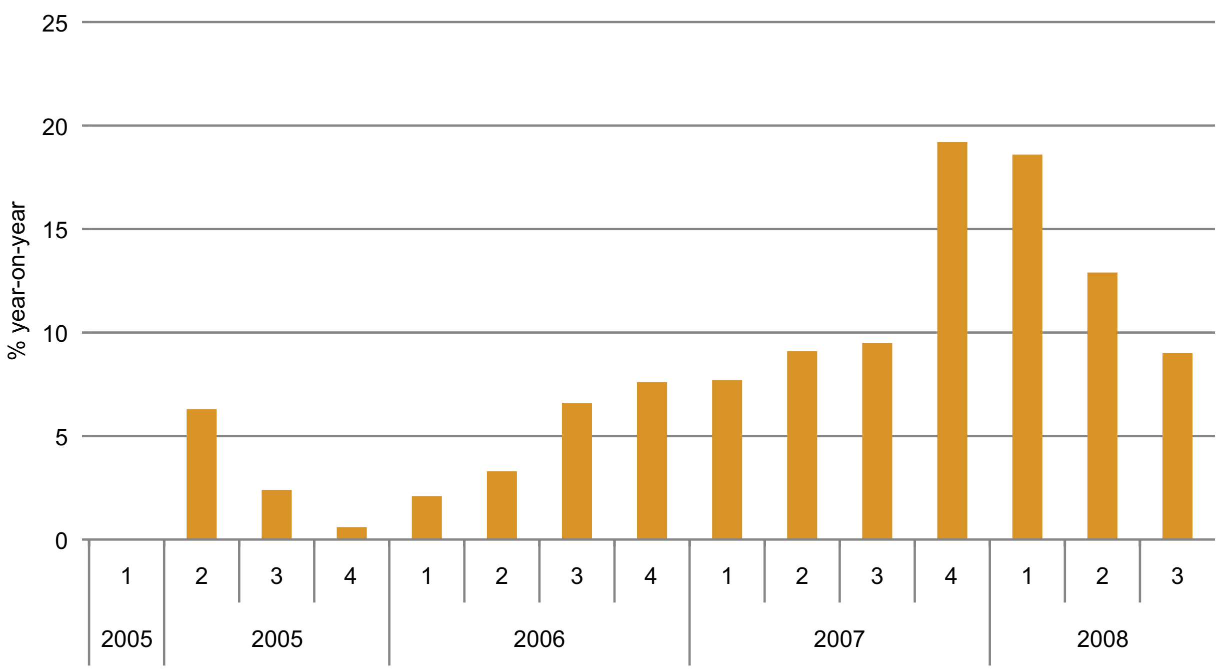
The housing market had experienced buoyant conditions in recent years. When Cyprus[2] joined the EU a few years ago, a boost was given to both the economy and the housing market, which was reinforced by accession to the euro area in 2008. In the run up to the euro, the housing market was very active and prices rose rapidly, reaching 20% towards in 4q 2007.[3] However, in 2008 the asking prices for houses levelled off. Even so, the surge in prices at the end of 2007 was still being reflected quarterly house price inflation data when compared to the previous year through into the autumn (Figure 5.1).

Central bank information on house prices, which is based on property valuations for mortgage advances, indicates that high annual rates of house price inflation existed throughout the five period from 2003 to 2007, with prices peaking at 15% in 2007. So, house prices rose rapidly in only a few years. This transformed the housing context and encouraged a substantial building boom in coastal areas and in the main towns.

Domestic housing demand was strong on the back of a surging economy and rapidly growing mortgage credit. There had been heightened interest in second homes from outside the traditional source of demand in the UK. People from the UK have for many years been attracted by the climate, cheap lifestyle, good public facilities and widespread use of English. But towards the end of the housing boom, Russian and other purchasers became more prevalent and less affected by borrowing constraints than western Europeans.

Housebuilding levels have been high. In fact, the country seems in recent years to have the highest housebuilding rate per 1,000 population in the EU, with the housing stock expanding by 30% in the past decade.

Figure 5.1: House price developments 2005q2 – 2008q3



Source: Adapted from BuySell Home Price Index, S.Platis Economic Research

[1]*Cyprus Sunday Mail report, 7.12.08.*
[2]*This chapter refers only to the Greek part of the island.*
[3]*According to BuySell Home Price Index, S. Platis Economic Research.*

CHAPTER 5: CYPRUS

Though a slowing in the market is evident, the extent to which the general global economic slowdown will affect the housing market in 2009 is hard to predict. The central bank is confident that the economy as a whole and the financial system will both weather the crisis. But much depends on overseas interest in homes on the island and both the UK and Russia have been badly hit by the economic crisis and have seen their currencies slump against the euro.

A period of housing market retrenchment may now occur. Housebuilding is still at high levels, despite the slowdown, and so is likely to fall further. The government offered assistance to the construction industry in a late 2008 €52m stimulus package but, all the same, job losses are likely to be high.

Housing system

General housing quality is good. Space standards are some of the best in the EU and much of the stock is modern and well-provisioned. Over half of all dwellings have been built since 1980. Growth has continued to be rapid in recent years with the dwelling stock rising by 30% in the decade up to 2007[4].

Owner occupation is around the EU average at 68% and many houses are owned outright. Another 14% are conventionally rented in the private sector. However, the tenure structure is complicated by the aftermath of the division of the island into the Greek and Turkish areas, which has led to a variety of atypical tenure categories, such as refugee estate, a Turkish Cypriot house, and self-help schemes aimed at refugees. These other categories depress the percentage shares of the more conventional tenures (Table 5.1).

Table 5.1: Tenures

	%
Owner occupied	68
Rented	14
Free	6
Refugee estate	6
Self-help housing scheme on government plot	4
Turkish Cypriot house	2

Source: 2001 Census

40% of the 340,000 dwellings are detached, another 30% are semis, 20% are apartments, and a further 10% are in mixed-used buildings. 16% of households are 1 person, 27% are 2 person and the other 57% are 3 or more persons[5]. So, household sizes are typically much higher than in northern Europe, although this characteristic is masked by the high number of holiday and retirement homes in the stock.

Average recorded housing costs as a percentage of household income are the second lowest in the EU – after Malta. They are only 13% of household consumption, compared to the highest cost country, Denmark, where they are 30%. (These Eurostat estimates include imputed rental income for owner occupied dwellings.)

Rents in the stock have been rising at 3-4% in recent years, somewhat above the general rate of price inflation. Rental dwellings are quite spacious at 116 square metres on average.

Roughly 10% of the population are non-Cypriot residents, according to the 2001 census, and the share has risen since then. Greek nationals represent a quarter of them. British people make up almost a fifth of the foreign residents, followed by smaller numbers of Russians and people from Sri Lanka and handfuls of other nationalities. Foreign residents enjoy special low income and inheritance tax rates. The British are the stalwarts of the retirement and second-home markets.

The use of apartments primarily for rented tourist accommodation has been on the decline. Their number fell by 10% in the decade prior to 2001, as holiday makers increasingly opted for full-service hotel accommodation or their own second home; which they, of course, may rent out for all or part of the season. Second homes numbered around 40,000 in 2001, after major expansion in the 1990s. That figure is likely to be much higher now.

Stamp duty and transfer taxes are levied on purchases; building is subject to the standard 15% rate of VAT, although this is offset by government grants for properties of less than 250 square metres; capital gains are taxed at the time of sale; and there is also an annual property tax, rising in steps to 4% for the most expensive properties.

[4] *Cystat*
[5] *2001 Census*

CHAPTER 5: CYPRUS

Transactions difficulties have been reported. There are complaints of serious delays in registering title in the Land Registry, said to run into years in some cases, and the English language press have reported stories of unscrupulous developers and estate agents thriving in the holiday home building boom[6].

There is a policy emphasis on promoting owner occupation. To this end the government offers a variety of schemes aimed at low-to-middle income families. They provide tax benefits, subsidised prices, and lower interest loans. There are also programmes to improve the housing conditions of those 12,000 or so households still living on refugee estates. Expenditure on them is set to rise to €112m in 2009.

Housebuilding

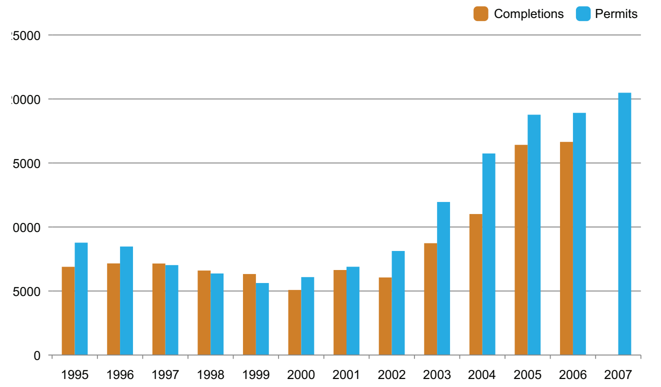
The country currently has a high housebuilding rate relative to population at 21 dwellings per thousand population (in 2005); a level only matched by Ireland at the peak of its recent boom. Over 6% of GDP is devoted to housing investment annually, significantly more than the EU average. This high level of building reflects the island's status as a holiday and retirement destination.

The rate of housebuilding dipped in the late 1990s and 2000 but then rapidly accelerated to 16,700 units in 2007, over three times the 2000 trough level (Figure 5.2). During the boom years, properties were sold off plan and new developers entered the buoyant market.

The number of dwellings for which building permits were issued was 12% lower in the first 9 months of 2008 than in the previous year. However, there still seems to be growth in apartment building, as there was a 6% increase in the number of permits for flats. The growth in apartment building can be seen in the 25% decline in the average area of new dwellings between 2001 and 2006, although the average floor space was still generous at 149 square metres[7].

The high rate of building has put pressure on per square metre residential construction costs for a number of years. For example, they rose by 23% between 2002 and 2006.

Figure 5.2: Housebuilding 1995 – 2007



Source: Cystat

Macroeconomic influences

GDP per capita is 8% less than the EU average but consistently good growth rates recently mean that the standard of living is catching up with the EU average. Since 2004, growth has been around 4% a year and though it slowed somewhat in 2008 and may fall further in 2009. The economy had slowed in the early 2000s, following a downturn in the tourist industry, but recovered quickly.

Tourism is a major part of economic activity. It has been weakening recently, due to the European recession and a loss of price competitiveness. Exchange rate movements affected some of the core tourist markets, such as the UK, and increased competition has been felt from destinations such as Turkey and Egypt.

Inflation averaged around 2% for the four years up to and including 2007. However, the country's reliance on imports meant that prices surged to be almost 5% higher in the autumn of 2008. The fall back in commodity prices should see inflation lower in 2009.

The level of participation in the labour market is quite high and employment growth during the boom was strong. This meant that households can generally afford to buy a home and possibly invest in housing to rent as well.

With such a high level of foreign interest in Cyprus, the housing market is not only affected by the performance of the local economy but also by those of the other countries.

[6] *See, for example, Waring, Financial Mirror, 24 January 2007 & Cyprus Mail, 29 September 2007*
[7] *Cystat*

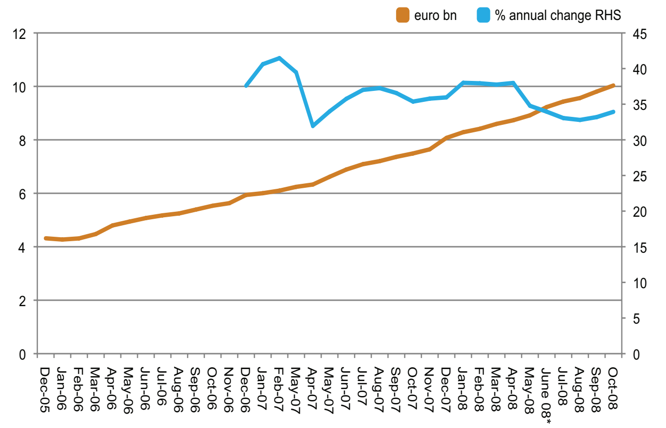
Mortgage market influences

Traditionally, limited recourse was made to mortgage borrowing but that is now beginning to change and mortgage use is growing rapidly from a low base. In the past few years, housing lending has risen by a third or more each year (Figure 5.3). Housing loans were 2.3 times higher October 2008 than they had been in December 2005[8]. Even so, the mortgage debt to GDP ratio was only 21% in 2006 and although it has grown since then it is still low by international standards[9]. Surveys have shown that young households tend to have low mortgage levels and are frequently in receipt of parental gifts to fund their housing[10].

Commercial banks are the main providers of loans. They have been offering attractive interest rates and extended repayment terms with lower down payment ratios. Competition has been intense, helping to account for the large rise in lending. Interest rate rose during 2008, rising by 105 basis points between March and September, which helped to account for the slowing of housing market.

Population growth is fast, mainly through inward migration. The number of people living in Cyprus expanded by 110,000 over the past decade, a 17% increase. The influx slowed from the 1990s into the 2000s but then speeded up again to peak in 2004, since when it has been declining again (Table 5.2).

Figure 5.3: House loans Dec 2005 – Oct 2008



Source: Central Bank

Table 5.2: Population developments 2000 – 2007

Thousands	2000	2001	2002	2003	2004	2005	2006	2007
Population	690.5	697.5	705.5	715.1	730.4	749.2	766.4	789.3
Net migration	4.0	4.6	6.9	12.3	15.7	14.4	8.7	-
Population growth	7	8	9.6	15.3	18.8	17.2	17.2	22.9
% population growth	1.0	1.1	1.4	2.1	2.6	2.3	2.2	3.0

Source: Eurostat

[8] *Central Bank*
[9] *European Mortgage Federation*
[10] *Central Bank research paper*

CHAPTER 5: CYPRUS

Population forecasts assume continued substantial increases, with another 100,000 people added every ten years until 2040. If this prediction turns out to be true, it would make Cyprus the country with the highest population rise in the EU – growing by 43% up to 2050.

Whether people will continue to come and live in Cyprus on such a scale is inevitably subject to uncertainty and speculation. Potential resolution of the problem of the divided island would lead to further substantial population changes in particular localities.

The fertility rate is low at 1.4 births per woman, down from 2.5 in 1980. Furthermore, most immigrants are middle-aged or older. The consequence is that the population is ageing rapidly. It is expected that those over 65 will represent a quarter of the population by 2050, twice as many as now. Those aged over 80 will quadruple in number over the same period.

Housing needs will obviously change with such a transformed population structure. There will also be substantial strains on public sector budgets in a variety of ways and taxation may have to rise to pay for them. Given forecasts of the number of elderly, the government-based pension system could reach a fifth of all public expenditure by 2050; which is a substantial 13% of GDP compared to less than 3% in the EU as a whole. The island's image as a cheap, low tax haven would come under considerable stress as a result.

Factfile: Cyprus

Background

Population (m) 2006	Annual Population Growth %	Fertility Rate* 2005	Years Life Expectancy 2005
0 .77	1.0	1.4	79

*Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)

Economic

	2004	2005	2006	2007	2008
GDP per capita purchasing parity standard based (EU25=100)	90	92	92	93	92
Real GDP growth %	4.2	4.0	4.0	3.8	3.5†
Inflation – consumer prices % (HICP)*	1.9	2.0	2.2	2.2	4.8
Employment rate % (15-64 yrs old in work)	68.9	68.5	69.6	-	-
Labour force growth	3.8	3.8	3.6	1.7	-
Unemployment rate %	4.6	5.2	4.6	-	-

*2008 Oct y-o-y† 3q 2008

Sources: Eurostat, World Bank, Cyprus Statistics Office

CHAPTER 6: FRANCE

Overview

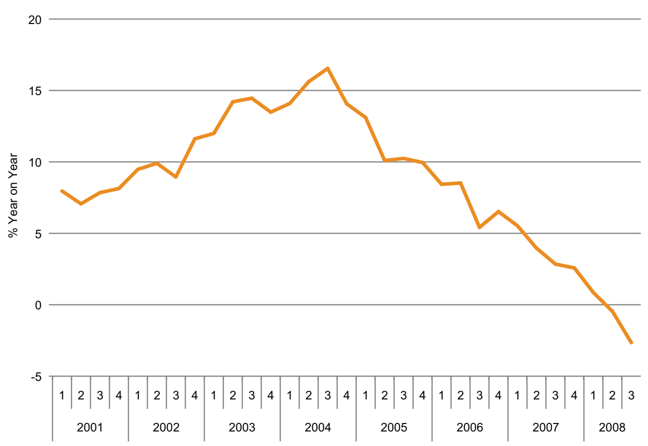
The long boom in French house prices ground to a halt in the summer of 2007 and 2008 saw significant falls, according to FNAIM. By 4q 2008, the price of existing homes was down 10% on the year, with the decline concentrated in the second half of the year. The official INSEE existing house price index based on notaries' transactions, which tends to lag the FNAIM asking price index by 3-6 months, indicated that prices peaked in the first three months of 2008, signalling the end of boom, after which they fell slightly during the next six months.

Transactions of existing homes fell by estimated 30% in 2008, according to FNAIM, and the number of houses on the market waiting to be sold grew substantially. Housebuilding was also in retreat, after a marked surge in the final years of the boom.

Housing starts declined by 15% in the first 10 months of 2008, presaging the end of hopes of a rapid solution to the nation's chronic housing shortages - especially of moderately priced housing in the major conurbations. The prospect for 2009 is for further falls in prices and output as the economy slows and downward pressures on the housing market mount.

There have been some regional differences in housing market performance. The once buoyant south-east recorded the fastest rate of decline; followed by north-east and west. But housing market retrenchment has essentially affected the country overall.

Figure 6.1: Change in house prices 2001q1-2008q3



Source: FNAIM

The credit crunch initially had only a limited impact on the French housing market. Mortgage loans even grew by a tenth on an annualised basis in 2008 up to October, according to central bank data. Even so, mortgage interest rates rose throughout most of 2008 and lending conditions markedly tightened. Then the intensification of the credit crunch in autumn 2008 brought the crisis to the fore during the closing months of the year and severely affected housing market dynamics: directly in terms of mortgage lending and indirectly via its negative impact on the real economy and the resultant reduction in housing demand.

The government tried in the second half of 2008 through a variety of initiatives to stimulate housing demand and limit repossessions. It is intended to expand bank lending following the October crisis period. However, it met resistance on competition grounds from the European Commission to its credit plans, which at the time of writing remained unresolved. In any case, whether those and other stimulus measures will succeed in halting housing market decline during 2009 remains uncertain. Revival may have to wait until 2010 at the earliest. A supply overhang, paradoxically increased by earlier government measures to expand supply, may delay recovery.

Prior to 2007, the French housing market had been one of the booming areas of Europe, with significant price rises occurring for a decade. In fact, real house prices doubled between 1996 and 2006. However, the rate of price growth actually peaked way before the onset of the credit crunch in the summer of 2004, at 16% a year, and following that price inflation gradually subsided (Figure 6.1). Such a trajectory still gives some hope for a housing market soft landing in 2009. Yet that prospect diminished in the last months of 2008 as a severe lack of mortgage finance took over the fortunes of the housing market.

Towards the end of the boom demand was boosted somewhat by the fulfilment of a presidential election pledge to reintroduce mortgage interest tax relief. Under the new arrangements households can deduct 20% of mortgage interest rate repayments for five years, with an annual cap set at €3,750 for singles and €7,500 for couples. Some of these tax breaks are likely to have been quickly capitalised into house prices.

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In 2008 as the severity of the credit crisis became apparent a series of measures were introduced, the aim of which were to revive housing activity. Included amongst the initiatives were a significant increase in the eligibility for zero interest rate mortgages; more government guarantees for mortgages; and the purchase at substantial discount on asking prices of 30,000 unsold new dwellings for social housing purposes.

The French housing market, like most others, is no stranger to booms and slumps. House prices in the first half to the 1990s fell by around a third in real terms. In fact, marked real price declines have been a common experience of most previous downswings and may well occur again now - unless interest rate reductions and government measures manage to moderate price decline.

In a country where long-term fixed rate mortgages predominate, the housing market is only indirectly affected by ECB interest rate changes. Instead, developments in long-term interest rates are of greater importance. The restoration of normal conditions in capital markets as well as to inter-bank lending will consequently be necessary conditions for any noticeable revival in the housing market.

The housing system

There has been a long history of strong state involvement in housing - both in renting and owner occupation - through subsidies, tax breaks, land use policies, rent controls and financial regulation. Although some forms of state involvement have declined substantially over the past twenty years, the French tradition of strong state intervention remains strong particular areas - such as social housing; stimuli to investment; cheap mortgages; savings for housing; planning; renovation; and urban regeneration. A special housing construction tax on employers, the ‘Logement 1%’, adds around €500 million a year to the public sector’s housing budget.

What is more, housing policy is deliberately used in a Keynesian way to manage demand in the economy. The aim is a stated goal of housing policy in a way rare elsewhere, though it has recently come back into fashion elsewhere since the onset of the credit crunch.

There is a significant programme of urban regeneration and housing renovation as well as interventions in new build. Such state-aided programmes are undertaken under a number of policy rubrics. They peaked at the end of the 1990s after which they declined, but grew again from 2005 with national concern over social cohesion and rundown neighbourhoods. Renovation and modernisation of the existing stock currently represents around half of all housing investment.

The urban riots of 2005 led to a strong policy response with regard to housing, which continues under the present government. A document was published ‘Logement: le gouvernment s’engage’, outlining more than 60 housing measures. One of them focuses on the demolition of the worst social housing and another on major renovation schemes of buildings designated to remain. A new urban renovation agency manages them and other programmes outlined in those measures or introduced since (ANRU - Agence nationale pour la rénovation urbaine).

France has the largest stock of housing in the EU, when measured on a crude number per thousand population basis. Partly, this is accounted for by the relatively large amount of second homes (around 10% of the stock), concentrated in the southern part of the country; and by the high level of vacancies: they have remained around 7% of the stock for many years. Such vacancies are associated with the continued rural to urban shift of the population and with rundown stock in older industrial areas but also with individual housing and investment preferences, which for a variety of reasons keep some dwellings officially defined as vacant. Fiscal penalties on vacant dwellings have recently been introduced in an attempt to reduce the vacancy rate and these taxes are expected to raise €18 million in 2009.

A fifth of the stock has been built since 1980 and two-thirds since 1945. The housebuilding rate is quite high by EU standards: at 6.0 per 1000 population in 2004 and it grew significantly after that during the final years of the boom[1]. In the 1990s, an average of almost 300,000 dwellings was added to the stock each year and output has been even higher in the 2000s. But, despite this high rate of building, chronic shortages have remained, particularly of affordable housing in the main urban areas.

[1] *INSEE*

Almost 60% of the stock is individual houses and the rest are flats located in multi-dwelling structures. 16% of the total stock exists as dwellings in high-rise buildings of 4 storeys or more[2]. Much of the social sector is located in unattractive suburban areas and many of them are still in need of substantial improvement.

Owner occupation

The number of households owning their principal home started to grow noticeably during the recent housing boom after being stable for many years. In 1992, it was estimated that 54% of primary residences were owned by their occupants. By 2005, the share had risen only marginally to 57%; though it may have grown further since then. However, because the number of households has been expanding rapidly, the number living as homeowners has been rising at an accelerating rate: by 125,000 households on average a year between 1990 and 1995; by another 163,000 a year to 2000; and by 205,000 annually to 2005. Between 1990 and 2005, there were 3 million extra owner occupiers in total; accounting for as much as two-thirds of the total net increase in the stock.

Expansion of owner occupation reflects a notably higher propensity to live in the tenure amongst the 35 to 54 age group. Purchase is spreading to younger households as well. The tax and subsidy system is becoming more tilted towards the tenure, which as well as rising living standards is encouraging such developments, especially via mortgage subsidies and tax breaks.

The current government has set itself a target of raising the homeownership rate to 70%. Achieving that aim would result in a major transformation of French society and at best must be regarded as a long-term goal, especially given the current downturn in the market. As part of this process, 40,000 social housing tenants a year are expected to become owners of their dwellings in a programme reminiscent of council house sales in the UK[3].

A subsidised mortgage loans policy exists in the form of a ‘zero per cent’ loan programme, known in France as the ‘prêt à zero %’ programme (PTZ). This scheme provides moderate to middle income, first-time buyer households with zero interest loans. Applicants are processed through the usual mortgage channels and standard mortgage loans can be given to borrowers on top of the PTZ. This has made lending to such applicants more attractiveness for commercial firms, as the PTZ element is state guaranteed, offering in practice a boost to the down payments that first-time buyers can make. There are caps on loan sizes, based on incomes, household sizes and national price zones.

Another recent loan scheme also aims to encourage low income homeownership, but offers more generous terms than the PTZ. It is known by the acronym NOT. Both PTZ and NOT loans now carry full government default guarantees.

As part of a package of emergency housing measures introduced in October 2008 as a result of the financial crisis and its impact on the housing market, the income caps on PTZ loans have been raised until the end of 2009. For a household with two children outside the Paris region, the cap has been raised from approximately € 2,900to €3,750. The new terms are estimated to make 60% of households eligible for PTZ loans. This should give greater confidence to lenders as it lowers the default risk on their elements of total loan packages offered to home buyers.

Since its introduction in the mid-1990s, well over a million moderate income households have used PTZ loans. Up to 2005, they were used mainly to buy single family houses. It is common for younger French people to stay in their parents’ home throughout their early years of adulthood. 29% of men aged between 24 and 29, for instance, still live with their parents during which time they may accumulate savings for a housing down payment. So, the PTZ scheme by acting as an implicit deposit top-up assists in smoothing the transition from parental home to home ownership, especially outside of the higher priced areas.

PTZ loans had been declining in use, with the number falling by 30% between 1998 and 2004. But, early in 2005, as part of the programme of increasing the affordability of housing, the scope of the programme was extended significantly by making it available for existing as well as new housing; thereby removing the only new building stipulation of previous years. Further reforms in 2006 increased the loan and income caps in the more expensive areas of the country. Around 250,000 people utilised PTZ loans in 2007[4].

[2] *Housing Statistics in the EU 2005/6*
[3] *Housing Ministry*
[4] *Ministry of Housing*

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Heavily subsidised sources of credit are generally important in house purchase. They represented more than a fifth of total credits in the new housing market in 2004. Therefore, the recently revived mortgage interest tax relief measures are just one of several avenues for owner occupiers to benefit from state-subsidised borrowing. Further subsidies also arise in building and renovation.

It could be argued that such demand subsidies stoke housing demand, which may be good in downturns but helps to force up prices in the boom years. Their distributional impact may also be questionable, despite stated aims to subside those most in need. Lending on current income criteria to first-time buyers, for instance, subsidises young people on steeply rising career ladders, who will have substantial own resources a few years later, as well as others who may be less fortunate.

Private renting

Around 40% of dwellings are rented and a quarter of all households live in the private rented sector and around 15% in social housing[5]. Households who rent privately are generally located in the inner city areas of the large cities, with the greatest number in Paris. Such tenants are highly mobile: two-thirds occupy their dwelling for less than four years.

The number of privately rented dwellings has been fairly static over the past forty five years at around 6.5 million dwellings, although their average quality has greatly improved over that time. Nearly 60% of private rented dwellings were built after 1948 and as many as 14% since 1990, with new building encouraged by attractive renovation subsidies and land allocations. Most landlords, 93% of them, are private individuals rather than corporations, according to INSEE surveys.

Rent control exists in a variety of forms, depending on the type of property and the length of the tenancy. Under the most common form of arrangement, rents may be freely agreed in leases for new and renovated dwellings but then subsequent rent increases are linked to an official reference index. This regulation was introduced in 1989 and so is often known by that date. It has been in force for all new tenancies since 1997.

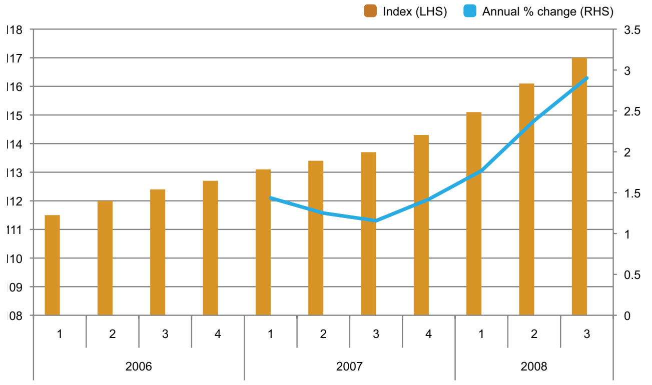
From 2006, the permitted formula for annual rent adjustments switched away from the construction price index, which was rising at a much faster rate than general inflation, to a composite rent reference index (known by the acronym IRL - Indice de Référence des Loyers). The new IRL index is based 60% on the consumers' price index, 20% on the construction cost index, and 20% on an index tracking landlords' estimated costs for management and repair. The IRL grew quite substantially during 2008, almost reaching 3% in the third quarter reflecting general inflationary pressures (Figure 6.2).

For tenancies existing prior to 1997, rents are still regulated and renewals must stay at a level comparable with those for similar dwellings in the locality. There are also around a quarter of a million properties with rents that were frozen at 1948 levels. However, there has been some liberalisation and the fiscal situation of the owners of such properties has been improved as well.

In the social sector, the prime determinant of rent levels remains the time a housing development was built. A recent study found that average social rents were 40% less than equivalent market rents[6].

Average rent increases in both the private and social sectors tend to be modest because of the controls imposed on existing contracts. Average rents have risen in nominal terms in recent years, though in real terms the increases have been quite modest (Figure 6.3). The rent rises for new contracts alone have been relatively modest in recent years as well. Paris saw some buoyancy from 2007 with rises near to 6%. However, additional supply in many parts of the country during 2007 and 2008 has led to a softening.

Figure 6.2: Rent reference index 2006 q1 - 2008 q3

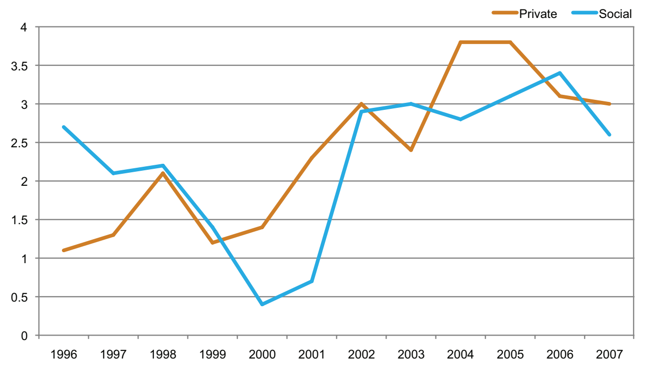


Source: FNAIM

[5] *25% private & 19% social of all primary residences. Housing Ministry*

[6] *INSEE*

Figure 6.3: Increases in rents 1996 - 2007



Source: INSEE

IPD has reported strong returns for investment in residential properties in recent years. Total returns were 14% in 2007, down from 21% in 2006, because of declining house price growth. The income return was only 3.5% and capital growth added another 10%. The slowing of the housing market will sharply diminish those returns over the next few years.

Social Housing

Social housing is estimated to represent 19% of principal dwellings. Its standard has improved significantly since the mid-1980s. This upgrade has involved large-scale public expenditure on refurbishment as a majority of the stock dates from the 1960s and 1970s, with only 9% built since 1990. Local authorities now have a target of providing for 20% social housing in the new construction permitted in their areas and they are subject to central government scrutiny if they fail to meet it.

Between 2005 and 2007, the construction of 276,000 social dwellings under a variety of programmes was agreed and funded. 2009 will see funding for a further 100,000[7]. Part of this is to be financed by annual sales of 40,000 dwellings to tenants, although the downturn will make this target harder to achieve.

Housing allowances are paid to tenants and to homeowners as a consequence of several pieces of legislation. The most common one, APL[8], is also used to promote access to property ownership by partly covering mortgage costs. Over 10% of owners, around a third of private sector renters, and 48% of social housing tenants are in receipt of some sort of allowance, in programmes which cost €14 billion in 2004. ALF[9] is paid to households with children and to young couples with no children, when household income is below specified levels; while ALS[10] is paid to single people, mainly students, who are not entitled to APL.

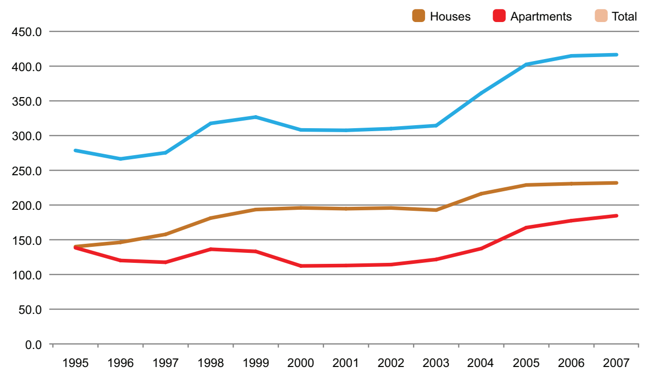
Recent immigrants and other ethnic-minority groups comprise a significant proportion of tenants in social housing. Many live in the subsidised-rent projects run by Habitations à Loyer Modéré organisations (HLMs), particularly in the oldest dwellings. Such groups have a high proportions of large, low-income families and they experience some of the poorest housing conditions.

Housebuilding

Housebuilding has been high in recent years, though it is now weakening with the downturn. This pattern reflects developments in the private market, but also state initiatives via planning initiatives, renovation and renewal, tax breaks and subsidies, and social housebuilding.

The growth in housebuilding was relatively slow during the early years of the market upturn from the mid-1990s to 2003, despite rising prices during the period (Figure 6.4). However, starts took off following government initiatives and averaged around 400,000 annually between 2003 and 2007; 30% higher than the average of the previous three years.

Figure 6.4: Housing starts 1995 - 2007



Source: INSEE

[7]Housing Ministry
[8]Aide personnalisée au logement
[9]Allocation de logement à caractère familial
[10]Allocation de logement à caractère social

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By 2007 building was at a scale not seen since the early 1980s, highlighting the impact of recent policy initiatives on housing supply. However, in 2008, building slowed substantially, so that by October starts were running at an annualised level in Metropolitan France of 367,000 residences (442,000 authorized), a 15% (20%) fall. Both apartments and single family homes were affected by the decline, which was seen across all regions of the country, apart from the Ile de France.

The surge in housebuilding after 2003 was particularly marked with regard to the building of blocks of apartments, both in the private sector and especially for much revived social housebuilding. Previously, the output of apartments had actually fallen from mid-1990s levels, so the turnaround was all the more noticeable. This change in the composition of output reflected public intervention rather than market forces: particularly government social housing initiatives and affordable housing programmes for first-time buyers and other purchasers. However, in total, more single-family houses continued to be built than apartments: reflecting the growth of owner occupation; general demand for higher space standards; and the suburbanised nature of modern French society.

Outside of the historic centres there is a preference for new houses rather than apartments. This preference reflects underlying migration, suburbanisation, demand and other social trends. Infrastructure improvements have played a part in encouraging the outward movement of populations. Fast train (TGV) routes out of Paris, for example, have stimulated housing growth in wide array of cities and towns with improved journey times to central Paris.

There are several ways in which houses are built. A common means is when prospective homeowners commission dwellings to be built on plots they have recently purchased or already own. As a result, large-scale developers have a much smaller market share than in countries like Britain, Ireland and Spain.

Four specific schemes are now on hand for private investors to encourage provision of more private affordable rental housing under the rubrics of the programmes ‘Robien’ and ‘Borloo’; named such after previous housing ministers. Both programmes funded housing across a wide range of localities but recently have been directed more specifically to areas of housing shortage. The state housing agency ANAH also provides grants for the construction and improvement of private rental housing. It has funded an estimated 32,000 new privately-owned, rent-controlled tenancies to date and will be instrumental in the renovation of a further 15,650 rental properties in 2009. There is an overall target of 100,000 renovations by 2012, which will involve a stepped increase in activity from current levels[11].

Social housebuilding does not depend on market conditions but rather on public subsidy, agency initiative and land availability. Political pressure has been strong to achieve extra housing output in this sector. In fact, it may well be the case over the next few years that social housing will be the most dynamic housing sector in the absence of a marked revival in the market sector.

The government’s half a million homes a year target is now in jeopardy because of the housing market slowdown. In practice, the target has always been an optimistic one, rather than reflects the absorption capacity of a predominately market-based housing system. The surge in housing output since 2003 is particularly likely to exceed the effective absorption capacity of housing demand over the next few years. Vacancy rates have been rising and a growing supply overhang may slow market recovery in both the owner and renter sectors of the market.

Macroeconomic influences

Economic growth prior to 2008 was good, with the economy growing at around its potential rate for a number of years. However, growth faltered in 2008 due to the deteriorating world economy and the economy may be in recession throughout 2009.

Job creation is weak, while unemployment remains stubbornly high and will increase with the slowdown. International agencies have argued that there is a need to free up the labour market to increase the long-term growth potential of the economy. The government is committed to labour market reforms but, as with previous administrations, is finding strong resistance to its proposals.

[11] *Housing Ministry*

The state plays a large role in economic activity. Public expenditure at 54% of national income in 2005 is one of the highest in the EU. Poor government finances limit the potential for additional measures in the current situation, though considerable political emphasis is currently being given to economic recovery and revival of lending by the financial sector.

A longer term fiscal concern is the costs of pensions on public expenditure. The impact will create the need for structural reforms as the retired begin to form a larger share of the population. Some of those structural reforms and cutbacks may well fall on state programmes related to housing.

The economy is likely to recover in 2010, but the negative experience of 2008 and its continuation into 2009 is likely to continue to weaken consumer sentiment with respect to housing. If housebuilding falls substantially that will itself have knock on effects on the economy, given the current high level of housebuilding even after recent falls.

Mortgage market

The French mortgage market differs in a number of respects from those in other countries, because of the frequent interlinked nature of state schemes with private savings and lending activities. There are a variety of products and packages and a significant proportion of them include subsidised savings schemes, like the *Plan d'épargne-logement*, and subsidised housing loans.

Contractual saving schemes, especially the *Plan d'épargne-logement*, have been important traditional sources of finance for the owner-occupied sector. In them, individuals agree to save a certain amount for at least five years. The interest they receive is below market rate, but they get an additional government bonus. At the end of the contractual period, they can then obtain a below-market rate loan of 2.5 times the sum saved and can also use the money saved as a deposit on a home. Around 10% of all pass-book savings accounts are held in housing savings accounts. The value of such savings was €270billion in 2005.

However, as a share of housing finance these schemes have declined substantially in recent years. This has been due to the growth of conventional mortgage products; greater competition amongst mortgage providers; the introduction of other subsidised mortgage schemes; and the expansion of other, more attractive, savings options.

As well as conventional mortgage finance, there are loans regulated by the state, such as *Prêts conventionnés* (PC). Under the PC scheme, a public or private-public organisation (like the Crédit Foncier de France) is involved in mortgage contracts with private banks, enabling the overall lending rate to be priced at below the market level. There are further subsidised loans, some of them especially directed at moderate income households, such as the zero % mortgages considered earlier.

The main players in the mortgage market are the commercial banks; the mutual and co-operative banks, consisting mainly of Crédit Agricole, Crédit Mutuel and Crédit Foncier; plus other financial companies[12]. Competition increased during the boom years within the highly regulated, nationally-orientated, banking system. The outcome has been an enlarged range of products and packages, narrower spreads, extended repayment times and increases in permissible loan-to-value and loan-to-income ratios. Yet, competition is still sufficiently limited to enable banks to impose risk-minimising terms; to exclude higher-risk customers; and to tighten credit conditions when market risks seem to be growing. The duality of competition and restraint, combined with the off-balance sheet nature of public mortgage loans, has contributed to maintaining a relatively low share of mortgage finance in GDP at 32% in 2006[13].

Until autumn 2008, none of the major financial institutions faced the funding difficulties experienced by UK providers. This may account for why there was not a sharp reduction in mortgage funding prior to then. However, loan conditions did tighten significantly in autumn 2008. The government did inject capital into banks in common with similar actions in many other countries and as a consequence expects them to lend additional funds to house purchasers. If this pressure works, the housing market may revive quite quickly in 2009. However, experience elsewhere has shown that such a response is by no means certain.

Most mortgages (over 90%) are taken out on a fixed interest basis with an average term of 25 years. The popularity of variable rate mortgages grew rapidly a few years ago as short-term interest rates fell. They peaked at a 17% market share in 2005 but then declined to only 7% of the market by the autumn of 2007 because rising interest rates dissuaded borrowers from using them[14].

[12] *Bank of France*
[13] *EMF*
[14] *FNAIM*

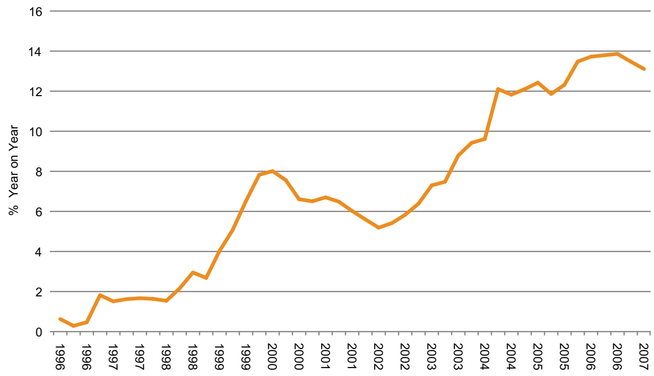
CHAPTER 6: FRANCE

Although housing-related debt is low by the standards of many of the other leading EU economies, it expanded significantly during the years in the housing market. The biggest surge came after 2003 but growth appeared to peak in 2006 and fell somewhat in 2007 as the housing market began to slow (Figure 6.5). However, despite the credit crunch loans for house purchase were still been rising in the first nine months of 2008 and increased by 10% between September 2007 and September 2008 (Figure 6.6). However, at the same time, the cost of loans drifted up by around 50 basis points for both fixed and variable rate products, which help to deter housing demand (Figure 6.7).

The extent to which cuts in ECB interest rates and potential falls in longer term rates affect mortgage costs in 2009 remains to be seen. Given the general state of the French economy and the recent rapid rises in house prices, they are unlikely to offset other downward pressures on prices.

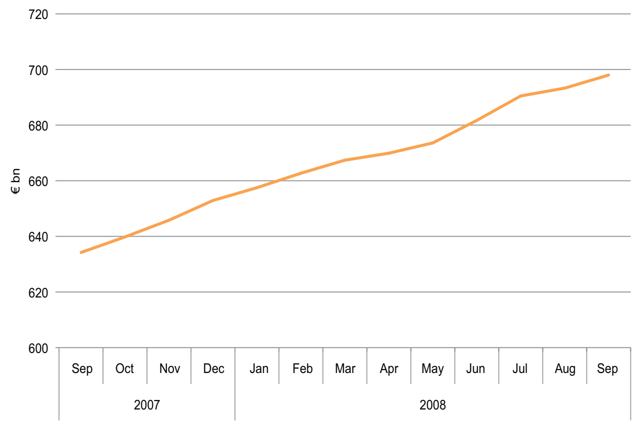
The ratio of the long-term loans of households, most of which are housing-related, to their disposable incomes was 69% in 2006, which is still low by the standards of many other large, advanced economies[15]. However, these figures are hard to interpret on a comparative international basis. The apparent scale of borrowing may be artificially lowered through the way in which the data are measured and the complex interventions of the state into personal housing finance. In addition, the country has a relatively large private rented sector, so individuals not only borrow for owner occupation but also as landlords and little is known specifically about French 'buy-to-let' finance. Nevertheless, the measured low housing debt ratio highlights the weak direct linkages between housing finance and the national economy. Moreover, equity withdrawal is low. However, the recent scale of housebuilding has heightened the housing supply side linkages, as noted earlier.

Figure 6.5: Growth of outstanding mortgage debt 1996q-2007q1



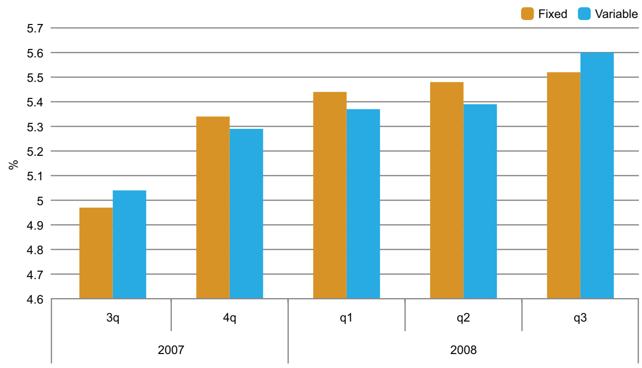
Source: Bank of France

Figure 6.6: Recent housing loans: Sep 2007 - Sep 2008



Source: Bank of France

Figure 6.7: Interest rates on loans for house purchase



Source: Bank of France

[15]OECD

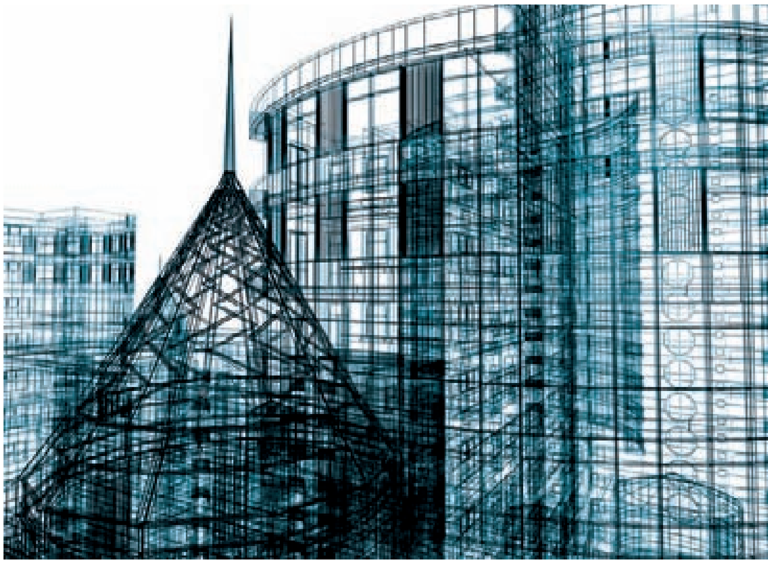
Demographic influences

As with many other countries, household size has been declining over time and was an average of 2.3 persons in 2005. As a result, household numbers have been growing substantially: 2.5 times faster, in fact, than the population over the past 20 years.

The number of households is expected to increase annually by an average of between 240,000 and 260,000 from 2000 to 2020, with the fastest rates of growth in the initial years of the period[16]. Making assumptions about such items as immigration, vacancy rates, and demolitions and renewals, it is estimated that 350-400,000 new dwellings a year will be needed up to 2010 and 320-370,000 a year in the following decade.

These estimates do not take account of economic factors, such as rising demand with higher standards of living or intra-regional migration to growth areas. However, neither do they take account of affordability problems, which have been significant in recent years. Cyclical factors are likely to cause variations in new housing demand. So, it is not clear whether the aspirations implicit in such forecasts will actually be met over the period.

An ageing population is contributing to the rise in household numbers. The greatest increase is going to occur over the next couple of decades, with the number of those aged over 60 growing from a current 13 million to 21 million by 2035, after which time the rate of increase declines. On current trends, by 2050 over a third of the population will be over 60. The ageing of the population has long-term implications not only for housing provision and social services, but also for pensions, taxation and economic performance and will induce major structural changes within the economy and public sector as a result, which will have long run consequences for housing taxes and subsidies and broader housing policies.



[16] *SESP Note No 165*

CHAPTER 6: FRANCE

Factfile: France

Background

Population (m) 2006	Annual Population Growth %	Fertility Rate* 2005	Years Life Expectancy 2005
62.0	0.6	2.0	81

*Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)

Economic

	2004	2005	2006	2007	2008f
GDP per capita purchasing parity standard based (EU27=100)	110	112	111	111	108
Real GDP growth %	2.5	1.7	2.4	2.1	0.9
Growth in real private consumption %	2.5	2.2	2.5	2.4	0.9
Inflation – consumer prices % (HICP)*	2.3	1.9	1.9	1.6	3.0
Labour participation rate % (15-65 yrs old in work)	-	69	69	69	-
Employment growth	-	0.5	0.9	0.9	-
Unemployment rate %	9.3	9.3	9.2	8.3	-

*2008 Oct y-o-y

Housing market

	2004	2005	2006	2007	2008f
Growth in residential investment	3.3	6.1	6.9	2.9	-2.6

Taxes

Owner occupied housing: mortgage interest relief – Partial with caps.

Capital gains exempt - yes

Imputed rental income - not taxed

VAT on new housing – 19.6% (5.5% social housing)

Stamp duty – 2-3%

Property taxes as share of all taxes 2002 – 7%

Property taxes as share of GDP 2002 – 3%

Sources: Housing Statistics in the European Union 2005/6, OECD, INSEE, World Bank

CHAPTER 7: GERMANY

Overview

House prices fell by 2.2% in 2008, according to estimates based on the Hypoport German House Price Index for existing houses. New building permits also declined to some extent by about 2%; while mortgages rose by around 2%. So, the market showed signs of weakening after several years of being broadly static.

It is rare for a housing market to find such an apparent equilibrium, because short-term cycles tend to over-and under-shoot longer-term trends, but Germany seems to have pretty much found itself in a state of little change over the past few years. A similar pattern exists at the regional level, with the more dynamic regions in the west recording marginally higher price growth than that elsewhere but, again, in terms of the sharp gyrations and regional differences in market dynamics seen in many other countries everything seems rather tranquil.

The credit crunch has not passed Germany by. Fears of bank runs in autumn 2008 forced the government to offer guarantees on bank deposits. Some institutions have also had to be rescued, such as the major mortgage lender Hypo Real Estate. Other banks had state injections of capital. Total state action amounted to €500billion. Unsurprisingly, given these events and experience elsewhere, inter-bank lending seized up and a committee of MPs overseeing the banking rescue reported in mid-December that the rescue had failed in its objective of freeing up credit availability again[1].

The economy was hit by the problems of the global economy and moved into quite a deep recession during 2007 in which it is expected to remain until 2010. The Ifo economic forecast for the country in December 2008 predicted a contraction of 2.2% during 2009, one of the sharpest in decades. There is some pessimism that the situation could be even worse. The government has been reluctant to participate in the major reflationary packages undertaken in other countries, such as France, the USA and the UK. Lower incomes, squeezed consumer expenditure and constrained borrowing are bound adversely to affect the housing market during 2008 and perhaps beyond. Though the German housing market may have missed out on the boom, that does not mean to say it is insulated from the bust, especially as the downswing is being driven by a common lack of credit.

The German housing market remains oddly distinctive in its recent performance. Expansion of owner occupation in a country with a majority of renters is also likely to remain a gradual process at best. In fact, the most recent official survey showed that the homeownership rate had dropped slightly from 43% in 2002 to 42% in 2006.

Two other factors have contributed to muted housing demand. First, as elsewhere in the euro area, rising interest rates were increasing mortgage borrowing costs until late 2008. Interest costs were over a quarter higher in 3q 2007 than in 2005 and they continued to drift up through most of 2008 by roughly a further 50 basis points. Second, 2007 was the year that owner purchase subsidies were abolished and VAT was increased by 3% to 19%, which is significant for housing because the standard rate of VAT is charged on new building. As well as raising the cost of new housing, these changes were announced a long time in advance. Unsurprisingly, many people brought forward their housing plans after which building subsequently slumped and has not revived since. Such tax and subsidy changes along with the long-term existence of capital losses from falling house prices have depressed owner occupied housing demand, which helps to explain why the tenure is not growing.

House prices and rents have been pretty much flat or gently rising and falling in nominal terms for over a decade now, while average prices in real terms have been falling (Figure 7.1). Given the state of the economy and relatively plentiful housing supply, except in a few city regions, the prognosis remains for only limited price change over the next few years. Previous experience and the current economic climate suggest that falling interest rates are unlikely to have much effect in stimulating housing demand in the near future.

[1]*Financial Times 14.12.08*

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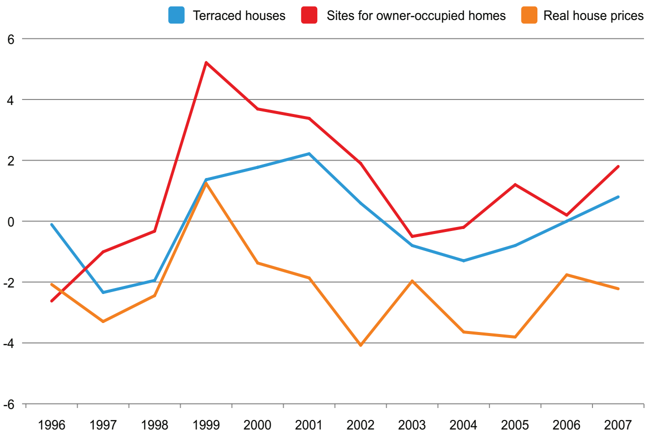
Figure 7.1: Changes in terraced house and land prices 1996 - 2007



Source: BulwienGesa, OECD

Recent performance has been influenced by three factors distinguishing the housing market from those in many other European countries. The first is the unusually large role played by renting, with owner occupation the minority tenure. Second, new supply seems elastic and plentiful by European standards. Finally, the country's mortgage market has not been subject to any significant structural or competitive changes in recent years and borrowing terms were not loosened much and, so, the credit surges seen elsewhere did not occur.

Housebuilding rates have been subject to some marked swings in recent years, induced by subsidy and taxation changes. They are not expected to grow much over the next few years because of the relatively quiescent state of the housing market and comparatively poor demographics.

Despite weak house prices and rents for some time, housing consumption costs have still risen. Official surveys suggest that almost a quarter of household expenditure went on housing in 2006, compared to only a fifth in 1991. Most of the rise in the share occurred in the early years of the period up to 1995, since when housing costs have mainly grown proportionately to incomes. But, the fact that 25% of incomes are spent on housing does not suggest that relative housing costs are much out of line with those elsewhere in the EU. This should be borne in mind when considering future house price changes. Because housing costs are already relatively high, the scope for 'catch-up' in German property prices seems limited.

Important causes of housing cost increases have been ancillary expenses like water, heating and electricity charges; plus improved housing standards, such as higher living space per person, better amenities, etc[2]. On a comparative basis, the current income share of housing costs in Germany highlights the danger of inferring relative housing costs simply from recent changes in property prices.

Homeownership

Only 42% of the housing stock is owner occupied across the country as a whole. So, the country has the highest rental share in the EU; a proportion only surpassed by Switzerland in Europe as a whole. The owner share is 11% higher in the old Federal Republic area than it is in the East (Table 7.1)[3].

Private renting is around the same size as owner occupation, by far the highest share in the EU. Social housing is now only 6% of the stock and is declining gradually through estate transfers and sales and as debt is paid-off. Germany has a unique time-dependent definition of social housing, because after subsidised loans are paid off housing is no longer classified as being social. There is also a co-operative rental sector, divided roughly 40-60 between East and West, which accounts for another 6% of the stock.

The share of owner occupation varies considerably across the country. Broadly, the north and east have lower owner occupation rates than the south and west (Table 7.1). The traditional politics of local government in Hamburg and Berlin, with strong traditions of social housing and in the case of Hamburg public land acquisition and development, mean that they are predominantly renter cities with only 20% and 14% of home ownership respectively.

The largest decline in home ownership between 2002 and 2006 occurred in the new Länder. This was the region where house prices had fallen the most, making homeownership an unattractive prospect. Interestingly, many of the Länder with the highest owner shares actually experienced the greatest falls in percentage shares in recent years. Economic factors, notably the expected returns from owning, clearly seem to be important influences on tenure choice, as successive international studies have shown.

[2]*Bundesbanks Monthly Report, September 2007*
[3]*Federal Statistical Office*

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Table 7.1: Owner Occupied shares national and regional

	2006	**Change in % share in 2002-06**
Saarland	55	-2.0
Rheinland-Pfalz	54	-1.4
Niedersachsen	49	-2.0
Baden-Württemberg	49	-0.2
Bayern	46	-2.5
Schleswig-Holstein	47	-2.3
Hessen	44	-0.4
Former Federal Republic	45	0.0
Germany	42	-1.0
Thüringen	41	-1.2
Bremen	35	0.3
Nordrhein-Westfalen	39	-0.3
Sachsen-Anhalt	38	-1.7
Brandenburg	40	-0.2
Mecklenburg-Vorpommern	33	-2.7
New Länder	31	-3.6
Sachsen	30	-1.5
Hamburg	20	-1.7
Berlin	14	1.4

Source: Federal Statistical Office

There are social distinctions in tenure choice. Only a quarter of single person households are owner occupiers, whereas 56% of households containing more than three people live in the tenure. A half of those aged over 60 are homeowners, as are more than two-thirds of those with net monthly household incomes at or above €3,200. In summary, homeownership is associated with ‘large property, later in life, families with children, better-off, suburban or rural’ types of housing. So, it is misleading to classify Germany simply as a nation of renters. Moreover, as elsewhere, owning their own home is often something to which many households aspire, particularly if they have, or aim to have, children and would like to be outside of the urban cores and live in a single-family dwelling. The demographic structure, however, is biased towards small-sized households, which encourages renting.

Around 70% of households consist of only 1 or 2 persons and the share of small households will continue to grow as the population ages. In Berlin, currently half of all households consist of single people, while in Munich the percentage is 46%. In this context, it is unsurprising that the country has one of the lowest average numbers of people per dwelling in Europe at 2.2. Average household size is even less in rental accommodation, because singles and couples are concentrated there.

Only 28% of the stock consists of single-family structures (terraced, semi- and detached houses), which is low by north west European standards. Most apartments are in low rise, rather than multi-storey, buildings but densities are typically high all the same. Apartments in such built forms are relatively easy to manage for large and small landlords alike, whereas owner occupation is more generally associated with single-family housing. Therefore, the built form of Germany’s housing stock reflects, and has been influenced by, the structure of household types and high share of renting in the country.

Nevertheless, the greatest demand pressure is currently for single-family homes, partly because of their relatively small presence in the stock and also because of the desire of many households for more living space as their incomes rise. This demand also translates into a preference for owner occupation, as described above. Single-family homes represent the most common type of newly built dwellings and are typically in the shortest supply in the economically strongest areas.

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Local housing shortages more often than not are associated with specific housing types, locations and qualities than with a general lack of housing. One sort of housing, such as small, old-style, poorly located apartments, can easily be in excess supply while another is in chronic shortage, particularly single-family housing in good locations. The existence of such housing sub-markets and the spread-out urban geography of the country can make reliance on aggregate average housing indicators misleading for an understanding of real housing experiences.

To an extent, the current low ownership rate is due to long-past housing policies and, also, to more recent subsidy and tax break policies. Many housing policies and subsidies operate at the Länder level and vary substantially between them, so it is difficult to give a precise overall picture of tenure policy biases and how they have changed. Nonetheless, housing politics in general in the 1950s and 1960s favoured rental building in both the social and private sectors, especially in certain urban regions in the West and throughout the old East. Renovation programmes after the 1970s continued that bias.

Tax-wise, there is no mortgage interest tax relief but until recently newly built, single-family owner occupied dwellings benefitted from a specific tax break known as “Eigenheimzulage”, estimated to cost €7.5 billion in 2004[4]. The cost was also rising because, from 2004, existing dwellings were brought into the scheme. Then, the new coalition government agreed in 2005 that this tax break was to be fully withdrawn in 2006.

Quite what the structure of future tenure relationships will be remains to be seen over the next few years. When the long-run fall in house prices finally ends and consumers begin to expect that housing is once more as good an investment as other assets, the expectation must be that homeownership will grow at the expense of renting, because the fiscal benefits previously given to landlords have fallen the most. Yet, given the extent of security of tenure regulations, it will be a long-time before landlords could profitably unwind their investment positions, even if they wanted to. There are also still many institutional and fiscal biases in the housing system, many of them propagated at the Länder level, which influence consumer housing choices and housing supply.

Tenure-specific subsidies and tax breaks still exist. For example, general capital gains taxation has been raised to 25% but owner occupied dwellings are exempt from the tax – not that that matters much in the current price environment. Tax breaks can also be derived by using specific craft workers in building work.

Some legislative changes have improved the attractiveness of home ownership. In 2007, a new condominium act was passed, which should encourage apartment purchase. The law now permits 75% majority decision-making in building management in place of the previous need for unanimity, which makes repairs and renovations far easier to organise. Moreover, individual liability for common debts is now limited to a proportional burden only and operating expenses can be more fairly apportioned between households. Disputes are easier and cheaper to refer to the courts as well.

Currently, around 40% of total household wealth is in housing, either via owner occupation or residential investment. This proportion is less than in many higher owner occupation share countries, especially as many Germans rely heavily on state pensions for their retirement income needs and, so, do not have significant pension assets in their wealth portfolios. Recent government policy is ostensibly simultaneously trying to encourage greater reliance on private pensions and owner occupation. The latter has a pension link on the grounds that homeowners have smaller housing outgoings in retirement than do renters.

A new state-sponsored pension scheme (the “Riester pension”) has been in existence since 2002. Its aim is to increase personal pension provision and it is being utilised to encourage access to owner occupation as well. Between €10,000 and €50,000 from a person’s accumulated funds can be used to build or purchase owner-occupied housing located within Germany. The borrowed amounts must be repaid back into people’s pension funds prior to their retirement and the properties purchased must be occupied by them during their retirement. The feasibility of such a scheme shows the low level of mobility currently existing within German owner occupation.

[4] *OECD Country Report, 2004*

Many new owner occupiers organise the building of their own home on a plot they purchase – or, more precisely, arrange for an architect or building company to organise its construction. They then live in that dwelling for many years. This practice and the age and social characteristics of most owners mean that many homeowners do not move in a sequence of stages on a life-cycle housing ladder, as is common in countries such as the UK and USA. Moves earlier in a person's lifecycle occur within the rented sector and mobility is quite high within that tenure because of the low transactions costs of moving and the age profile of tenants. Once the move is made into owner occupation that home then tends to be the one in which a person lives for the rest of their life.

Important consequences of the organise-your-own-building, low mobility nature of owner occupation is that transactions are relatively low and existing home sales are concentrated in particular parts of the stock. Land plot prices are also an important indicator of demand in the new build owner occupied sector, but there is no way of knowing precisely when sites will in fact be built upon.

Thin and specific markets hinder clear consumer understandings of relative market prices and they raise home search costs. Agency costs are also high as overheads cannot be spread across a large number of sales, all of which is likely dissuade some potential house purchasers from actually making market transactions. At a more aggregate level, price information is harder to acquire in such market contexts and is of variable quality, although a number of new sources of house price information have emerged in recent years. The situation is made worse because an absence of price information from the major mortgage providers and property registries. The situation is improving, however, and the Association of German Mortgage Banks is planning to publish a quality-adjusted house price index from 2009 and to extend it to the local level.

As noted earlier, housing policy is mainly a regional rather than a national matter. This is said to be one reason why housing statistics in Germany are so limited, because the regions cannot agree on common frameworks nor who should pay to improve them. The regional Länder and local authorities have responsibility for housing and land-use policy and, as a result, can influence the local mix of housing tenures. Their powers are exerted in a variety of ways: through programmes related to housing renovation and urban renewal; housing subsidies; mechanisms for residential development land control; land ownership; via relationships with social housing institutions and with state-owned and regionally based co-operative savings and mortgage banks.

Two supply-side constraints, in particular, influence the expansion of owner occupation. Both arise because of regional and local government actions.

1. Land supply constraints There are sometimes difficulties in obtaining appropriate land supply because of regional or local government reluctance to allocate land in land-use plans. In areas of high demand, for example, there are general planning constraints on suburban expansion. These tend not to arise because of the NIMBY type factors common in the UK and parts of the USA, but rather because of the general policy preferences of regional planning authorities, which are increasingly concerned about sustaining extensive green space in the more urbanised regions for recreational and environmental reasons.

   Historically, planning constraints have tended to be temporal in the German system. The planning system is hesitant in the face of sudden increases in housing demand but, once new land-use plans are put in place, it may encourage over-investment in particular housing types. This is partly because plan formation tends to involve extensive negotiation between a wide variety of local agencies and subsidy commitments by some levels of government in order to achieve desired planning outcomes.

   This type of regional and local public policy framework helps to explain the belated surge in housing investment in the 1990s, some years after the initial post-reunification demand impetus arose. Similarly, the subsequent slow reaction to the fall off in housing demand from the mid-1990s may have had a planning element to it, because town expansion and renewal schemes were already in place and were difficult to turn off once in motion.

   Some local authorities are hesitant to sanction land release for owner occupation because they have to bear the full infrastructure costs associated with such suburban expansion yet face an uncertain, but lengthy, period before receiving revenue receipts from property taxes and state subventions as a consequence of those investments.

2. Fixity in the rental stock Another frequent supply-side constraint is associated with regional and local level policies that hamper the transfer of rental properties into owner occupation or into the ownership of landlords that are more strongly market driven. This has weakened in recent years with respect to certain large scale transfers. Even so, the security of tenure offered to existing tenants, under general federal enabling and Länder specific laws and policies, frequently gives landlords little opportunity to sell out, even when prices make the option attractive. Tenant associations are important lobbyists in local politics in a country where the majority of voters are themselves tenants. Generally, they are resistant to change – preferring the bureaucracies they can influence to the market forces that would undermine their power. These are significant factors in cities with a relatively high demand for owner apartments and large stocks of low yielding rental property, such as Munich.

   A general political economy point perhaps needs to be made. In owner-occupier dominant countries like the USA and UK, it is often argued that politicians favour owner occupation because they are chasing the marginal votes necessary to win office from homeowner households. By contrast in a country where private renting predominates, like Germany, the housing concerns of greatest interest to politicians wanting to be re-elected are more likely to be related to renting. Perceived threats to the status quo for tenants in private rental housing in Germany elicit media coverage and political responses that would be regarded as remarkable in high owner occupation countries. The liberally-minded judiciary are also more than likely than not to see the tenant as the underdog when interpreting evidence in any dispute with a landlord. Courts are loath to evict, for instance. Overall, the general institutional framework is more tenant than home owner friendly.

Rental Housing

Private renting

According to official surveys, the majority of private rental dwellings, around 10 million of them, are owned by small landlords and are concentrated in the West. A further 2.6 million are owned by housing companies throughout the country and a mix of institutions own the rest (about 1.5 million dwellings) – and they include financial institutions, real estate companies and non-profit organisations, amongst others. So, overall, around 30% of the private rental stock is owned and managed by professional firms and the rest is run by small landlords.

The scale of small-landlordism is unusual in Europe and has been sustained by attractive tax deductions. Tax breaks also probably account for the remarkably large number of lodgers recorded as living within owner occupied dwellings. Almost a quarter (23%) of owner occupied dwellings are said to contain lodgers, despite the fact that the more affluent parts of the population live in the tenure – a unique international practice. This statistical artefact helps to depress the apparent overall size of the owner occupied sector by bolstering the apparent number of tenants by 3.4 million households.

Rents are regulated both by broad federal rules and also by the policies of the 16 regional Länder in co-operation with municipalities, each of which has specific detailed rules that change periodically, creating a complex picture overall. The broad principle is said to be one of 'softening' of market rental movements, so most commentators conclude that rents follow market principles with a long lag[5]. However, there are insufficient studies to verify this claim accurately.

Rents are freely negotiated at the time when a household rents a dwelling. After that, however, rent controls apply. They may be linked to inflation or to rent levels in comparable dwellings, which are determined by the sheer weight of existing tenancies rather than by the relatively small number of current market transactions. If a dwelling's rent is less than in comparable ones, any increase is smoothed because it can only be implemented up to a maximum of 20% extra on the rent for three years. This means that overall rent levels lag far behind implicit current market rents when there is a sudden increase in demand or inflation[6]. The national rent index invariably increases at a slow rate. It only rose at around 1% a year between 2001 and 2005, for example, which is less than the general rate of inflation. The slow movement of rents and the disincentives faced by renter households to move within the tenure or into owner occupation suggest that rent controls actually more often than not determine so-called market outcomes rather than follow them.

[5] *This is argued, for example, in Structural Factors in the EU Housing Markets, ECB, 2003. See also Bundesbank Monthly Bulletin, September 2003*

[6] *Rent data from Bundesbank*

Nevertheless, rent controls have not been a political issue for some years now, because there is a general situation of oversupply in many localities and, so, market rents are either only rising gradually, or have actually fallen. Tenants also have less incentive to move into ownership in an era when house prices have been falling.

Tenants have security of tenure as long as they pay the rent and behave well, except in the rare occasions when a member of the landlord's family needs the accommodation or when the building is going to be replaced.

The IPD German residential index, based on the portfolios of nine institutional investors, showed a return of 6.0% in 2007. This was made up of a 3.4% cash flow return and 2.5% capital growth.

Social renting

Social housing means something different from elsewhere in Europe, as it does not refer to a specific set of non-profit housing providers with special relationships to central and local government, but rather to specific subsidy systems. The social housing subsidy system, moreover, can be used by private landlords and for low cost owner occupation. Dwellings only remain in the socially rented sector for as long as they receive interest rate subsidies, plus around ten additional years – which typically comes to approximately 40 years altogether.

Social housing institutions are in long-term decline following a switch in policy from supporting specific providers. Even so, many cities still have at least one publicly-owned property company providing housing[7]. These companies are organised within the Gesamtverband der Wohnungswirtschaft (GdW)[8]. Members of GdW lost the privileges of their non-profit status in the early 1990s, following a scandal surrounding the financial collapse of one of them, and are now treated as profit-making entities.

Privatisations and sell-offs

There have been some substantial sales of rental homes in the past few years by non-profits, industrial firms with residential estates and the public sector. Portfolios with a total of around 1.3 million have been sold to domestic and foreign investors. In general, funds aim to make returns in several ways: through renovations, sales to tenants, other disposals, managerial and financial efficiencies and hoped for future rent and price rises. Some investors had over-optimistic views of the returns that could be made and naively anticipated that Germany had 'missed out' on the housing boom and, so, would have one soon. As result, several recent purchasers have already sold out as returns have been lower than expected and highly leveraged purchases left some of them exposed in the credit crunch.

Public sector and municipal bodies still own around 4.5 million dwellings. Some city governments are reluctant to sell social housing and other parts of the stock have limited market potential.

REITs were launched in Germany following legislation in 2007 but housing has generally been excluded from REIT activities. They are not allowed to acquire pure housing investments as part of their real-estate portfolios and the residential element of mixed-use schemes has to be less than 50%. The no housing stipulation was put into the legislation following widespread negative political reaction to the consequences of introducing more market-oriented owners into the rental market. It was widely believed that if REITs became housing landlords they would operate less in the interests of tenants than occurs with existing institutional arrangements. Such a belief highlights the practical limits of market forces in German rental housing. The world financial crisis meant that 2008 was an unfortunate year to set up such vehicles and only two REITs were set up. However, more are expected to join them as financial markets improve.

In the East, the large rental stock was rundown at reunification, so that there has been extensive renovation and rebuilding. The programme of housing privatisation in the East has been far slower than was originally anticipated and vacancies are high. There are hundreds of thousands of vacant dwellings in the East, most of which will probably never be used as housing again. Demolition and renovation programmes continue. Similar measures on a lower-scale are also underway in the older industrial towns in the West.

Housebuilding

Housing completions fell by 16% between 2006 and 2007 and permits data suggested that another, though slight fall was in prospect for 2008. However, overall, housing investment was expected to show a moderate 1% rise. But economic slowdown will affect housebuilding in 2009, so another fall in housebuilding is to be expected.

[7] *In Berlin, for example, there are about ten public housing companies.*

[8] *The organization of the private housing companies is the Bundesverband Freier Wohnungsunternehme e.V., (BFW). However many companies are members of both organisations.*

Over the past fifteen years, the level and type of housing building have been strongly influenced by government subsidy and taxation policy. The scale of intervention had been so great as to make it worthwhile providing a brief overview of the whole period for, without it, recent fluctuations in housebuilding make little sense.

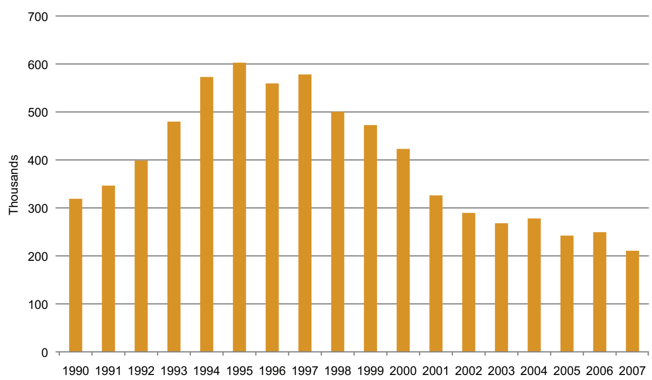
A major building boom occurred in the mid-1990s stimulated by the post-reunification experience. Policy makers over-reacted to temporary accommodation shortages and new housing production subsidies and tax breaks were rushed through. In addition, the government provided low interest loans for housing investment and further incentives were offered in the East under the Promotional Area Act.

The scale of the government primed housebuilding programme can be seen in Figure 7.2 and was out of all proportion to long-term housing demand, it transpired. By the mid-to-late 1990s, signs of severe over-building in many localities were apparent. This encouraged a downswing in the housing market and a rising vacancy rate, as excess supply came on stream and was only slowly absorbed. Even now, vacancies remain high, especially in the East – though this is not the case in the more economically buoyant metropolitan areas of the West. For example, Munich has a vacancy rate of only 1.6% compared to 4% for the country as a whole.

The overall aggregate effect of the 1990s building boom was substantial. Altogether 4.4 million dwellings were completed between 1991 and 1999 – with most of the units being small to moderate sized apartments – and the overall housing stock rose by a substantial 11%.

Housing investment in the 1990s - at 8% of GDP in 1998 - was far higher than normal. Its subsequent sharp decline had a significant impact on aggregate demand in the economy, with especially strong regional effects in the East. What level the trend annual rate of housebuilding will settle down to is hard to estimate in view of regional factors, demand adjustments to the new tax regimes, and uncertainties over population projections. It may well be the case that current housebuilding levels are still too high, especially for smaller apartments in weaker demand areas.

Figure 7.2: Housing completions 1990 - 2007



Source: Federal Statistical Office

Macroeconomic influences

Activity in 2008 slowed rapidly because of weak private consumption and poor export performance due to the global slowing. The fourth quarter saw intensification of the economic deterioration and, according to Bundesbank forecasts in December 2008, activity is expected to decline sharply over the winter period and not revive until 2010, with the expected upturn in the global economy. However, that recovery itself is also likely to be weak. The prospects for housing look poor in light of these pessimistic forecasts. Moreover, as the EU's largest economy, the state of the German economy is important for other countries' levels of economic activity, including that in their housing markets as well.

One feature of the economy has been inflation. Having moderated to only 1% in September 2006, inflation then accelerated and was running at over 2.5% in 2008. However, falling commodity prices and the recession are expected to curtail inflationary pressures sharply in 2009.

Unemployment was 11% on an internationally comparable basis in 2004 and remained high, although it had fallen slightly to 8% in 2008. The recession will push it up once again. Unemployment is concentrated in the East and in the older industrial areas of the West. One structural problem affecting the economy is the remaining huge economic gap between East and West. The process of adjustment in the East, and with it the evolution of a more typical housing structure still has a long way to go.

Mortgage market influences

The mortgage market relies on finance provided by one or other of the three pillars of the financial system: the commercial banks, the public savings banks or the co-operative sector. Via each route, a prospective purchaser may raise finance through loan packages. On offer are variable rate loans but more usual are mortgages with a rate fixed of five years or more – 10 years is the most common. There are prepayment penalties during the period for which the rate is fixed. In 2005, around 80% of the housing loans held by banks of all types were long-term fixed interest mortgage ones. Mortgages secured on housing may also be used for other purposes and are often a source of credit for the small business sector.

The country has a unique financial system and a large number of banks, with two-thirds of the total credit institutions existing in the euro area as a whole. Mortgage banks traditionally had the sole right to issue mortgage bonds in the capital market (Pfandbriefe). Their bonds are covered by the real estate (and marine) mortgages they hold in a matching process. A legal requirement is that these mortgages have first call on properties. High prepayment penalties and low mortgage default rates give confidence to bond investors with regard to the strength of the mortgage banks and their regulatory regime; especially a 60% limit on loan-to-value ratios and existence of strong capital bases and/or state guarantees of the issuing banks.

There seems little likelihood of significant changes in the German mortgage industry. The prepayment penalties have come into conflict with European Commission aims to liberalise cross-border mortgage lending but remain firmly in place.

The Pfandbriefe market, set up in the nineteenth century, has formed a model for others elsewhere in Europe and has fundamentally influenced the structure of mortgage lending in Germany. When combined with the three separate pillars of the German financial system – the private, state and co-operative - the nature of German mortgage offers begins to make sense to the uninitiated. For decades, the main mortgage banks have been subsidiaries of the universal banking institutions existing in all three of the financial pillars. Within the universal bank framework, a variety of mortgage packages are sold to owner occupiers and landlords structured around the bond-funded mortgage loan.

Consolidation within the banking sector is effectively limited to changes within each ownership form, because of the distinctive ownership structures of the co-operative and state-owned banking sectors. Some state banks have merged in recent years and some have got into difficulties through overambitious lending and investment strategies. There are few pressures for organisational restructuring, so a widely fragmented ownership structure remains. This limits the opportunities for scale-economies and innovations in the mortgage industry and reduces the opportunities to narrow spreads and cheapen borrowing costs for consumers. One of the major changes of recent years has been a lengthening of the potential repayment period, which now is possible for up to 30 years. This makes annual repayment costs more affordable as long as incomes are steady or growing.

The mortgage banks' monopoly access to covered bonds was abolished in 2005, following pressure from the European Commission which was worried about the competitive effect of the public guarantees previously given to state-owned mortgage banks. Now any licensed institution has access to the Pfandbriefe market. At the same time, regulatory and capital adequacy criteria have been strengthened to ensure that all licensed participants remain solvent in the face of financial shocks and, so, cannot threaten the virtually risk-free perception of the bond market with investors.

As elsewhere, institutions lending mortgages screen customers for their ability to repay a mortgage and loans can be advanced up to a 100% of a dwelling's value. However, such high loan-to-value ratios are uncommon. Loan offers may consist of a mortgage bond loan, which because of its security commands a good interest rate, and other elements with different repayment terms, degrees of security and interest costs.

The existence of the Pfandbriefe core to housing loan packages may confuse those not used to the German financial system into believing that loan-to-value ratios for residential loans are capped at a 60% ratio, which is not the case. 18% of new housing loans in aggregate have not been mortgages in the past few years, pushing average overall LTVs towards the 80% level[9]. Nevertheless, the typical 80% LTV ratio is less than exists in some other countries, especially for first-time buyers, and indicates that credit availability is more strictly rationed in Germany.

[9] *Bundesbank*

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Housing loans from building and loan associations, Bausparkassen, are common adds-on to bond funded mortgages. These institutions organise housing savings and loan schemes, whereby households commit to long-term savings contracts offering a below market interest rate in exchange for a similar termed loan advanced when required, providing that agreed savings thresholds have been reached. The total amount paid into savings and loan accounts in 2006 was €25billion, a relatively small but still significant part of housing finance activity. As with mortgage banks, most Bausparkassen are now parts of universal banks and their activities contribute to the mix of housing finance packages on offer.

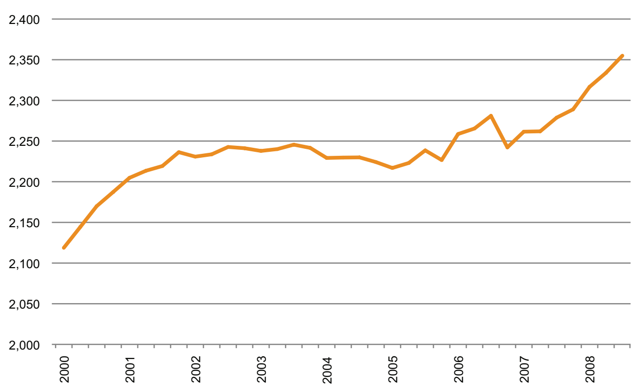
Competition in the mortgage market is high but is structured by some basic and unchanging procedures. Those rules not only militate against large loan-to-value ratios but also against a systemic bias towards generous valuations of properties, as seen in some other countries in recent years, because such a trend might undermine the Pfandbriefe market. The German mortgage system consequently has built-in conservative lending criteria that do not exist in many other countries' mortgage systems, which rely more on the perceived viability of mortgage issuers and their ability to limit the scale and consequences of defaults.

Mortgage finance volumes grew during the expansionary 1990s but since then the increases have been modest but have not contracted since the credit crunch as they have in some other European countries (Figure 7.3). There was a pickup in mortgage demand at the end of 2007 and by q3 2008 loans were 3% higher than in the year before. However, the deterioration in the economy after that is likely to have slowed expansion once again. Interest rate rises have been a significant dampener on housing demand since the second half of 2005. However, they may fall in 2009 (Figure 7.4).

A significant part of mortgage borrowing is used to finance rental housing, which has been an important factor in determining mortgage market behaviour, because many rental investors have experienced softening rents and falling capital values in recent years.

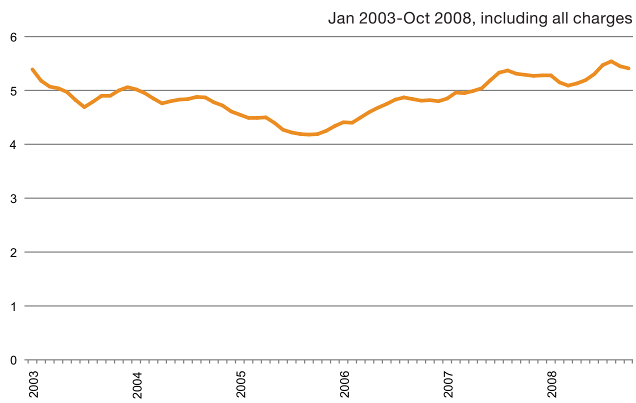
The depressed state of many local rental markets and the limited amount of social housebuilding in recent years have helped to flatten off mortgage growth – as these factors have probably led to more mortgage debt being paid off in those sectors than taken out. However, owner occupied housing's share of the mortgage market is greater than implied by its tenure share, because it tends to be associated with more expensive dwellings and larger per unit borrowings.

Figure 7.3: Housing loans 2000q1 - 2008q3



Source: Bundesbank

Figure 7.4: Average interest charges on new housing loans



Source: Bundesbank

Population trends

The population is falling slightly at present but is forecast to decline significantly. Recent estimates suggest that, at current birth rates, immigration levels and probable increases in life expectancy, the population will drop by 9 million to 74 million by 2050, a more than 10% decline.[10] However, population forecasting is an inexact exercise based on assumptions that may not hold, especially given the potential scale of future population movements within Europe, the geographic centrality of the country and the problems that will arise with an ageing society.

On current projections, a substantial 37% of Germans will be over the current retirement age of 60 by 2050 and ageing will have significant demographic effects in just a few years' time (Table 7.1). The current old-age ratio (retirees to people of working age) is 44 (i.e. 44 people over 60 for every 100 aged between 20 and 59). By 2020, this will have risen to 55 and by 2030 to a substantial 71.

An ageing society will have implications for pensions, health care and public finances and for housing. The demand for special needs accommodation for the elderly will grow exponentially; the number of single person households will rise; and the aspirations of an increasing affluent post-60 age cohort could have a substantial impact on housing demand patterns. Housing demand will become less locationally tied to employment and more influenced by personal relationships (to family and friends) and living preferences.

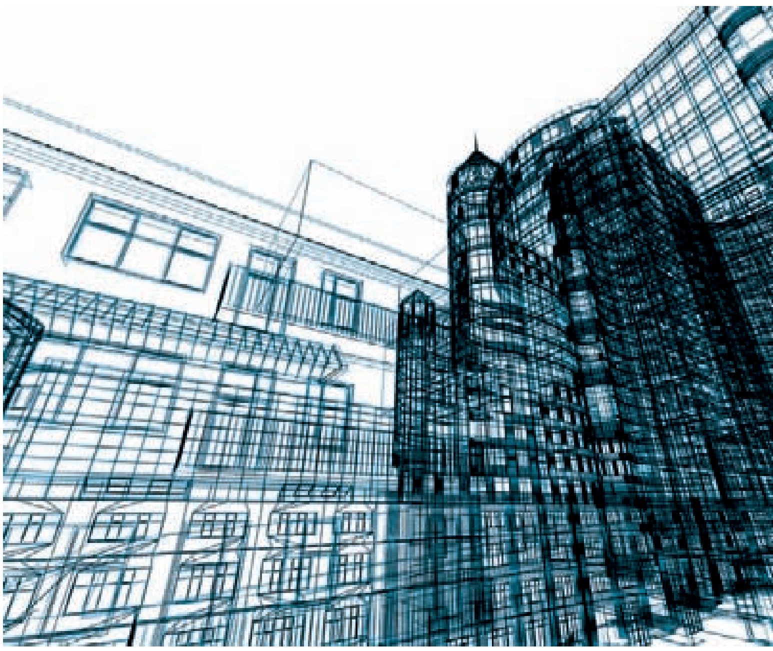
The implications for the housing market are made more complex by three other important demographic factors. First, household size should continue to fall and, so, lead to a greater demand for dwellings than implied by population decline alone. Second, the greater the fall in the population the more likely is there to be substantial internal migration towards the economically strongest regions and the most desirable retirement locations. So, the impact of any decline in housing demand will be geographically concentrated into a number of 'problem' areas and regions. Third, it is hard to believe that the country would go through a painful process of demographic adjustment without altering rules regarding citizenship and immigration. To an extent, the rules do not even have to change as economic forces will come into play. The rising earnings likely to come about with a declining labour force should encourage others with free access to labour markets (i.e. those from elsewhere in the EU) to move to the good German employment opportunities then on offer.

Currently, the country has far more foreign nationals living in it than any other European country in absolute terms: 7.3 million compared to the next highest country, Spain, at 4 million. In part, this reflects recent immigration but also the length of time and difficulty to acquire German citizenship in comparison, say, to France and the UK, something which, incidentally, encourages the propensity to rent.

Table 7.1: An ageing society

% of population aged:	2001	2050
Less than 20	21	16
60 and over, of which:	19	37
80 and over	4	12

Source: Federal Statistical Office



[10] *Federal Statistical Office forecasts*

CHAPTER 7: GERMANY

Factfile: Germany

Background

Population (m) 2006	Annual Population Growth %	Fertility Rate* 2005	Years Life Expectancy 2005
82.4	-0.1	1.4	79

*Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)

Economic

	2004	2005	2006	2007	2008f
GDP per capita purchasing parity standard based (EU27=100)	116	115	114	113	111
Real GDP growth %	0.8	1.1	3.2	2.6	1.4
Growth in real private consumption %	-0.3	0.3	1.2	-0.3	-0.6
Inflation – consumer prices % (HICP)*	1.8	1.9	1.8	2.3	2.5
Labour participation rate % (15-65 yrs old in work)	-	79	79	79	-
Employment growth	-	-0.1	0.7	1.2	-
Unemployment rate %	9.8	10.6	9.8	8.4	-

*2008 Oct y-o-y

Housing market

	2004	2005	2006	2007	2008f
Growth in residential investment	-3.6	-3.8	6.5	0.4	1.2

Taxes

Owner occupied housing: Mortgage interest relief – no

Capital gains exempt – yes

Imputed rental income – not taxed

Stamp duty – 3.5%

VAT on new housing – 19% (from 2007)

Property taxes as share of all taxes 2002 – 2%

Property taxes as share of GDP 2002 - 1%

Sources: Federal Statistical Office, Eurostat, OECD, World Bank

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Overview

Hungary has not had the rises in house prices experienced in some other central and eastern European countries in recent years. Prices did surge by 76% nationally between 1998 and 2001 and by even more in Budapest, with the greatest price growth concentrated in the new build market. But then price growth gradually petered out, with some revival between 2002 and 2004, as vote winning subsidies were withdrawn and fiscal austerity caused a sharp reduction in economic growth.

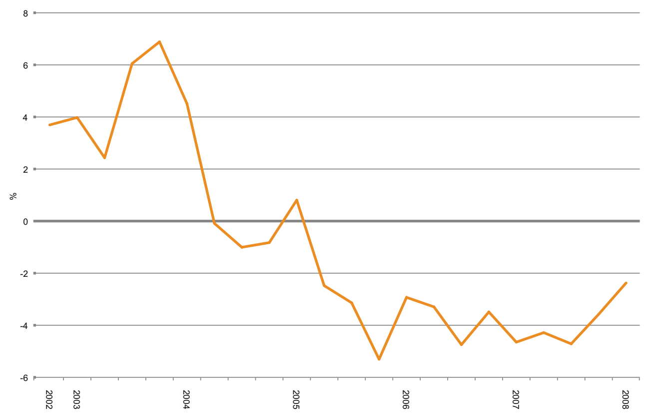
In fact, in real terms average house prices have been falling by around 4% a year over the past three years nationally, according to central bank sources – though there is no accurate house price measure (Figure 8.1). Transactions were also 10-15% down in 2008.

In nominal terms, the new build condominium market in Budapest, which is the sector that has been exhibiting the strongest price growth, recorded a 4% rise in 2008. However, given the country's relatively high inflation rate, such a rise meant a 1% fall took place in real terms. Existing house prices, for which transactions are greatest, saw no significant change in nominal prices at all.

The main causes of a subdued housing market in recent years have been the economic and public finance problems facing the country, which have limited consumers' spending power. However, housing supply was also growing relatively fast until 2007, which helped to moderate price pressure. During 2007 and most of 2008, housebuilding remained at relatively high levels. The existence of the credit shortages from autumn 2008 onwards is likely to result in sharply reduced building levels over the coming period.

Despite the country's general economic problems, the mortgage market boomed in 2006, 2007 and for much of 2008. This helped significantly to stimulate housing demand. More recent events since then indicate that mortgage borrowing is likely to be sharply curtailed in 2009. As in other parts of Europe, mortgage credit availability is likely to be the key driver of housing market activity in 2009 and beyond.

Figure 8.1: Real house price change 2002q4 - 2008q2



Source: Hungarian Central Bank

The intensification of the world financial crisis in autumn 2008 posed a considerable threat to the Hungarian financial system, but bank recapitalisation and assistance from the IMF and ECB steadied the situation.

Nonetheless, lending to households has been drastically curtailed; with higher interest rates and tightening loan conditions. What is more, households have mainly been borrowing in foreign currencies. Although new loans of this type have virtually dried up, existing borrowers are now exposed to substantial exchange rate risks and the threat of higher repayment costs.

Anecdotal evidence suggests that the housing market has been nearly frozen since the autumn but it is hard to judge the overall impact because key events have been so recent, but the picture will become clearer as 2009 progresses. There is general optimism that, as there has been no recent price boom, the downward readjustment of prices will be slight. However, there are a number of uncertainties which may lead to more difficult times than that. Amongst the factors that may tip the housing market into deeper problems are the freezing of credit markets and the associated cessation in interbank lending; the scale of the foreign-exchange loan exposure of households; the size of recent household borrowing; and the potential depth of the current recession. Adverse developments in relation to any of them could lead to higher loan defaults and a worse housing market outcome in 2009 that is being hoped for.

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The use of mortgages has expanded rapidly in recent years from a very low base. However, the total loan book is not much above 11% of GDP. Over the last few years, until the closing months of 2008, borrowing in foreign currencies eclipsed Hungarian forints (HUF) lending because of the much more attractive interest rates on offer. Foreign currency loans rose to 60% of net household borrowing in 2008. This currently represents a significant exchange rate risk to households' finances and to the housing market in general.

Housebuilding peaked a number of years ago in 2004 during the then housing boom. Although it subsequently recovered somewhat, it was still almost 25% less than that peak in 2007 but building was maintained during 2008. A growing development industry has been playing an increasing part in housing construction in recent years. It focuses on entry-level rather than upper-market accommodation, and in 2007 and 2008 almost matched in output individual 'organise-your-own' (OYO) building. However, the credit crunch is likely to affect the development industry badly and some firms may be forced to fold as a result. There is a lively second-hand market in cities like Budapest, especially for better-quality homes of which they are quite a number.

The existence of substantial transactions in the existing homes market and the relatively good supply of existing dwellings relative to demand have contributed to the lower level of price increases in the Hungarian housing market compared with those in several other central and eastern Europe countries, where the new build markets dominate recorded transactions and prices, even though such markets represent only narrow segment of their housing stocks as a whole.

A local property tax is being introduced in 2009. Its details are subject to local authority discretion, which means that its impact on the housing market is at present unclear.

The housing system

Housing standards are relatively better than the average for central and eastern Europe, though low by western European values in a country where the average standard of living is two-thirds of the EU average. There are not the absolute shortages typical of neighbouring countries, though inevitably insufficient housing exists in high demand areas, like Budapest. Nonetheless, substantial quality and repair problems remain in the existing stock.

At 93% of the housing stock, Hungary has one of the highest homeownership rates in both the EU and the world as a whole. There is a long tradition of owner occupation. Even in the 1980s, it was around 65% with virtually all of the remainder of households renting from the state.

Rural housing has traditionally been owner occupied and so has much middle-class urban housing. All the major cities have substantial neighbourhoods of relatively high-quality, middle-to-upper income residences built in the nineteenth and early twentieth centuries and some later pre-1950s housing. More parts of the existing stock correspond consequently to middle-and-upper income group housing aspirations than is the case for some of the other countries previously within the Soviet bloc, where low historic building rates, neglect, war-damage, demolition and industrialised building left poorer housing legacies.

During the shift to a market-based economy in the 1990s, there was a substantial programme of selling-off state housing. This greatly increased the amount of owner occupation and left only 4% of the stock in state hands. How much of the ostensible 'owner occupied' stock is actually rented out in full or part is unknown, so the 90+% figure may exaggerate the true incidence of owner occupation because of the existence of unrecorded privately rented dwellings. Even so, the owner occupied rate is clearly high.

The lack of significant formal rental housing markets has implications for mobility and the ease with which new and moving households can obtain accommodation. A feature of the current housing situation is a low level of mobility. A typical person moves 2.7 times in their life compared to 6 or 7 times in western Europe.

Sales of previously state-owned flats have mainly been on a condominium basis. This has had consequences for the privatisation of housing. Many apartment buildings ended up as mixed tenure ones with local authorities remaining responsible for them. In Budapest, for example, the number of local authority-owned dwellings fell from 150,000 in 1996 to only 63,000 towards the end of 2000; yet, the number of residential buildings owned or part owned by the local authority fell by only 1,500 to 16,000 over the same period. At the end of 2007, over 13,000 residential buildings were still linked to the municipality: over 11,000 of them multi-dwelling residences of mixed ownership[1].

[1] *Central Statistics Office*

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The total housing stock in 2005 consisted of 4.2 million dwellings. The average dwelling size is 75 square metres (63 in Budapest) and there were 2.4 people per dwelling. The stock is relatively old, with around a quarter built before 1945 and only a limited amount constructed since 1990. Almost 70% of the housing is single family and another quarter is in 2 to 4 storey structures, so high rise flats are far from the norm. The situation is very different in Budapest, however, where a quarter of the stock is apartment blocks of 5 storeys or more and less than a third is single-family[2].

There are quality problems in the housing stock, although improvements are being made with demolitions of some of the worst and renovations of others. A significant amount of housing lacks facilities, with around a quarter of dwellings failing to meet the official comfort standard. Many also lack one or more basic amenities, especially in rural areas and small towns. For example, over a third of dwellings have no link to public sewerage[3].

Maintenance is also an issue. Recent surveys suggest that only a quarter of dwellings require no repairs, around two-fifths need partial restoration, and another fifth need full restoration. The situation is worse in Budapest, where only 10% of dwellings require no works and 38% full restoration or demolition[4]. In addition, many rural houses, especially those built prior to 1990, utilised poor quality building materials and building labour of limited skill and as a result can be in bad shape. The dwelling backlog requiring substantial investment is consequently large and will take many years to work through.

Today in the larger cities, the stock is made up of four main housing types:

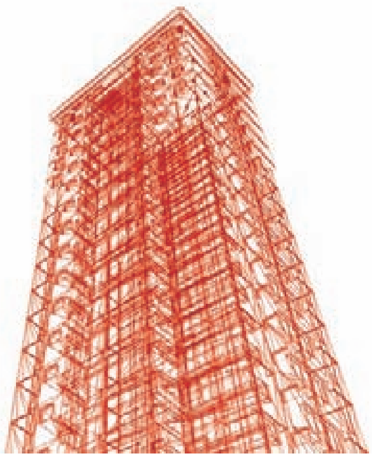
- inner city multi-family buildings built at the end of the 19th century or during the inter-war years
- single family housing in suburban and semi-urban settings
- housing estates from the centrally planned economy era – often large scale – comprised of 5-10 storey buildings, built in suburban locations
- Recently-built single family and condominium properties.

During the 1970s and 1980s most urban housing construction utilised industrialised large panel and other concrete systems, producing standardised flats on large housing estates with around 55 square metres of living space. A fifth of the population, 2 million people, now live in such dwellings[5]. Many of these buildings are in a poor state of repair and have bad insulation. However, not all of them are necessarily at the bottom end of the housing market in terms of relative prices. According to Otthon Centrum, better quality ones with improved insulation, energy-saving services and, most importantly, their own meters for measuring energy use may command at least the same prices as equivalent brick-built dwellings in the same neighbourhood.

Low income people who have remained tenants cannot afford the higher rents of improved properties and local authorities have been reluctant to subsidise improvements. Many new owners have also been reticent to provide their financial contributions to the repair and improvement obligations that came with ownership, either because they cannot afford them or do not want to pay for some other reason. The law was uncertain about the enforcement of repair obligations until recently when contributions to collective building repairs became compulsory.

In 2001, the government introduced a subsidy scheme to aid refurbishment, and to date most of the expenditure has been on insulation. However, the programme is small in scale and so it has only had limited impact.

General government housing subsidies have varied substantially over the past decade. Some programmes were blatant pieces of electioneering, which subsequently had to be clawed back. Yet the overall level of general subsidy remains substantial and represents a significant public finance burden.



[2]Central Statistics Office
[3]Central Statistics Office
[4]Central Statistics Office
[5]Ministry of Interior

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A wide range of subsidies aimed at the owner occupier market or parts of it have been introduced at various times. They include interest rate subsidies for housing-related savings deposits and for mortgages; aids to condominiums to renew common areas; grant subsidies for younger couples with children to construct, enlarge or buy homes; VAT relief for new housing; tax breaks on capital repayments; and stamp duty wavers. Complex stipulations and caps were imposed but, overall, the subsidies have been generous. The scale of some is influenced by market behaviour. For example, in terms of interest repayments, foreign currency mortgages were for a number of years until late 2008 cheaper than state-subsidised for int-denominated loans. This limited the latter's attractiveness and so kept the resultant subsidy down.

Changes in the tax and subsidy rules for housing have on occasion led to sudden changes in housing market activity overall and in particular arenas, as, for example, with the criteria for the interest rate subsidies on mortgages. The latter were initially set up on the basis that the government would pay the difference between a specific borrower interest rate and the one charged by lenders. At first the scheme was only for new dwellings but it was then extended to existing ones as well. Such an open-ended subsidy to better-off households could not last. Unsurprisingly, the programme was cut back – but not abolished - in a crisis economic reform programme in 2003. Curtailment caused the loans market to fall rapidly in 2004, depressing the housing market in turn.

The justification for most housing subsidies on economic terms seems scant, particularly as they target only current incomes or family circumstances, rather than specific groups that permanently find housing finance difficult. Part of the benefit of subsidies is also likely to percolate through to other market participants rather than remain with initial beneficiaries. For example, interest rate related subsidies benefit the financial institutions providing mortgages. Such indirect effects further lower the justification for subsidies ostensibly based on social concerns.

Many subsidies are used to assist with transactions in the existing home market, rather than are solely related to new homes; in part because lower income borrowers cannot afford new dwellings. One outcome is that this has incentivised more people to declare property transactions than is the case in some other central and eastern European countries.

The extent to which the trajectories of house price changes have been influenced by the subsidy regimes is unclear. The boom that peaked in 2004 had a strong subsidy aspect to it. There are likely to be other substantial effects. They have affected the timing and amplitude of market fluctuations in overall price levels and, in addition, relative property prices. In addition, they redistribute costs and benefits across households, often in inequitable ways.

Several changes have been made in property taxation. From 2008, capital gains tax changes have been made. Imposition of it has been reduced from sales in the first 15 years of ownership to only for the first five years of ownership. At the same time, the previous allowance made when calculating the tax of excluding sales' proceeds used to purchase a new home has been abolished. Furthermore, a local property tax comes into existence in 2009. It will be charged at a rate up to 5% of the values of building and land plots, with the details subject to local authority discretion. The luxury tax already charged on private owners of residential property worth more than HUF100 million has also been extended to companies in order to tighten up on tax avoidance.

Housing transaction processes, as elsewhere in central and eastern Europe, are not as easy, certain or as cheap as they should be. In 2004, a land and property registration law was introduced which is gradually improving matters with respect to title. More market information is likely to emerge over time as the government is committed to utilising and publicising the information on property transactions provided by tax collecting and title registry agencies.

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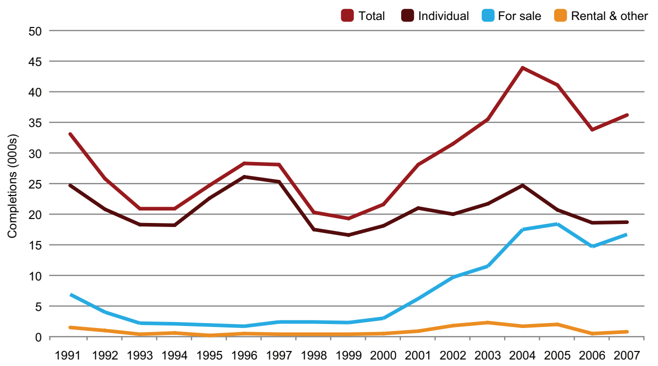
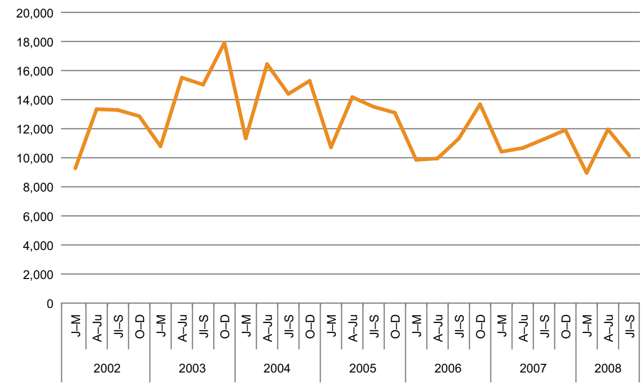
Figure 8.2: Housebuilding by type of developer 1991 - 2007



Source: Central Statistics Office

Figure 8.3: Building permits issued 2002q1 - 2008q3



Source: Central Statistics Office

Housebuilding

Up to the 1990s, most of the 80, 000 to 100,000 houses built annually were in the social sector. Output was not directly geared to assessments of consumer need but rather had become an integral part of the then centrally-planned economy in which a production machine had to be fed whether or not it satisfied consumer preferences. Social housebuilding then virtually ceased after 1990, although there was a slight revival following the introduction of investment subsidies in the early 2000s. They were subsequently abolished and social output fell to a negligible level again (see the 'rent and other' category in Figure 8.2).

Following the demise of social housebuilders, Organise-Your-Own (OYO) building remained the principal form of housebuilding. It is undertaken by individuals managing the construction of custom-designed, or generally fairly basic, single family units on plots of land they already own or have recently acquired. OYO output has been subject to cyclical variations over time and has been on a slight downward trend. Output in this sector fell by a quarter from the most recent cyclical peak in 2004 to 2007, though it rose slightly during the first nine months of 2008 (Figure 8.2).

The general market in new housing for sale is a fairly recent phenomenon. There were only a few developers in the 1990s and they focused on the rarefied upper-end of the market. Housebuilding for sale really took off when the state mortgage interest subsidy regime was introduced in the early 2000s. From being measured in the hundreds, developers' output grew to over 18,000 units in 2005, which was 45% of total production, nearly matching that of OYO building (Figure 8.2). However, in 2006 housebuilding for sale began to decline as the state's fiscal reassessment bit into housing market subsidies and the economy and general consumers' expenditure faltered. Construction revived somewhat in 2007 and broadly held up during the first nine months of 2008, with only a 3% year-on-year fall in build-for-sale completions recorded[6]. But since then the building industry has became badly affected by the credit crunch.

Banks have reined back loans to developers as well as to households, forcing many to halt projects. Furthermore, once schemes are underway they are difficult to stop until built out. Builders have faced significant rises in costs due to rising wages and commodity prices. As the demand for new housing is rapidly declining, developers' finances are being squeezed and a significant number of developers may fail during 2009 as loans are called in.

There has been marked cyclical behaviour in housebuilding levels since the early 1990s, as Figure 8.2 shows, with much of the fluctuation resulting from shifts in public policies towards housing. For example, output more than doubled in the five years up to 2004 and then fell back as subsidies were cut and the economy faltered, even though they remain substantially above the low 1990s levels.

[6] *Central Statistics Office*

For sale output is predominantly built by large-scale firms, many of them foreign. The foreign ones have the financial muscle, the marketing credibility and the economies of scale necessary to succeed. The typically smaller domestic firms are less able to cope on a sustained basis, particularly in raising credit. Hungarian firms are said to be crowded out of the most prestigious, central Budapest areas by foreign firms more able to pay for land and to persuade foreign buyers to purchase their products. British, German, Austrian, Spanish, Israeli and Italian firms have been active in the land market, buying up land. However, land prices in the first half of 2008 were flat and even falling in some areas. Greater interest has been shown in refurbishment and conversion of existing buildings and mixed-use schemes in Budapest as building land in the more attractive and central areas has become scarcer. Foreign firms have also moved out from central Budapest to suburban areas, to other large cities, and to the Lake Balaton holiday area[7].

Building permits, a good leading indicator of future output, started to decline in 2004 and were down 24% on their 2003 peak by 2006, although they levelled off in 2007 and 2008 up to September (Figure 8.3). Expectations of future building requirements consequently did not seem to have factored in any major slowing of building but the reinforcement of the financial crisis in autumn 2008 is likely to result in a significant reduction in permit applications in 2009.

Macroeconomic influences

A fragile economy has contributed substantially to housing market weakness. Growth up to 2007 was around 3-5% yearly. However, it slowed substantially in 2007 to 1.1%. It picked up in the first half of 2008 – with the economy falling into recession in the year. The impact of global financial problems is expected to lead to negative growth in 2009 of minus 1.7%, according to central bank forecasts.

The economy has faced big problems with a large government deficit, running at over 9% of GDP in 2006. Since then a squeeze on private and public consumption, including a government austerity package, has reduced it to around 3.5%. The deficit was primarily caused by political parties propelling themselves into power through unsustainable populist fiscal measures, such as the early 2000s mortgage interest subsidies. Once in place, such measures then prove politically difficult to undo. There have also been chronic problems with tax collection. To make matters worse, there is an associated balance of payments current account deficit of around 6% of GDP.

Inflation was high in the 1990s and then moderated, falling to below 4% in 2005, after which it rose again. A sharp spike of almost 8% was reached in 2007, partly due to the government's austerity measures and also because of imported inflation. The slowing of the economy in 2008 brought inflation down to around 6.5% and it is expected to moderate further in 2009. However, the burst in inflation and the scale of government deficits have removed any hope of accession to the euro area for some years to come.

Unemployment is high at 7% and is rising and expected to reach 9% in 2009. Employment growth has been non-existent for a number of years and wage inflation remains high in the service sectors. The percentage of the population of working age in employment at only 61% is significantly lower than in western Europe. So, labour market developments are not helping housing; yet neither is housing helping labour market flexibility and utilisation.

Mortgage market influences

Up to the 1990s, mortgage debt was around 15% of GDP and most of it was used to fund social housebuilding. This finance market all but disappeared by the mid-1990s as old debts were paid off and housebuilding and associated mortgage loans sank to low levels. The use of mortgages really picked fromup 2002, following the government mortgage subsidy schemes mentioned earlier. Subsidies were also made available to support the issue of mortgage bonds to encourage the evolution of a bond market. After the advent of such generous subsidies borrowing boomed, so that by the end of 2007 outstanding mortgage loans were close to 3.0 trillion HUF. This was a substantial increase in such a short time period but the market overall is still small-scale by western European standards as it still represented only around 11% of GDP in 2006[8].

[7]*Otthon Centrum Residential Market Monitor 2007/2 & 2008/1*
[8]*European Mortgage Federation*

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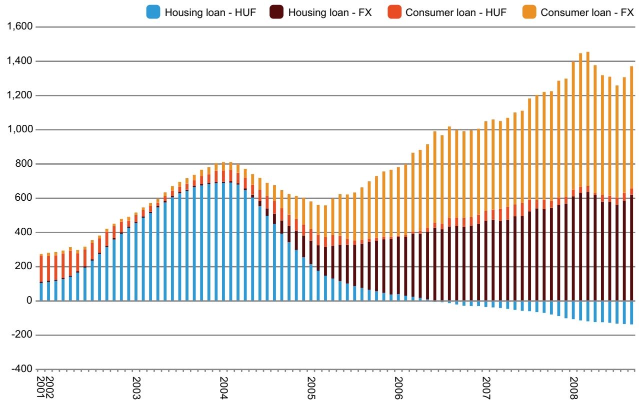
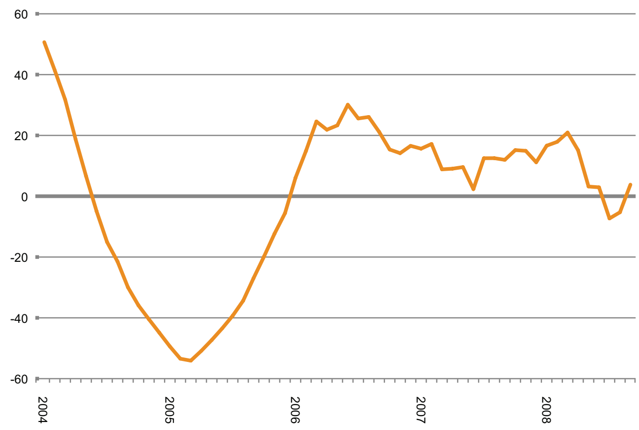
Figure 8.4: Household loans by currency denomination Dec 2001 - Sep 2008



Source: Central Bank

Figure 8.5: Growth rate in housing loans Jan 2004 - Sep 2008



Source: Central Bank

Mortgages denominated in foreign currencies (FX) grew dramatically from 2004. From hardly existing previously, FX mortgages had crowded forint-denominated ones out of the new loans market by 2006, with more forint loans being repaid than issued since then The most common currency used has been the Swiss franc but banks offer a wide variety of options, including the Japanese yen. The great attraction of FX loans was the much more attractive interest rates on offer with them. Consumer lending also grew substantially over the same period, much of it again in foreign currencies, so that loan levels were twice as high in 2008 than in 2005, though net lending declined slightly during the first half of 2008 (Figure 8.4). However, the continued strength of the loans market came to an abrupt halt in the last quarter of 2008 with escalation of the financial crisis.

Household loans have fluctuated in line with recent behaviour of the economy and housing market. Net housing loans peaked early in 2004, and then fell in 2005, only to expand rapidly over the next three years. They even grew significantly after the onset of the worldwide credit crunch, during autumn 2007 and the first half of 2008 (Figure 8.5).

Consumer lending rose even faster from 2005. In 2003, it had represented less than 10% of the net flow of household borrowing but by 2008 it was over 60% of all net borrowing. Such consumer lending is obviously of importance to the housing market. The ability of consumers to service such loans influences default rates on housing loans and the desire of consumers to contemplate housing purchase.

The intensification of the credit crunch in October 2008 led to a sea change in bank lending practices, as many commercial banks announced that they would stop lending, or at best severely limit, FX loans. Loan spreads were also significantly increased, particularly for new borrowers. The use of intermediaries in the selling of mortgages, which had reached half of all originations in 2007, was also sharply curtailed. This was partly due to the existence of diminished competition, so that banks felt less obliged to use this route but, also, because originations by non-bank agencies were regarded as potentially more risky types of loan.

The downside of borrowing in a foreign currency, of course, is the exchange rate risk incurred and the past year has seen significantly greater exchange rate volatility, exposing borrowers to such greater payment risks. The central bank has expressed concerns about the lack of financial sophistication of many borrowers, who generally do not factor exchange rate risks into their decision-making.

If households continue to face considerable increases in their monthly outgoings during 2009, due to interest or exchange rate pressures, a wave of defaults could threaten the housing market. More optimistically, it is mainly better-off households that are involved in house purchase and they as a group are more able to bear the burden of negative shocks without defaulting.

Loan products have also been cut back since October 2008 and lending criteria significantly tightened[9]. The overall result will be that lending is likely to fall significantly during 2009, lowering housing demand. Furthermore, because of the withdrawal of FX lending, state-subsidised forint loans are likely to become attractive again. A side-effect of that will be to raise housing-related public expenditure at a time when major attempts are being made to cut back state spending.

The mortgage market is dominated by two major Hungarian firms, OTP with 80% of general banking business and around 60% of mortgages and FHB, the Land Credit and Mortgage Bank. Foreign banks from Austria, Belgium, Germany and Italy have entered increasing the degree of competition. Expenditure on marketing has been growing and many new branches have opened. The overall market share of the top five lenders in new housing loans was 68% in 2007, according to central bank estimates.

The profitability of banks operating in Hungary has been high, according to the ECB, due to the margins earned on loan business. The margin on housing loans has been particularly great. It was 5-6% on the credit institutions' outstanding housing loan portfolios at the end of 2005, according to central bank estimates. It attributed this partly to weaker price competition in comparison to elsewhere, including other central and eastern Europe countries. Spreads have altered since then, narrowing first as competition intensified and then widening as the credit crunch hit home.

Demographic influences

Demographics are playing an important part in stimulating housing demand, with strong growth in the number of households, especially in the metropolitan regions. In addition, there is an exceptionally large proportion of the population in the 20-24 years old age cohort and they are now entering the housing market as first-time buyers or as tenants.

The population is also ageing, which is contributing to a growth in single person households. Forecasts suggest that the percentage of the population aged over 65 will rise from the current 15% share to 21% in 2025 and 29% in 2050.

Over the longer-term, some falls in the size of the population is expected. It has already dropped slightly over the past decade. The fertility rate is significantly below replacement levels (see Factfile). The actual scale of the change depends on assumptions made about lifestyle choices[10]. If they remain as at present, the population will dip by almost 0.5 million (out of a current 10 million) by 2020 and then remain at around that level. Alternatively, if the household formation habits of the old EU15 prevail, the decline is likely to be much greater with an 800,000 fall by 2020 and a huge 3 million fall by 2050 - although this latter prediction is likely to be unrealistic as it assumes no inward migration, which is unlikely in what will by then be a far more affluent country.

Notable spatial shifts in population are occurring as identified in a recent study of census data, with movements of population from the rural east and the older declining industrial regions. The prime growth area remains the Budapest region. Yet, Budapest itself has seen the loss of 0.5 million people over the past decade as processes of suburbanisation take place.

[9] *Central Bank*
[10] *Central Statistics Office estimates*

CHAPTER 8: HUNGARY

Factfile: Hungary

Background

Population (m) 2006	**Annual Population Growth %**	**Fertility Rate* 2005**	**Years Life Expectancy 2005**
10.1	-0.3	1.3	73

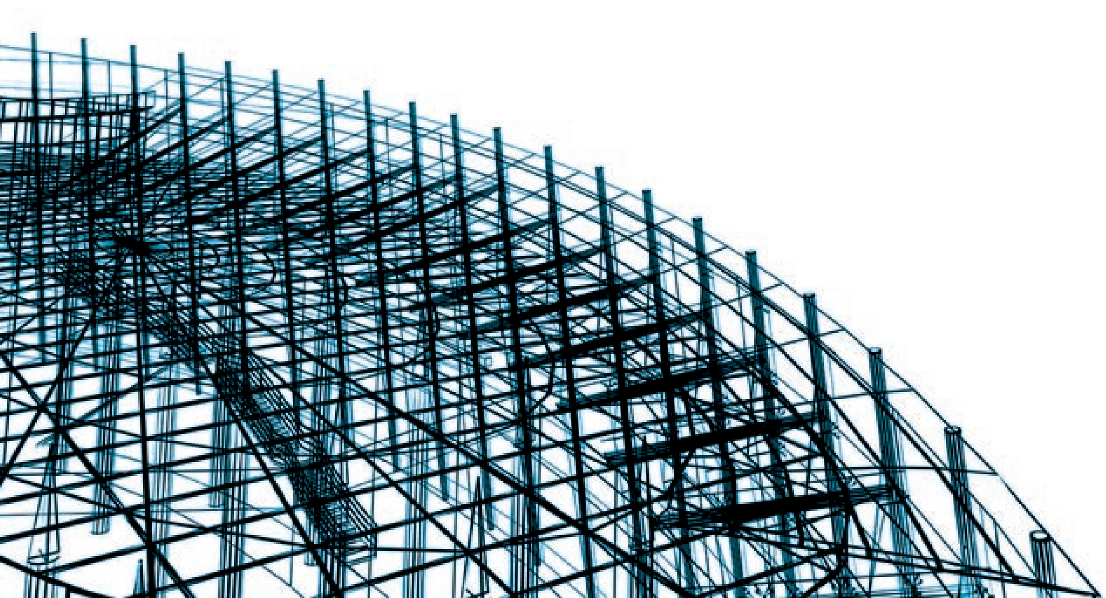
*Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)

Economic

	2004	**2005**	**2006**	**2007**	**2008f**
GDP per capita purchasing parity standard based (EU27=100)	64	64	65	63	63
Real GDP growth %	4.9	4.2	4.1	1.1	1.4
Growth in real private consumption %	3.1	3.4	1.7	0.6	1.2
Inflation – consumer prices % (HICP)*	6.7	3.6	3.9	7.8	5.1
Labour participation rate % (15-65 yrs old in work)	-	60	60	60	-
Employment growth	-	0.0	0.8	0.3	-
Unemployment rate %	6.1	7.2	7.5	7.4	7.9

*2008 Oct y-o-y

Sources: Eurostat, OECD, World Bank.



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Overview

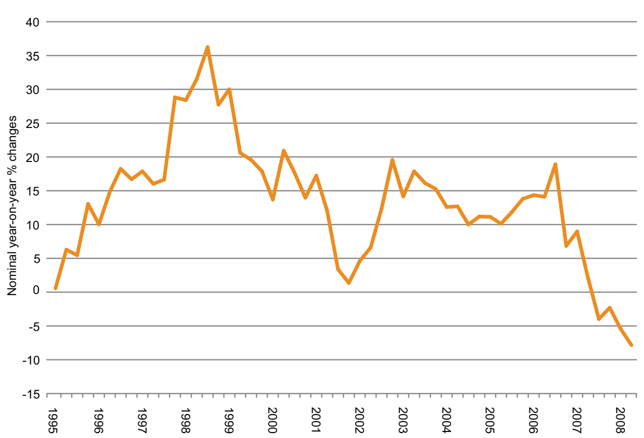
Year-on-year prices were down by 9% by December 2008, according to the ESRI/permanent tsb index. House prices had by then fallen by 15% from their early 2007 peak. The prospect for 2009 is for further price reductions as a major housing market correction continues.

Other indicators of market activity in 2008 also showed that the rate of decline is still substantial. Housebuilding was 53% down by year end from its peak in 2006. The number of mortgage loans had fallen by 48% in 3q 2008 from their level two years previously.

Ireland's previous house price boom had been the longest and strongest in Europe (Figure 9.1). It was driven by a buoyant economy, positive demographics, easy credit, and falling interest rates. By 2006, real house prices were 2.9 times higher than they had been in 1996.

The change in price performance after 2007 marked a dramatic shift in market sentiment. The myth that house prices would never seriously fall in Ireland has been punctured. This could lead to a sea-change in attitudes that will probably affect purchaser and lender expectations for many years to come.

Figure 9.1: Existing dwelling prices, 1995q1-2008q2



Source: Housing Statistics

The current softness of the market can be attributed to a number of factors. The credit crunch has obviously played an important part by affecting both the availability and the cost of credit. However, the market has already been slowing in the months before the onset of the credit crunch with prices dropping by 3% between February and August 2007. Rising interest rates, stretch affordability and high levels of supply all contributed to that weakness. But the curtailment of mortgage lending from autumn 2007 then greatly intensified the downward pressures in the housing market. Consumers and investors, in turn, put off house purchases in a falling market. The slowdown then accelerated with the number of new mortgages issued down in 3q 2008 by 32% on the previous year (37% by value) and only half the number of those of issued two years before, according to the Irish Banking Federation.

The collapse of the housing market helped to plunge the wider economy into deep recession, with GDP falling by almost 2% in 2008. This has led to a vicious cycle in which a declining economy further dampens the housing market that then lowers overall growth once more. Such feedback effects have been particularly important in Ireland because of the previous importance of housing in the economy as a whole. At the peak of the boom, one in eight jobs was linked to housebuilding and related construction.

Affordability had been severely reduced by the sheer scale of previous house price rises, although the current round of price falls is gradually improving the situation. The EBS/DKM affordability index suggests that affordability will be back at early 2005 levels for first-time buyers by January 2009. Vacancies have also risen substantially in rental markets and rents have started to fall as well.

Buy-to-let has been important in housing market activity. At the peak of the boom, residential investors were reported to be buying around a third of the new dwellings produced in the Dublin area. In 2008, investors still accounted for 17% of all new mortgage borrowing. Yet they are facing falling rents, declining capital values and rising mortgage costs, so they are no longer such important purchasers of housing as they once were. In fact, there is now a risk of significant defaults amongst them.

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A severe overhang of housing supply is helping to precipitate further price decline. At the end of the boom, the country was producing a record level of housing output. It reached a remarkable 16% of GNP in 2006, whereas 3 to 4% is a more typical European figure. Although supply has been tumbling in the past few years, demand has been falling even faster. Builders try to chase would-be purchasers with price cuts and other inducements but buyers are scarce. Unsold stocks remain high and output is likely to fall much further in 2009 as a result.

Irish households are now some of the most heavily indebted in the Europe. Mortgage lending reached 135% of personal disposable income in 2006[1]. Consequently, there is a prospect of rising defaults and negative equity, especially amongst those who bought near the peak of the boom. However, defaults have been at extremely low levels, measured in the hundreds. Furthermore, though some recent borrowers may have little of their own equity in their properties, many others have a large cushion of housing equity. Central bank staff recently estimated household net worth at almost 680% of the value of net disposable income, even after a year of falling prices[2].

The economy is expected to continue to decline in 2009 by roughly the same amount as in 2008. With mounting problems in the world economy such forecasts may prove to be optimistic. Interest rates are likely to fall and most current lending is at variable rates. But lenders are concerned to improve margins, so not all of interest rate reductions are going to be passed onto borrowers. What is more, the potential benefits of falling interest rates are being offset by weak economic prospects and pessimism about future house price changes. Continuing housing market decline is in prospect and it may be some years before sustained recovery occurs and, even then, price growth may remain feeble for far longer.

In the Budget Statement of October 2008, several measures were introduced in the hope that they would stimulate housing demand. However, the overall impact was modest with tax reductions in some areas offset by increases elsewhere. The central bank has cautioned against taking measures to resist what it regards as a necessary readjustment in property values.

The most important Budget change was a rearrangement of some elements of mortgage interest tax relief arrangements, which were previously capped for everyone at a tax rate of 20% and only applied during the first seven years after purchase. From 2009, first-time buyers (FTBs) who have bought since the beginning of 2005 are going to have their rate of tax relief increased from 20% to 25% for the first two years after purchase, and to 22.5% in years 3 to 5, with the rates for the final two years staying the same at 20%. To fund this change, the relief for non-FTBs was reduced from 20% to 15%. The tax gains for FTBs were offset by a 1% tax increase on all income up to €100,000 and 2% on the balance above that. In addition, the loan caps on an existing local authority mortgage scheme were increased and a single government initiative was introduced that consolidates and somewhat expands previous equity share arrangements.

The housing system

The country has one of the highest home ownership rates in the EU with a recorded 75% of households living in the tenure (80% according to a recent ESRI survey). Roughly half own outright and the other half are paying off a mortgage. A further 10% live in social rented housing, which consists of local authority dwellings and various forms of voluntary and co-operative housing. Another 10% are in the private rented sector[3].

The emphasis on house purchase is encouraged by the tax system. There is mortgage interest tax relief (at the new rates described in the previous section) and no taxes on imputed rents or capital gains. There is also no local property tax. By contrast, stamp duty on purchase can be quite high, rising in steps to 9% for the most expensive properties. The incidence is complex, especially as several types of purchaser and property have been given exemption. For example, first-time buyers now no longer incur the charge, nor do purchasers of new dwellings with floor areas of 125 square metres or less.

[1] *CBFSAI*
[2] *CBFSAI July 2008 Quarterly Economic Bulletin*
[3] *CSO*

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There is a long history of poor housing conditions. In 1980, the country had the lowest number of dwellings per thousand inhabitants in the old EU. It still has worse housing conditions than other countries with similar living standards, despite the recent building boom, with floor areas per person of around a fifth less than the western European average[4]. Household size is also relatively high at 2.94 persons in 2002, though it had improved from 3.34 in 1991[5]. Undoubtedly, the historic lack of dwellings was a root cause of the recent long housing boom.

The strength and extent of that property boom means that the country has the youngest average age of dwellings in the EU. Overall, the construction industry contributed almost a quarter of GNP at the peak of the building boom, much of it from housebuilding and other housing activities, such as repair and refurbishment[6].

The structure of dwelling types is unusual for the EU in that there are very few apartments and multi-occupancy structures. A large number of dwellings (45%) are detached houses (frequently single-storey bungalows); a further 29% are semi-detached; and 23% are terraced. Only around 3% of dwellings are apartments, though in Dublin a far higher share are bed-sits or apartments (14% of dwellings)[7]. Over three-quarters of new housing consists of the bungalow, detached and semi-detached types, with around a fifth being apartments.

The general type of housing built is land intensive and standardised in form. This leads to spread-out suburbs, both around Dublin and in other growth areas further afield. This urban form gives rise to long commuting journeys on a frequently overstretched infrastructure network. Land supply constraints near the major cities have been encouraging spread out development and reports have called for a more economically and environmentally sustainable living pattern[8].

A report by the UK's Policy Exchange think tank has argued that the Irish planning system creates too many 'starter homes', of often mediocre quality on monotonous estates, and allows insufficient quantities of larger, better quality properties. The lack of better properties is fuelled house price inflation, it argues, so that the high headline housebuilding figures give a misleading picture of the true supply situation[9].

Social housing

Social housing includes both the local authority housing and voluntary non-profit housing sectors. The sector is dominated by local authorities with 8% of the total housing stock, while the voluntary sector has only 2%.

Social housing completions accounted for less than 10% of all new building by the late 1990s. Since then, the number of new social housing units has been rising on a trend basis to average around 5,600 dwellings a year between 2002 and 2007. Yet, with the boom in private housebuilding, its share of output did not increase until the onset of the current building slump. It had reached 16% of all output by q2 2008 and its share is likely to rise further, while the downturn continues. There are long waiting lists to enter this type of accommodation because the subsidised rents are far lower than those charged in the private sector.

Local authorities also run affordable housing and shared-ownership housing schemes. However, the aggregate impact on new private supply is small, providing 3,216 new dwellings out of a total of 90,000 in 2006. Affordable housing schemes involve local authorities in partnership arrangements with private developers, whereby developers construct dwellings for sale at below the market price with local authority subsidies. Around 1,700 local authority dwellings are also sold each year and the number has been rising[10]. 5% of households receive housing allowances.

New subsidised housing has been made available under the provisions of the Housing Planning and Development Acts 2000-2002, whereby developers have in principle to allocate 20% of land to social uses. In all, 2,198 units were created in this way in 2006, mainly of affordable housing, plus a number of serviced site and land transfers to local authorities and payment of almost €40m in financial contributions from developers[11].

Private renting

The private rented sector is roughly the same proportionate size as that in the UK and, like it, operates on broadly free-market principles with market-based rents and limited security of tenure. In earlier years, it was relatively small and rundown but with market liberalisation and the house price boom, investors poured in, so that many landlords are recent entrants.

[4] *Housing Statistics in the EU 2005/6*
[5] *CSO*
[6] *Review of the Construction Industry 2007 and Outlook 2008-2010, DKM Economic Consultants, 2008*
[7] *Quarterly Housing Survey, CSO*
[8] *Housing in Ireland: Performance and Policy, National Economic Social Council, Dublin, 2004*
[9] *Bigger Better Faster More, Policy Exchange, London, 2005*
[10] *DoELG Housing Statistics*
[11] *DoELG Housing Statistics*

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Rents had been rising strongly, by 7% in 2006 and almost 10% in 2007. However, the market seems to have turned with recorded falls of 8% in the first eight months of 2008[12]. Vacancies are growing and agents have reported that a quarter of residential property sales were by investors in 2008 (29% in 2007)[13]. However, with overall house sales at far lower levels than in earlier years, this does not indicate a mass sell-off by landlords. Some investors were also still buying.

More recently, some regulation has been introduced again. A report in 2000 from the Commission on the Private Rented Residential Sector led to the introduction of new regulatory restrictions, the registration of tenancies and the setting up in 2004 of a Private Residential Tenancies Board (PRTB), which aims to deal with disputes between tenants and landlords without recourse to the courts. In practice, only a handful of disputes are actually brought before it, although the threat of such action is likely to influence landlord-tenant negotiations more widely. In addition to dispute resolution, the Board also carries out policy research, provides policy advice and aims to develop model leases and good practice guidelines.

The Residential Tenancies Act 2004 imposes the requirement that only 'market' rents can be charged. This introduces a form of rent control using other currently existing local rents as the reference. In periods of rising rents, this may slow movement to equilibrium points because new rents will be higher than current ones. However, the recent changes in private rents suggest that this requirement is being interpreted loosely. Rents also can only be changed once a year.

Another regulation greatly enhances security of tenure with the introduction of 4 year security of tenure cycles. After the first six months of a tenancy, when it can be terminated without specifying grounds, landlords have to issue 3.5 year leases under which they can only terminate a tenancy on the basis of a limited set of criteria – such as non-payment of rent, overcrowding, selling the property and refurbishment. Furthermore, all tenancies have to be registered by landlords with the PRTB, which can share information with the Department of Social and Family Affairs, local authorities and the Revenue Commissioners to limit either tenant or landlord fiscal and regulatory abuse. The penalties for non-compliance are tough. Furthermore, a list of all registered tenancies is now published on the web. The additional regulatory requirements raise landlord costs and risks and, thereby, equilibrium yields. That inevitably deters some investment but how much is uncertain.

New regulations on the quality of rental homes are being phased in from February 2009. They shall immediately apply to new lettings but others will be given a four year phase-in period. Under them, central heating, or an equivalent, will be required and higher minimum standards imposed for food storage, food preparation, refuse and laundry, ventilation, lighting and fire safety. The external appearance and condition of rental properties will be subject to minimum standards as well. Most significantly, the traditional bed-sit will be phased out as all rental accommodation will have to have its own toilet and bath/shower facilities. These rules will be backed up by a €4 million inspection service, with a stepped increase in the already 14,000 inspections of rental properties made in 2007. The inspectors deemed that 20% of visited properties violated regulatory requirements[14].

While rises in standards may be a laudable aim, these changes are not without cost as they will remove the cheapest accommodation and raise minimum rents. This restricts consumer choice and may impact on labour mobility, especially in a country which has recently come to rely on a significant turnover of temporary migrants to assist with labour market flexibility.

A wide strata of people own more than one property and the majority of landlords are small-scale ones, owning between 1 and 3 properties. According to a 2007 survey, 27% of buy-to-let investors are under 35 years old and most were aged under 45. 87% of landlords still felt that housing offered better long-term appreciation possibilities than other forms of investment[15].

[12]*Sherry Fitzgerald Lettings Index*
[13]*Sherry Fitzgerald*

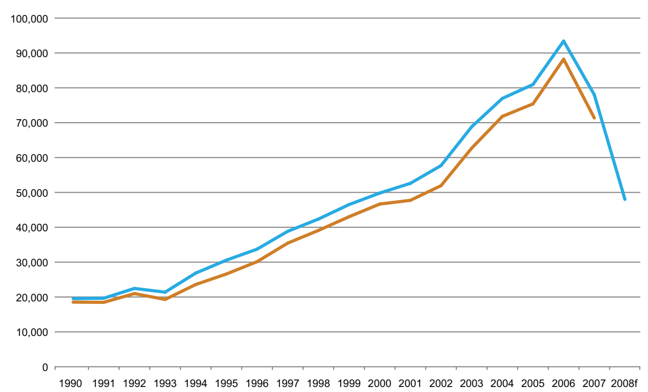
[14]*Housing Ministry*
[15]*EBS Building Society/Gunne Residential Landlord Survey 2007*

Housebuilding

Housebuilding grew rapidly through the long years of the boom, rising from around 20,000 in 1992 to peak at around 90,000 in 2006 (Figure 9.2). New dwellings were being completed at a rate of 21 units per 1000 population in 2005.

As soon as the market softened, output plummeted. By 3q 2008, completions were 30% down on the previous year and 46% down on the same period in 2006. Output was expected to be 48,000 in 2008. However, even at this much reduced rate of building, there are few sales of new properties at present so output is still on a downward trend and only 25,000 units are expected to be completed in 2009. Eventually, more homes may be needed but output is unlikely to revive much until the overall housing market starts to turn up.

Figure 9.2: New dwelling completions 1990 - 2008



Source: CSO

Macroeconomic influences

The economy entered a prolonged period of recession following the onset of the credit crunch and the downswing in the housing market. Given the previous importance of housing and related activities in the economy, the collapse in activity has had substantial ramifications for the economy as a whole. The economy declined by around 2% in 2008 and a similar contraction is expected in 2009.

Housebuilding itself fell by over 6% of national income in 2008 alone, but was still around 7% of economic activity – roughly twice as much as in many other European countries. As construction rates tumble, it will continue to act as a drag on the economy.

Many other sectors of the economy boomed along with the housing market, such as other parts of the construction industry, key retail sectors, and estate agencies, plus financial and legal services. They are now all facing substantial contraction with the loss of housing related business.

The hope is that 2009 will see the worst of the contraction over. Substantial reallocations of economic activity are underway in a small, highly open economy, one that is dependent on economic events elsewhere. So, a significant risk exists that the recovery will take substantially longer and the country will have to learn to exist with a much reduced economic role for housing.

The government deficit is set to be a substantial 6.5% of GNP in 2009, according to the October 2008 budget statement, one of the largest in Europe. The deficit limits the options for further expansionary fiscal measures in the short run but will require correction in the long-term. The housing market itself may well feature in those reforms, despite the political unpopularity that would generate, given the current generosity towards it in terms of tax reliefs and the absence of local property taxation.

Growth during the 1990s was spectacular – transforming the economy and the standard of living of the population. In 1993, for example, GDP per capita was 84% of the then EU average; by 2006, it had risen above all EU countries, with the exception of Luxembourg. Foreign inward investment, encouraged by the low corporate tax regime, was an important factor behind this economic growth, as was the burgeoning housing market.

Demographic factors fuelled growth. In addition, increasing numbers of women joined the labour force, so that labour force participation rates are now around the EU average. Job creation was consistently strong, running at 4% in recent years, helping to fuel demand and spending power in the housing market.

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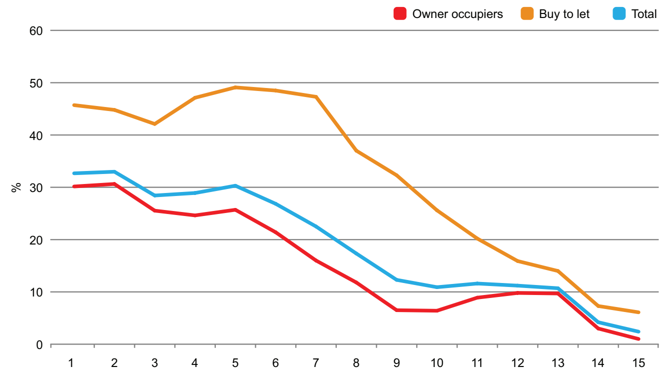
Even as late as 2007, economic growth was 6%, so the onset of recession marked a substantial change. Employment growth has faded and unemployment is rising, and could double by 2009. Recent inflationary pressures are abating with the economic slowdown. Annual inflation was running at around 3% between 2006 and 2008 but is expected to be less than 1% in 2009. The country has an income policy that affects significant parts of the economy and all parties agreed to a wage freeze for 2009 in light of the severe economic circumstances.

Mortgage market

The decline in mortgage activity has been substantial over the past two years. The number of mortgage loans dropped by 48% between 3q 2006 and 3q 2008 (Table 9.1). The falls were spread across all loan categories, though the rates of decline were least in lower-risk remortgaging and largest for investors. Both demand and supply factors have led to these rapid falls but credit rationing is now firmly in place in contrast to the far more relaxed criteria prior to the credit crunch.

Previously, mortgage growth had been spectacular with almost 50% yearly increases in 2005 and 2006. By autumn 2007, €136billion of mortgage loans was outstanding, €16billion of which had been securitised. Lending institutions competed fiercely by offering mortgage packages with greater flexibility in terms of repayments and loan-to-value ratios. They also encouraged customers to remortgage via attractive refinancing packages. A handful of retail banks now dominate the mortgage market.

Figure 9.3: Growth in mortgage lending Dec 2004 – Aug 2008



Source: Irish Bankers Federation

Table 9.1: Volume of mortgage lending by type of loan

	2006q3	2007q3	2008q3	% change 06/08
First-time buyer	2,288	1,939	1,322	**-43**
% share	**21**	**22**	**23**	**-**
Mover	3,233	2,327	1,464	**-55**
% share	**30**	**26**	**26**	**-**
Investor	2,193	1,745	937	**-57**
% share	**20**	**19**	**17**	**-**
Re-mortgage	1,613	1,822	1,158	**-28**
% share	**15**	**20**	**20**	**-**
Top-up	1,635	1,151	797	**-51**
% share	**15**	**13**	**14**	**-**
Total	10,962	8,684	5,678	**-48**

Source: Irish Bankers Federation

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The degree of securitisation built up in the final years of the boom was relatively low by the standards of several other European countries but all the same the shutting off of capital markets triggered intense competition for deposits, which has helped to raise mortgage costs. The flow of funds into Irish financial institutions has been aided by the blanket guarantee of deposits given by the government in the autumn of 2008 when there were fears of a run on banks.

Changes in mortgage interest rates were influential both in stimulating the boom years and slowing the market down. Mortgage interest rates fell, almost without interruption, from early 2001 to q3 2005. After that, the trend reversed along with general rises in euro area interest rates. By q2 2007, mortgage interest payment costs per €1000 borrowed had risen by 50%, although mortgage interest tax relief sheltered borrowers from a part of that. So, the market was slowing significantly prior to the credit crunch, which then tipped it into major decline. Increases in euro area interest rates led to further mortgage cost increases during 2008, with the average cost of loans for house purchase rising by 45 basis points between February and July 2008. Whether subsequent cuts in interest rates from October 2008 will be sufficient to stimulate housing demand is moot, because of the problems of the economy and pessimistic consumer and lender views on the future trajectory of house prices. Banks are now interested in bolstering spreads further and will find it easier to do as competition is now limited.

The country has a tradition of variable rate annuity mortgages. However, a wide variety of mortgage products are now on offer and surveys suggest the borrowers are sensitive to costs in the early years of the mortgage and many choose products on that basis alone[16]. For example, fears of further rises in interest rates pushed up the share of ‘fixed’ rate loans to 45% in q2 2007. (Rates are typically fixed only for two or three years.) By contrast, towards the end of 2008 virtually all lending was at variable rates in anticipation of further rate cuts[17].

Interest-only loans hardly existed prior to the 2000s but then gradually grew in scale, representing around 15% of all loans in the period before the onset of the credit crunch. The era of tighter mortgage conditions does not initially seem to be limiting their use. They reached 21% of lending in q1 2008, before falling back again[18].

Mortgage terms lengthened considerably during the final years of the boom, especially for first-time buyers. In 2004, 23% of FTBs took out loans with repayment terms longer than 30 years and the percentage had increased to 63% by 2007 (75% in the Dublin area)[19]. Such long repayment horizons indicate that their financing for many years will remain a burden for their borrowers, particularly if inflation remains low. In addition, they limit the ability to extend mortgage terms further to ameliorate potential repayment difficulties.

The down payment barrier to homeownership for younger households grew ever higher as house prices rose. This led to substantial financial gifts by parents to their children and the acronym ‘PG’ (denoting a parental financial gift at the time of a first mortgage) has entered the local vocabulary. A fifth of first-time buyers benefited from an average €15,000 gift from a relative, according to a 2005 survey[20]. The scale of such intergenerational transfers is cited in central bank studies as a reason why equity withdrawal has a limited effect on aggregate consumption in Ireland, in contrast to a number of other European countries. Other influential factors keeping equity withdrawal low has been the high propensity to invest returns from the housing market in other housing assets, either as second homes or for investment purposes in Ireland and elsewhere. The ability of parents and others to help FTBs is also going to be key in any future revival of the housing market, especially as LTV requirements have risen in the aftermath of the credit crunch.

[16] *First Time Buyers Survey, Irish Banking Federation, Aug., 2007*
[17] *DoELG Housing Statistics*
[18] *DoELG Housing Statistics*
[19] *DoELG Housing Statistics*
[20] *First Time Buyers report, ESRI-Permanenttsb*

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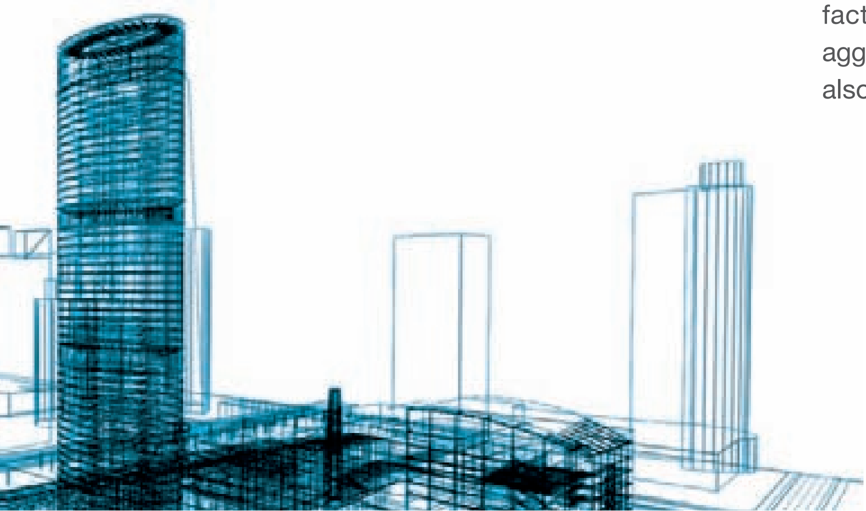
Demographic influences

Demographic factors continue to stimulate underlying demand. The population reached a low point of 2.8 million in 1961 but since then has risen by 50% to 4.24 million. It rapidly grew by 2% annually from 2002 to 2006, both because of high natural increase and immigration. In addition, the age range from 20-44 has been increasing at more than twice the rate of the population as a whole. This age group comprises a key sector in the housing market, both as new entrants and as traders up when children come along.

The fertility rate is now similar to that of many other European countries. The number of births grew by almost third between 1994 and 2006, because of a bulge increase in women aged between 20 and 39 years, who were born at an earlier time when fertility rates were much higher. This characteristic is currently increasing the demand for accommodation sufficiently large to bring up children in relatively affluent families.

The population is forecast to increase quite rapidly over the next 35 years, according to recent CSO estimates. Moreover, household numbers are growing much faster than the population as a whole. Over 450,000 households were added between 1990 and 2003, a 36% increase. Relative household size is still towards the higher end of the EU range, so there is further scope for above average increases in household numbers.



However, net immigration is likely to slow as the initial surge from the new member states dies down. It already moderated from 72,000 in 2006 to 67,000 in 2007 and is likely to continue to fall as the country's economic problems persist. These falls will affect housing demand in the short-term, especially in the rental sectors.

The population is expected to age in line with experience in many other advanced economies. The elderly dependency ratio may treble by 2041, according to some CSO forecast scenarios, which will not only have considerable implications for pensions and public finances but also for the housing market. In consequence, there will be a gradual shift to a much greater emphasis on demand from older households.

Rental markets have experienced a marked increase in demand over the past couple of years - especially in Dublin. Yet there may well be a significant loss of tenant demand in the next few years as recent immigrants' tenure choices move closer to those of the existing population. A similar drag on rental demand may well occur as the population ages, because the privately rented sector primarily provides accommodation for the 20-34 age group.

Other consequences of potential demographic influences are a reduced need for starter homes and a greater role for trading up and down within the existing stock. These changes present challenges to the planning authorities and housebuilders alike, given the preponderance of starter type homes in recent construction.

The demographic factors discussed above suggest some ways in which the housing market might change in the future. However, it is important to remember two factors. First, demographic forecasting is fraught with difficulties and forecasts are subject to error. The mid-1990s projections, for example, substantially underestimated population growth in the 2000s. Second, demographic factors constitute only one element in determining aggregate housing demand. Economic considerations are also important and influential in demographic outcomes.

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Factfile: Ireland

Background

Population (m) 2006	Annual Population Growth %	Fertility Rate* 2005	Years Life Expectancy 2005
4.2	1.2	1.9	79

*Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)

Economic

	2004	2005	2006	2007	2008f
GDP per capita purchasing parity standard based (EU27=100)	142	144	147	149	149
Real GDP growth %	4.3	5.5	5.7	6.0	-1.8
Growth in real private consumption %	3.8	7.4	7.0	6.4	-0.5
Inflation – consumer prices % (HICP)*	2.3	2.2	2.7	2.9	2.7
Labour participation rate % (15-65 yrs old in work)	-	72	74	74	74
Employment growth	-	4.7	4.4	3.4	-
Unemployment rate %	4.5	4.3	4.4	4.6	5.9

*2008 Oct y-o-y

Housing market

	2004	2005	2006	2007	2008f
Growth in residential investment	7.2	6.6	0.8	-10.2	-25.9

Taxes

Owner occupied housing: mortgage interest relief – yes with caps

Capital gains exempt - no

Imputed rental income - no

VAT on new dwellings - 13.5%

Stamp duty - 0 to 9%

Property taxes as share of all taxes 2002 - 6%

Property taxes as share of GDP 2002 - 2%

Sources: Housing Statistics in the European Union 2005/6, Eurostat, OECD, World Bank

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Overview

The housing market slowed down somewhat in 2008. Nationally, prices in 2008 were flat – rising by only 1%, down from 5% in the previous year (Figure 10.1). The number of sales dipped by 13% and, by then, they were 23% below the 2003 peak. Mortgage growth was negative in 2008 as well, after more than a decade of significant growth, suggesting that the credit crunch has being having an effect on the housing market. However, mortgages are far less important in the housing market than they are in many other countries. Demand was also weakened by the fact that the economy had been in recession for much of 2008. Housing investment also fell, following several years of strong growth.

Over the past decade, house prices have not risen by anything like those in many other EU countries: growing by about 40% in real terms between 1998 and 2007. There was a surge in prices between 2000 and 2004 but that petered out well before the turn round in other countries. Weak growth, poor consumer confidence, limited demographic pressures and a responsive supply side have all contributed to the limited performance of the housing market in recent years. The OECD estimates that the house price to income ratio is around 115, which is marginally higher than in the USA but significantly less than in many other European countries at present.

Housebuilding numbers tend to be difficult to forecast accurately because of the scale of building that takes place outside of the formal building control framework. This helps to keep housing supply relatively plentiful. Physical shortages seem to be greatest in the major cities of the centre and north.

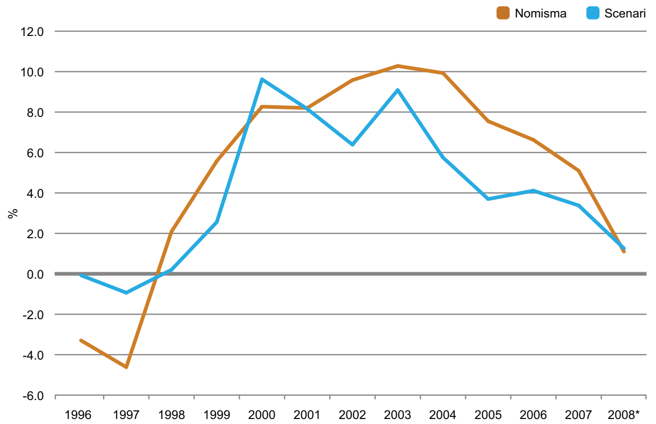
One upside of the muted performance of the housing market in recent years is that it is unlikely that the Italian housing market will experience substantial price falls, unless there is a dramatic economic collapse or severe problems in the financial system, neither of which seem likely at present. Instead, the prognosis is for further moderate declines in house prices and activity in 2009. However, the risks given the economy are clearly on the downside.

The housing system

House ownership is high, with almost three-quarters of residents owning their home (Table 10.1). If co-operative ownership forms are added to the total, the share of owner occupation rises to the mid-80% percentiles. This is matched by a declining share for the private rental market and there is very little social housing. Renting is highest among lower income groups.

Spatially, homeownership shares are highest in the south and in communes of less than 20,000 people. The share of families owning more than one house is decreasing, in parallel with the decline in the rental market.

Figure 10.1: House price changes 1996 - 2008



**forecast*
Source: Scenari Immobiliari, Nomisma

Table 10.1: Tenure shares, 1990 and 2003

	1990	2003
Owner occupation	68	73
Rental	25	19
Other forms	5	8

Source: Housing Statistics in the EU, 2005/6

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A large part of the stock is in quite poor condition with one quarter of dwellings estimated to need significant modernisation. The typical urban form is a dense one. Three-quarters of the housing stock is in multifamily units and 25% of dwellings are in high-rise buildings. Single-family structures are the smallest share of the housing stock in the EU – at only 25% of occupied dwellings[1].

Owner occupation has grown substantially in recent decades, rising from only 59% in 1980. The increase had several causes:

1. The practicability of mortgage borrowing has increased considerably in recent years. Mortgages are far more reasonably priced within the euro area than under the previous high inflation environment from the 1970s to the mid-1990s.
2. Despite relatively slow economic growth in the country as a whole, living standards have risen, especially in the more economically dynamic areas. Moreover, far more women now go out to work, so that two or more income households are now commonplace, making purchase more affordable.
3. Tax breaks are biased towards ownership with mortgage interest relief and low value assessments on imputed income and capital gains taxes. New housing carries a reduced rate of VAT at 4%, though repairs and renovations pay a higher 10% rate.
4. New housing supply is almost exclusively for homeownership, both in terms of new building and the renovation of existing properties. One long-term reason for the low repair standards has been extensive rent controls that had made it unprofitable for landlords to repair.
5. Rent laws changed in the late 1970s, and this policy inadvertently enabled landlords to sell out. The Fair Rent Act of 1978 established a common 4-year lease and continued rent controls. This made dwellings far more valuable in the owner occupied sector than in renting and enabled landlords to sell out when leases came up for their 4 year renewals. The transfer of previous rental properties into owner occupation, furthermore, has been associated with a large renovation programme as developers and households have bought and renovated properties. The shift has not been to everyone's benefit, as it has been accompanied by lengthy legal processes and many evictions of former tenants[2].

The rental law of 1998 has continued to make private renting typically a limited investment prospect. The standard contract enables the free negotiation of initial rents but commits landlords to four year contracts with the possibility of the tenant exercising the right to another four years' renewal under the same terms. During these contracts, rents can only be raised by 75% of the cost of living index annually. Landlords are likely to 'frontload' the fixed rents of long rental contracts to take account of expected future increases in market rents, unrecoverable inflation and dwelling capital values over the course of contracts. This rental cost-push effect further encourages households to opt for owner occupation at propitious times.

There are also a minority of lettings under 'pre-defined' contracts, which are controlled by local authorities at below market rents fixed by local social housing bodies. The incentives to landlords to accept such terms are exemptions from local property taxes and some lower national taxes as well.

Demographic factors are also influencing the shift to owner occupation. The typical Italian homebuyer is in the older 35-54 age range, whereas renters are more commonly younger or cannot afford homeownership. With an ageing population, demographics are pushing towards a greater propensity to own rather than rent.

The official data suggest that transactions in the rental market are, on average, greater by a third or more annually than those in the owner market, despite the fact that the tenure is over a fifth smaller in size. This not only highlights the higher mobility of renter households, but also the rental laws - because four year contracts imply that, on average, a quarter of contracts will be renewed each year.

Transactions data indicate that in recent years around 700,000 dwellings are bought each year, mostly by homeowners with only limited activity by investors, though second-home purchases will be substantial. This suggests that each owner household typically stays in a dwelling for over 20 years – with many homeowners living in the same property for much of their adult lives. Such levels of homeowner mobility are far less than in countries like the UK. Even so, mobility has increased substantially in recent years and transactions grew significantly during the housing market upswing, but have been falling away again over the past few years (Figure 10.2).

[1] *Housing Statistics in the EU 2005/6*

[2] *L. Padovani 'Italy' In P. Balchin ed. Housing Policy in Europe, Routledge, London, 1996*

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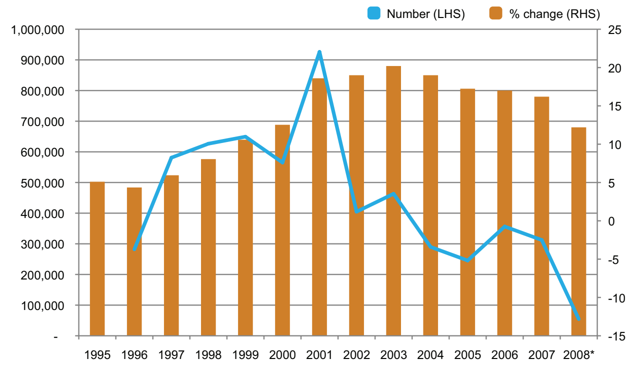
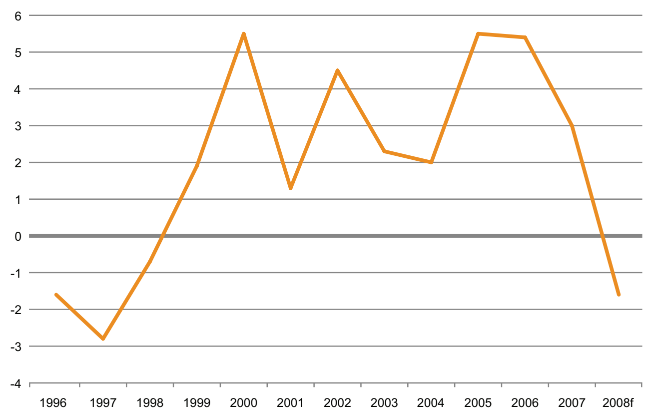
Figure 10.2: House sales 1996 - 2008



Source: Ministry of Internal Affairs, Scenari Immobiliari

Figure 10.3 Annual % change in real residential investment, 1996 - 2008



Source: OECD

Housing supply

Figure 10.3 indicates that until 2008 housing investment was more buoyant than the rest of the housing market, both because of new building and improvement. The data are unlikely to account fully for the large amounts of 'illegal' building that takes place in the country. The drop in building during 2008 corresponds to the general weakening of the economy and housing market activity.

It is hard to assess whether supply is adequate, because illegal building has been widespread for many years and there is no way of knowing whether it is rising or falling in scale. One thing is more certain: most of this unrecorded output is scattered development in the suburbs and urban peripheries. There is, consequently, still a limited supply of housing available for sale on the market in the places where demand is strongest - in particular of high-quality, well-located accommodation. New housebuilding, for example, is estimated to represent around 15% of the housing market nationally but only 5% in the major cities, where demand pressures have been greatest[3].

New recorded building investment is falling relative to maintenance and renovation. Investment in residential renovation and improvement is the most important market in the construction sector. Renovations have showed the strongest growth since 1998, thanks to tax incentives for renovations introduced by the then government to boost construction expenditure. Renovation has been encouraged by the trend amongst some affluent and younger households to live closer to city centres in attractive and historic neighbourhoods.

The limited long-term increase in house prices overall may suggest that the supply situation in fact is quite elastic over the long-run. However, given the often informal nature of building, much of the new housing and renovation fails to make it onto building permit, tax and data registers.

Macroeconomic influences

The country's economic performance has been lacklustre and outpaced by many other EU countries for a number of years, with the economy growing on average only by 1.4% a year from 1992-2003 and a similar 1.3% from 2004 to 2007. So, by 2008 the country had marginally slipped below the EU average of GDP per capita.

2008 saw the onset of recession, driven by declines in domestic private sector activity. The recession will intensify during 2009, which will further help to depress the housing market. Recovery should begin in 2010.

The country has some deep-seated economic problems. Competitiveness has been eroded by low productivity growth, high costs and an industrial structure vulnerable to exports from Asian economies. Governments have found it hard to introduce major economic reforms and the government deficit is stubbornly high.

[3]*Scenari Immobiliari Forecast Report 2006*

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Sluggish growth and a lack of government success in turning round the economy have dampened consumer confidence. This has contributed to the slow pace of the housing market compared with other more dynamic economies in Europe. Rising interest rates between 2005 and 2008 further eroded confidence in purchases involving large, long-term commitments like housing.

Inflation was around the ECB's target 2% level for several years but rose to 3.6% in 2008. However, falling commodity prices and the slowing economy should reduce it again in 2009.

Unemployment, although still relatively high at 6%, has been decreasing in the past few years, albeit at a slow pace, and moderate job growth is occurring. There are wide regional variations, with the unemployment rate over 20% in the deep south. Overall involvement in the labour market is still relatively low. At only 63%, it is one of the lowest in Europe.

Employment growth is often a notable stimulus to the housing market, particularly if it involves substantial inter-regional or city moves by the newly employed. The weak employment situation has therefore been a drag on the housing market and will probably remain so, especially in areas where jobs are traditionally limited in supply.

During the 1990s, nominal short-term interest rates dropped dramatically, from 14% in 1992 to 3% in 1999. Since joining the euro, they have obviously fluctuated in line with the rest of the euro area.

Mortgage market influences

A well-established mortgage market is a fairly recent event. Outstanding mortgages were only 19% of GDP in 2006, up from 6% in 1990[4]. Outstanding mortgage debt per capita is almost nine times less than in heavily mortgaged Denmark, for instance. Surveys suggest that only around half of purchasers use mortgage facilities, despite the apparent tax benefits of doing so. The residential market, of course, has been for a long time the final resting place for undeclared earnings. Yet, with the stability that euro area membership offers and a tightening tax net, the value of mortgage debt is expected to continue to grow rapidly in the future as the use of residential mortgages expands.

At present, Italy has an exceptionally low level of personal borrowing for an affluent society. The overall ratio of long-term household debt to household disposable income was only 40% in 2006, less than in any other of the world's major economies[5]. Recent growth in borrowing has been significant, however, and it is doubtless concentrated amongst dwelling purchasers and those who have taken out mortgages on their existing homes. The share of long term household debt to disposable income doubled in the decade up to 2006.

One factor holding back mortgage growth is the difficulty banks can have in recovering bad debts. Reforms have been made in recent years but the debt recovery process through the courts remains slow, cumbersome and costly. Such problems discourage potential lenders from entering the market, though spreads on mortgages do not seem out of line with elsewhere in the EU. Nonetheless, lenders may be forced by the higher repayment risk to impose tighter screening criteria on borrowers than in some other countries.

New laws were introduced in 2006 and 2007 aimed at liberalising retail banking and over time these measures should have a significant impact on the mortgage market. Specifically in relation to mortgages, transfers from one provider to another have been made easier and the legislation has banned penalties on early mortgage redemption. This will have significant knock-on effects because so many mortgages are taken out on a fixed term basis - 75% in 2007 - though the share varies in line with expectations of interest rate changes.

As well as the impetus of structural reforms in the financial services sector, it could be argued that, in the past, high public sector debt crowded out household sector lending possibilities. The high public sector debt ratio is still a cause for concern but it no longer crowds out the mortgage market, as interest rates are now determined by the ECB.

Interestingly, the introduction and growth of mortgage lending has paralleled similar developments in central and eastern Europe. The Italian experience highlights the fact that a country does not inevitably experience a major house price boom just because a new mortgage market rapidly develops.

[4] *European Mortgage Federation*
[5] *OECD Economic Outlook, 2006*

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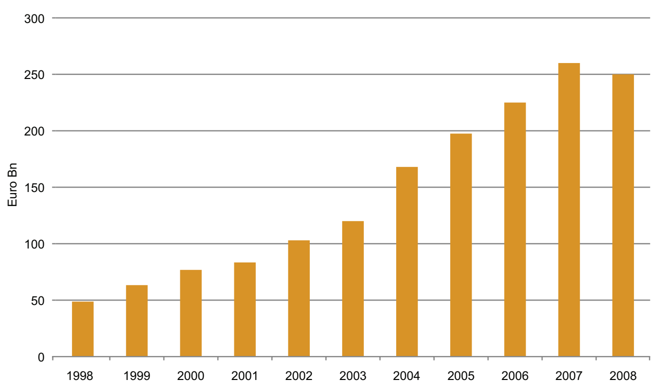
Mortgage advances had been consistently expanding until 2008 when they dipped somewhat, because of the slowing economy and the problems associated with the credit crunch (Figure 10.4). Mortgage interest rates have been rising since their low point in 2005. The average cost of mortgage with a term fixed for longer than a year rose from 4.17% in September 2005 to 6.00% in June 2008 and for a variable rate one the increase was from 3.66% to 5.70%. Such significant increases clearly deterred mortgage lending. Falls in ECB reference rates late in 2008 may cut mortgage costs but may not have much positive effect on housing demand as the economy is in recession.

Figure 10.4: Residential mortgage advances to households 1998 - 2008



Source: Central Bank, Scenari Immobiliari

Mortgages are advanced by commercial banks. In recent years, foreign banks from elsewhere in the EU have moved into the Italian market and they have played an important part in stimulating mortgage lending. They include Dutch and UK banks. Their entry was encouraged by the existence of the euro area because it lowered exchange rate and other financial risks of operating in a country that once had chronically high and volatile exchange and inflation rates.

Demographic influences

The total population is virtually static, because natural declines are being just offset by immigration. Household numbers are also stationary at 20.5 million.

Overall, population is decreasing in the major cities and increasing in the smaller centres. Moreover, there has been a long-term trend, as elsewhere, for residents to move away from the city centre to the suburbs – although this trend is now associated with a counter movement inwards towards the city centres.

In the absence of increased immigration, the total population is expected to stabilise, and then decrease by around 4%, over the next 15 years. Moreover, the population is ageing. There was a very high birth rate in the 1960s but there has been a subsequent demographic transformation, which gives Italy the lowest birth rate amongst OECD countries. As a result, the population is expected eventually to fall significantly, by 6.6. million between 2020 and 2050. The population will be a full 15% less than now by 2050.

Life expectancy is also high and rising. The result of these changes is that the country is experiencing one of the greatest demographic shocks of all advanced nations. People over 65 years old currently equal 10 million - about 18% of population - and the number will grow steadily to reach an estimated 16 million by 2040. By 2050, 31% of the population will be 65 or over[6]. Such a transformation is likely to have profound effects on the housing market.

Both the decline in population and increasing share of the elderly in it are also more pronounced in the northern regions than elsewhere. In the absence of significant inter-regional or international migration, significant housing surpluses may begin to arise in northern Italy.

Future household numbers are expected to increase somewhat over the next decade (although there are no official projections). Average household size is falling, although at 2.6 persons per household it is still much higher than in northern European countries[7]. However, it is close to the European average in the north of the country and much higher in the south.

Almost 30% of households contained 4 or more people in 2001, in contrast to only 16% in Sweden. Declining household size has implications for the balance between new build and renovation. Larger numbers of one and two person households, for example, make subdivisions of the existing stock more feasible.

[6]*OECD, Economic Survey: Italy, 2000; Eurostat*
[7]*In 2000. Housing Statistics in the EU, 2001, Finnish Ministry of Housing*

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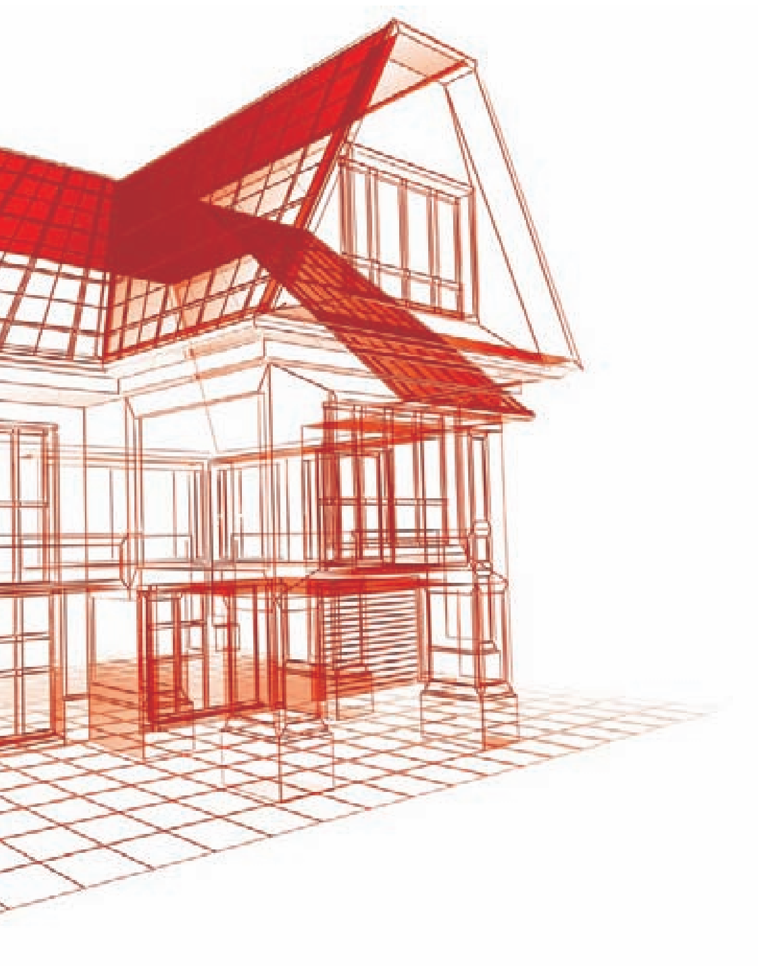
There is a long tradition of family members living together for longer periods of their life cycles than is common in many northern European countries. Italy, for instance, has the highest percentage in the EU of 20 year olds still living in the parental home (96%). This lifestyle often persists through a person's twenties, with 43% of men and 27% of women still living with their parents when they reach thirty[8]. In part, such behaviour is the result of social preferences, but it has also been based on a history of chronic housing shortages. So, it is to be expected that as affluence grows and housing conditions improve then progressively more people will set up independent households, further lowering average household size.

Immigration will partly offset the natural decline in population. Net inward migration has been rising rapidly over the past decade[9]. Immigrants include retirees from other EU countries as well as from those coming to find a better life from around the Mediterranean basin and beyond. Approximately 300,000 foreigners are home owners. They are now involved in 17% of purchase transactions. 1.2 million more live in decent rented accommodation but almost a million endure sub-standard conditions. This is creating a new huge housing problem for the country at a time when government finances are in poor shape and private sector investment is discouraged by rent controls and other regulations.



[8]*Mid-1990s data. 'Household scenarios for the EU, 1995-2025', Statistics Netherlands*
[9]*Housing Statistics in the EU, 2005/6*

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Factfile: Italy

Background

Population (m) 2006	Annual Population Growth %	Fertility Rate* 2005	Years Life Expectancy 2005
59.3	0.7	1.4	81

*Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)

Economic

	2004	2005	2006	2007	2008f
GDP per capita purchasing parity standard based (EU27=100)	107	105	103	101	98
Real GDP growth %	1.0	0.2	1.9	1.4	-0.4
Growth in real private consumption %	0.7	0.6	1.1	1.5	-0.5
Inflation – consumer prices % (HICP)*	2.3	2.2	2.2	2.0	3.6
Labour participation rate % (15-65 yrs old in work)	-	63	63	63	-
Employment growth	-	-0.2	1.6	0.8	-
Unemployment rate %	8.0	7.7	6.8	6.1	-

*2008 Oct y-o-y

Housing market

	2004	2005	2006	2007	2008f
Growth in residential investment	2.0	5.5	5.4	3.0	-1.6

Taxes

Owner occupied housing: mortgage interest relief – yes

Capital gains exempt - no

Imputed rental income - taxed

VAT on new dwellings - 4%

Stamp duty - 3%

Property taxes as share of all taxes 2002 - 5%

Property taxes as share of GDP 2002 - 2%

Sources: Eurostat, OECD, World Bank

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Overview

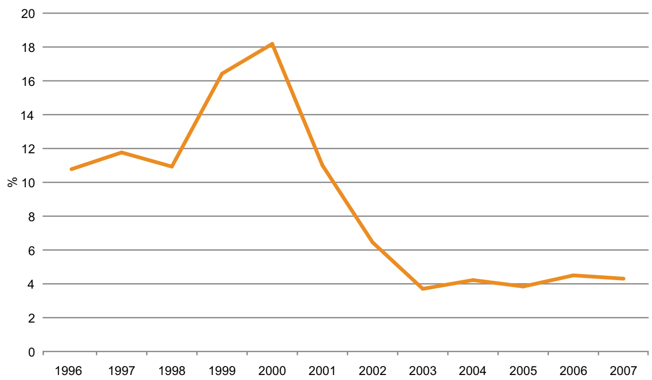
House price growth virtually ground to a halt in 2008 as the market continued to slow and there were tentative signs of falling prices in the last months of the year. According to Kadaster data, prices were up 1.6% in 4q 2008 on the previous year. Transactions data had shown more persistent weakness throughout the year, with a 13% fall in sales over the year to the third quarter[1].

As elsewhere, mounting economic gloom took its toll and optimism that the Netherlands housing market would avoid falling prices, voiced amongst others by the central bank in its autumn financial statement, began to evaporate. Confidence in the housing market weakened significantly with the intensification of the worldwide credit crunch. The financial system was badly affected with the shock nationalisation in September of the Dutch part of Fortis Bank – which included Netherlands retail parts of the former ABN Amro Bank - and state injection of funds into other banks. These banks had been major mortgage lenders and mortgages have been far scarcer in the closing months of the year. Economic growth halted in the second half of 2008 and the country may well be in recession in 2009. The troubles of the world economy have not spared the Netherlands.

Falling interest rates may boost housing demand but this is unlikely to offset the general problems of the economy, declining consumer confidence and tightening lending criteria. What is more, the country has one of the highest mortgage to GDP ratios in the world and a quarter of recent mortgage lending has been funded via special purpose vehicles, so that constriction of capital market lending will continue to have significant effects.

The period of the most rapid house price increases in the last boom was during the second half of the 1990s and the early 2000s. From 2003 onwards, price growth moderated to around 4% a year, so the country did not experience sharp surge in prices after that period as in many other European countries. Even so, by 2006 average house prices were 1.9 higher in real terms than in 1996. The period of sustained housing market expansion up to 2001 occurred in a period of high economic growth, with increasingly cheaper and more easily available mortgage credit, and when population and household numbers were rising fast. The economy then slowed markedly in 2001, lowering house price growth which did not pick up again as the economy improved (Figure 11.1).

Figure 11.1: House price changes 1996 - 2007



Source: Netherlands Statistics

Record levels of borrowing continued through much of the 2000s, at high average loan to value ratios. The level of mortgage indebtedness of many owner occupiers is exceptional by international standards. For example, 62% of new mortgage loans were classified as 'very large mortgages' in 2005, having loan-to-value ratios (LTV) of over 100%, while the average LTV of first-time buyers in 2007 was 114%. An inducement to high levels of household borrowing is mortgage interest tax relief (MITR) in a country with high marginal rates of taxation, so that consumers have an incentive to load debt onto housing. The central bank raised some concerns about the risk exposure associated with the scale of borrowing, particularly for younger households but more recently has been more confident that widespread severe mortgage difficulties are unlikely. However, the next couple of years are likely to prove difficult and a testing time for such optimism.

House prices rose particularly fast in the major cities over the past eight years (Figure 11.2). Prices in Amsterdam rose faster than national ones for most of the years of rapid price rises since the mid-1990s but have also been more volatile and actually fell somewhat in the slowdown of 2003. Other major cities experienced somewhat slower than average price rises, partly because much of the demand for owner occupied housing being associated with suburbanisation pressures that have come into conflict with the country's restrictive planning constraints.

[1]*NVM*

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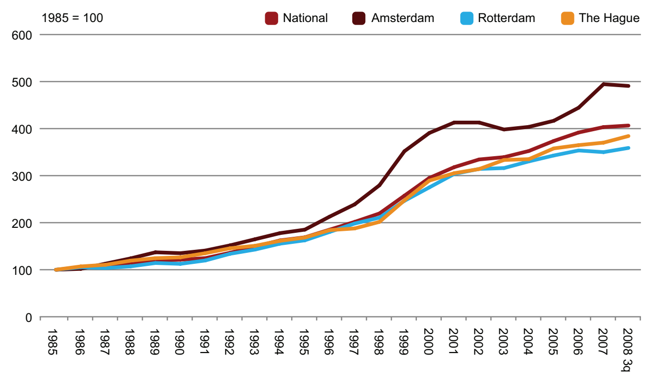
Housing supply remains extremely tight. Private housing completions were a quarter less in 2007 than they were in 1998 and the slowdown is reducing them further. Such a paradox of rising prices and falling housing supply reflects tightly constrained land supply and problems with converting both brownfield and greenfield sites into new developments. A significant cause of price rises has consequently been an extremely tight supply side, especially for the single-family homes to which many households now aspire.

Figure 11.2: City and national house prices 1985 - 2007



Source: NVM (rebased)

The housing system

Half of the housing stock is in the form of multi-family structures and half is single family dwellings. Of those single family dwellings, two-thirds are terraced houses. The housing stock is ageing, given low current building rates. 41% of it in 2007 was built between 1970 and 1995; 20% dated back to before 1945 and 13% was built in the previous 12 years[2].

In view of the country's apparent land constraint, it is perhaps surprising to realise that the average Dutch dwelling is one of the most spacious in Europe and that there is a relatively large availability of living space per inhabitant. Average useful floor areas are more than 10%better than in Belgium, France or the UK, for example.

The country has a tradition of dense urban forms, which have been encouraged by long-standing planning practices and the high cost of preparing land for housebuilding. Dense urban patterns, and the policies underpinning them, are now subject to intense pressures, arising from a desire for better standards, easy commuting and more spacious housing.

The state, at local and national levels, plays an important role in housebuilding as a key land developer. Until the 1990s, it undertook virtually all of the land development function. Although private developers have been more active in land markets in recent years, residential land is still mainly brought on stream by local authorities. Such a scale of public sector initiation of land development is unique in Europe and gives considerable power over housebuilding to highly interventionist public land-use planning. One aim of the new government is to introduce some form of impact fees so that developers can undertake development independently of local government with whom they are virtually required to cooperate at present, given the costs of land and infrastructure preparation for new building.

Owner-occupation

Traditionally, the housing system was characterised by a relatively low level of owner-occupation and a very large social housing sector. Recent years have seen a marked expansion of home ownership, which now stands at around 56% of the occupied stock - up from 42% in 1980. This homeownership share is still low by international standards but growth in owner occupation helped to stimulate the upward shift in house prices. How the share will increase further strongly depends on public policy, because three-quarters of rental housing is in the social sector and it has proved politically easiest to expand housebuilding there.

Owner occupation rates are far lower than the national average in some cities. Amsterdam had only 24% in 2006; Rotterdam 46% and Delft and Groningen 42%. This may help to explain the exceptionally high prices of houses in some of these cities and trends towards suburbanisation, because houses for sale are such small proportions of the available stock.

[2]*Ministry of Housing, Spatial Planning and Environment*

Transaction cost taxes are relatively high. Purchasers of new houses pay 19% VAT and existing houses are subject to a 6% property transfer tax. Yet, overall, property taxes (including those on non-residential structures) are quite small. They amount to about 2% of GDP with transactions bearing the brunt of the burden. Mortgage interest tax relief is available to owner occupiers. The OECD amongst others has been vocal in arguing that this distortionary subsidy should be withdrawn. In addition, the capital gains from rising house prices are not taxed.

A property tax has traditionally been levied by municipalities separately on occupancy and ownership. However, the tax on dwelling use was abolished with effect from 2006, leading to a loss of municipal income of almost a billion euros and a commensurate reduction in housing costs. On the ownership side, the capital value of dwellings for assessment purposes is based on the Valuation of Immovable Property Act (known by the acronym, WOZ). They lag housing market values by several years. A complex set of variations meant that in practice ownership taxes rise by relatively small amounts overall.

A Promotion of Home Ownership Act was introduced in 2001 to enable people on lower incomes to buy their own home. In 2007, the loan amount was increased to approximately €170,000 from €105,000 previously and the income cap was raised from €29,000 to €34,000. Its stipulations mean that it is most likely to be used for the sale of social housing to sitting tenants[3]. Each year a cap is put on the budget for this programme. A €40m scheme also exists to subsidise first-time buyers' loans. Under it, local authorities can advance loans as additions to standard mortgages, with half of the loans' costs subsidised.

A shift in housing policy

The state has long had a highly interventionist role in housing. With acute housing shortages for movers and new households, social tensions and growing problems of affordability for entry into owner occupation, housing has for a number of years been a controversial issue at the top of the political agenda. Housing policy was subject to much inter-party negotiation during the formation of the current coalition government, set up in February 2007, which looks as though it will last for its full term until 2011. The continuing political importance of housing was reinforced by the ousting of the then housing minister late in 2008, although what the impact will be on policy is unclear. The coalition's declaration on housing policy seems to mark a significant move away from the previous liberal, more market-oriented policy stance, which aimed at lowering the degree of state involvement in housing provision. A previous commitment to increase owner occupation is now downplayed, and earlier planned increases in social housing rents have now been abandoned. They will now rise only by the rate of inflation for an indefinite period. Moves towards creating more liberalised rental housing out of parts of the social and private sectors have been shelved as well. Planning constraints also seem to have intensified.

80% of new housing is planned to be built on brownfield sites with an emphasis on self-contained communities. Strong state intervention is put at the centre of this low spatial mobility, neighbourhood-oriented policy.

Social housing

Social housing as a share of all dwellings reached a peak of 38% in 1998 – an EU record. Since then it has declined marginally to 34%, though this is still by far the largest share for social housing in the EU. The growth of the social sector up to the mid-1990s was accompanied by a sharp fall in private renting, which now houses only about 10% of the population compared to 24% in 1980[4]. Most new rental properties are currently being built in the social sector.

Social housing providers are called housing corporations (equivalent to British housing associations). They are independent private non-profit institutions with the sole stated aim of providing good quality, affordable housing. They own 2.4 million units: 36% of their dwellings are in the low-rent category (almost 60% in Amsterdam and Rotterdam); 58% affordable; and 6% high rent[5]. Many are large entities and they form a key pillar of the Dutch 'Polder model' political system of cooperation and negotiation between state and non-state entities.

Given their large portfolios of properties, on which there is little secured debt and a steady rental income, housing corporations tend to be wealthy organisations subject to few financial pressures even though they receive no direct public subsidies and now pay corporation tax. The Aedex/IPD Dutch social housing index has shown gross returns (net of property management costs but before overheads and other organisational expenses) averaging 6% in 2007. The income return component has been far more limited, fluctuating between 2.5 and 2.7% between 2002 and 2006, or about 1% in real terms.

[3] Ministry of Housing, Spatial Planning and Environment
[4] Housing Statistics in the European Union 2004
[5] Ministry of Housing, Spatial Planning and Environment

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Housing corporations are under frequent pressure to respond positively to government policy initiatives. Local authorities are also empowered to monitor local agreements made with them in order to ensure that agreed housebuilding targets are met. In recent years, governments have particularly relied on housing corporations to build homes to overcome current shortages, thereby avoiding the need for direct government funding of building programmes. This building role is to continue and recent negotiations with the new government have added expenditure on improvements in the energy efficiency of the housing stock to the list. Housing corporations are also to play a greater role in urban renewal, using their own funds as well as government subsidy programmes.

Urban regeneration has moved up the political agenda because of social tensions, rundown social housing neighbourhoods and increasing spatial segregation. Housing allocation policies, renovation and building policies and the long-run movement of middle income groups out of social housing into owner occupation are leading to high levels of spatial segregation of ethnic minority groups. Much of the social stock is now ageing, with significant portions located in increasingly rundown neighbourhoods. For the big cities like Amsterdam, which have large shares of their housing stock in the social sector, urban decay and increased social polarisation are growing problems.

The housing corporations' national body signed an agreement with the government in autumn, 2007 to pump an additional €2.5billion into 40 priority renewal neighbourhoods over the next ten years on top of their current investment plans. This removed the threat of a compulsory levy upon them to finance urban renewal, outlined by the new government over the summer. Furthermore, they agreed to build 150,000 rented and owner-occupied dwellings between 2007 and 2010, mainly in urban renovation areas, with 80% suitable for the elderly – a targeted problem area. This is a substantial amount of new building for a country that only built 73,000 homes in 2006 altogether. The housing corporations have become significant providers of new owner occupied housing and currently almost 60% of their construction is outside the affordable sector. Sales of existing social housing stock are running at around 15,000 properties a year, according to VROM data. Though significant, this is unlikely to lead to much alteration in the scale of the social sector in overall housing provision.

Rent controls

With the exception of the small up-market sector, which represents 5% of all rental dwellings, rents are controlled with the same legislation applying to both the private and social sectors. Security of tenure is guaranteed – temporary contracts are forbidden – and tenancies can be passed onto spouses, children and others. Rents bear little relation to market levels but rather to a points system related to amenities and to service charges. If landlords do not keep up repairs, tenants can apply for rent reductions and rents can only be raised annually by a maximum amount decreed by the government. From 2009, tenants will also be able to request 'reasonable' improvements to their dwellings which landlords will be obliged to carry out.

Despite the long boom in house prices, real rent increases have been limited. Usually, when the Housing Ministry negotiates annual rent rises with landlords' associations it does not permit much of a rise above inflation, if any. Given escalating building costs, maintenance and refurbishment needs and other potential cost factors, these limited rent increases squeeze landlord finances. Yet, as much of the rental stock is owned by cash-rich housing corporations and private investment funds, governments clearly feel that it is politically popular to impose such costs on landlords.

Under the previous government, a new longer term view was taking shape. Tentative moves towards a more market-oriented approach were made, with plans to slowly liberalise parts of the controlled rent stock. Some real increases in rents were also going to be permitted. However, this programme was abandoned in 2007 during the inter-party negotiations to form the current government and future rent rises shall follow general price inflation. So, in 2007 rents were allowed to rise by 1.1% in line with inflation in 2006, and they will rise by 1.6% from July 2008 to July 2009 set by inflation in 2007, and so on.[6]

[6] *VROM*

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While freezing real rent levels is popular with many of the 40% of Dutch households that are directly affected by them, rent controls and low rent policies distort the operation of the housing market with long-term adverse consequences. Households are encouraged to consume excessive amounts of housing, leading to greater shortages than there need be. Housing providers have less income for investment and little financial incentive to be more efficient or to carry out improvements. Furthermore, accommodation has to be inefficiently rationed, especially in the most popular areas. Within that rationing system, existing tenants are favoured over new households and movers, leading to regressive distribution effects and enhanced social segregation. Households are induced to behave in ways that conform to social housing's access rules, which often work against labour market and other welfare policies. Informal and illegal rental markets are encouraged. General mobility is reduced. Another implication is that demand shocks result in queues and intense pressures on households to become owner occupiers because that is effectively the only free market housing option in most localities. Price volatility in the owner occupied sector is exacerbated as a result. In summary, such rent control policies invariably lead to general welfare losses rather than gains.

Around €1.5billion is spent annually on housing allowances in both the social and private rented sectors. The average annual allowance is about €1,700, with 30% of tenants – just over a million households - receiving it[7].

Privately rented housing

Around 10% of the stock is rented privately, approximately 750,000 dwellings. Around a quarter of the private rented sector consists of a higher rent 'free' market and the rest is subject to similar rent controls to the social sector.

There are two institutional types of private landlord. One consists of a small landlord sector of individuals and small firms, including room letting companies, and the other is a large landlord sector owned predominantly by around 30 institutional investors, which hold portfolios of around 150,000 properties.

Housing in the small landlord segment primarily consists of lower quality, moderate rent, small, pre-war dwellings in inner city areas. Institutionally-owned rental housing is in marked contrast to the small landlord sector. Much of it has been built over the past thirty years, predominantly in good city locations. The units are generally spacious, well-equipped and maintained to a much higher standard. The free rent elements of their portfolios are popular among mobile, affluent households.

Direct residential investment is common for Dutch pension funds and insurance companies. The ROZ/IPD residential index - based on 2,500 properties worth €20m, equally split between single family houses and apartments - recorded a 9.6% total return for 2007 - 2% down from the previous year - of which 3.7% was income return and the rest was capital growth.

Investing in controlled private rental housing is generally not particularly profitable, unless the investment was purchased for an attractive price or it leads to capital gains from subsequent sales of properties. Over the long-term, a regulated private rental sector cannot hope to compete with the tax breaks offered to owner occupiers nor the financial power of the social housing institutions. This induces sales when market and security of tenure conditions permit. So, without radical reform, the sector will continue to play only a modest role.

In Spring, 2008, the Association of Institutional Property Investors (IVBN) submitted a complaint to the EU Competition Commissioner about the increasing role of state-aided social housing institutions in commercial markets. IVBN members own 140,000 homes in the Netherlands and form a major part of the private rented sector.

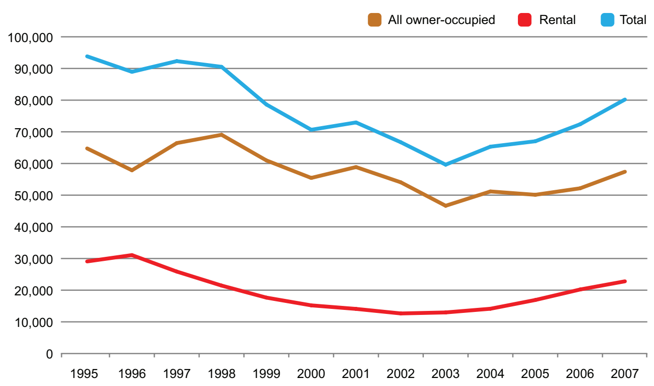
The lack of a substantial free market privately rented sector has consequences for household life cycles and the stability of the owner occupier market. In the absence of an effective rental option and with the existence of the attractive subsidies offered to home owners, many younger households embark on purchase and large mortgage commitments at a young age. This not only puts considerable strain on their own finances but also increases significantly the number of households vulnerable to financial hardship at times of interest rate rises. That the Netherlands chooses not to use the capital resources of the small investor to provide affordable accommodation for fellow citizens, common in so many other countries, is one of the major peculiarities of its housing policies.

[7] *VROM*

Housebuilding

Around 60,000 new private dwellings and another 25,000 social dwellings are built each year. Output declined steadily up to 2003, despite the surge in prices, but has risen by almost a third since then. 2007 was a particularly strong year with building up by 10%, with increases in both the owner occupied and social sectors, showing the fruits of government accords with the social housing corporations, noted earlier (Figure 11.3).

Figure 11.3: Housing completions by tenure 1997 - 2007



Source: NVM (rebased)

A further source of new housing supply derives from the conversion of redundant office and other commercial space, which has been estimated to have added around an extra 5-10% to new supply in recent years. This has been encouraged by the high vacancy level amongst commercial buildings following a building boom in the early 2000s. There is also some building of free market luxury private rental dwellings, especially in prestige downtown and renovation areas. However, the bulk of new private building is for owner occupation.

The scale of the long run decline in housebuilding has been substantial: the annual level of private housebuilding actually fell by 25% between 1998 and 2004, even though house prices were rising fast. This paradox has provoked considerable debate and the planning system and associated local authority provision of development land have been blamed for much of the problems.

Land release in the Netherlands is influenced both by a rigorous planning regime and because the land development process is organised such that local authorities provide the costly site infrastructure provision in a country where much of the land is below sea level or otherwise expensive to convert. Most housing is required in the Randstad core of the country but there is a long tradition of protecting the 'green heart' of that area from building. Added to this, general concerns about the environment have been increasingly interpreted in an anti-development way, familiar in other countries. The outcome of these pressures has been that development is severely curtailed in many parts of the country where housing is needed.

Recent planning strategies, such as the 'VINEX' one initiated in the 1990s, have tried to direct most development to a limited number of brownfield sites and to a handful of large-scale, suburban localities – with the latter aimed at creating environmentally sustainable, mini-new towns. The outcome is now widely recognised to have limited housing output. Problems arise in getting development underway, so it either does not happen or takes years to come on stream. Also, the mix of housing created is often inappropriate to satisfy market demand.

The last government was beginning to introduce measures to allow somewhat more market-sensitive, dispersed developments. A shift was announced away from 'imposing restrictions' to one of 'promoting development', although the general principles of strict planning and inter-agent consensus over development remained. Under the latest government the relaxation of planning controls has been reversed. Instead, a more active promotion of preferred schemes is in evidence and individual ministers have been made responsible for the implementation of particular projects in high housing demand areas. The VROM housing ministry has entered into agreements with local authorities in many urban areas and public-private partnerships are being encouraged in order to speed up housing delivery and to diversify its form.

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40% of new building is expected to be on brownfield land but sites are relatively limited. As many as 440,000 extra homes are forecast to be needed in the Randstad area by 2030, and many greenfield sites will have to be built on as well, so planning dilemmas are likely to remain.

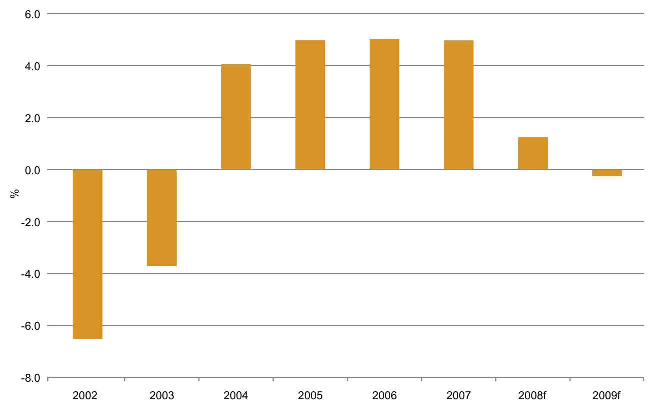
Whether a state-interventionist approach - with housing providers steered into meeting plan targets - is compatible with a market-driven housing system is a matter of debate and some scepticism. If the private sector does not respond to exhortation, output targets are likely to be missed. Similarly, if too much emphasis is put on the efforts of housing corporations, social mix and owner occupation goals will be unfulfilled. The dilemmas of Dutch housing policy remain as strong as ever.

A feature of housebuilding is that the average completion time of dwellings from the point when a building permit is issued to the actual finished construction of the dwelling is long and rising. In 1995, the average completion time was 13 months and it rose to 18 months in 2006. More detailed examination of the data shows that the skew of completion times has shifted. In the mid-1990s almost half of all dwellings were completed in less than a year, and that number has now dropped to a fifth while those taking more than 2 years have risen from a negligible amount to 30% of all dwellings. This suggests that the complexity of building projects has grown considerably, probably because of the changed nature of the development land on which housebuilding is permitted[8].

An extended length of building time, of course, tends to raise construction costs and in the Netherlands they typically rise faster than the general rate of price inflation. This means that the cost of housing construction is gradually rising over time, putting further strain on the country's ability to increase its housing supply.

Overall residential investment volumes, which include improvement and renovation expenditure as well as new build, fell dramatically during the economic slowdown in 2002-3. However, it grew at a faster rate than the rest of the economy between 2004 and 2008 and is forecast to plateau at a high level during 2009 (Figure 11.4), although that forecast maybe be over-optimistic if the housing market downswing evident in the closing months of 2008 continues into 2009.

Table 11.4: Private residential investment annual change 2002-2009



Source: CPB

Macroeconomic influences

The country has one of the highest standards of living in the EU, a third higher per capita than the average. This has been achieved over many years and sustained by a strong economy for much of the past decade. Growth was particularly strong in 2006 and 2007, which helped to keep up demand in the housing market in face of rising interest rates[9]. However, the general world economic slowdown in 2008 brought expansion to a halt. Exports were particularly badly hit as a result of declining competiveness caused by the increase in the value of the euro and rising labour costs. Financial services were also in retrenchment, as the financial crisis badly hit the country's leading banks.

As adverse economic forces mount, aggregate demand is likely to be further constrained in 2009 by static private consumption and declining fixed capital formation, which is likely to cause the economy to decline somewhat in 2009. This adverse aspect may significantly affect housing market prospects.

[8] *Netherlands Statistics*
[9] *OECD and CPB, Netherlands Bureau of Economic Policy Analysis, forecasts*

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Inflation is expected to fall in 2009, after rising somewhat during 2007 and 2008 due to the impact of commodity prices. As well as general world inflationary factors, price pressures reflect capacity constraints and labour shortages in the economy and the country's sensitivity to the cost of imports of food, energy and raw material items. However, the labour force has been growing and the rate of unemployment is not expected to rise by much, unlike in the first half to the 1990s, both of which are likely to sustain housing demand and limit repossessions. Labour participation rates are high, at almost 80% of the working population, but the share of part-time employment is relatively high, which tends to flatter such data.

Mortgage market influences

There are a variety of mortgage lenders. The most important ones are general banks, such as the now merged and nationalised ABN Amro and Fortis, plus ING (including Postbank), which itself received a significant injection of state capital in autumn 2008. In addition, there are some specialist mortgage banks and building funds ('bouwfondsen'), while insurance companies and savings banks also directly provide mortgage finance – but all of them amount to less than 5% of the mortgage market. Competition between the leading bank lenders has been intense in the past but the impact of recent mergers and the credit crunch has lowered competitive pressures significantly, enabling lenders to increase spreads in the face of growing risks.

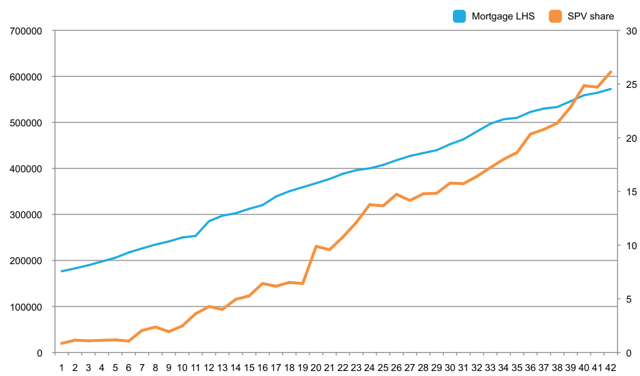
Prior to the credit crunch, almost a fifth of mortgage lending by Dutch banks was outside of the country because they had participated in general internationalisation trends and moved into new markets, especially into new EU member states, the USA and Asia. The recent acquisition and breakup of ABN-Amro by a consortium of European banks and the credit crunch have now curtailed such activities and as the world economy revives Dutch financial institutions may be more cautious about foreign expansion, particularly while such a large part of the financial system remains state owned.

Traditionally, fixed interest rate mortgages with a 5 yearly rate review were the most common mortgage product. Now, there is a far wide range of options to choose from. Consumers often obtain mortgage packages, financed with a mix of first and second mortgages, containing various potential combinations of payback terms and fixed and variable interest rates.

Securitisation has become an important feature of the mortgage market over the past decade. Under this arrangement, banks sell their mortgages on to special purpose vehicles, which issue new securities on the basis of them. Overall, mortgages represented 60% of the €170billion Dutch securitisation market in 2007, and securitisation now accounts for a quarter of outstanding mortgage debt (Figure 11.5)[10]. Growth was particularly fast from 2003 onwards and up to the autumn of 2008 institutions had little difficulty in placing mortgage debt on capital markets. The extent to which the European Central Bank has been important in such purchases is unclear, but some commentators have suggested that its role may have been significant.

Overall mortgage lending had been growing strongly, with lending rising almost threefold between 2000 and 2008 in nominal terms (Figure 11.5). The credit crunch so far seems to have had little impact on continued lending growth up to autumn 2008. Since then the indications are that lending has been sharply curtailed and those restrictions are likely to remain in 2009.

Figure 11.5: Mortgage lending 1999q1 - 2008q2



Note: SPV = Special Purpose Vehicle
Source: Netherlands Central Bank

[10] *Netherlands Central Bank*

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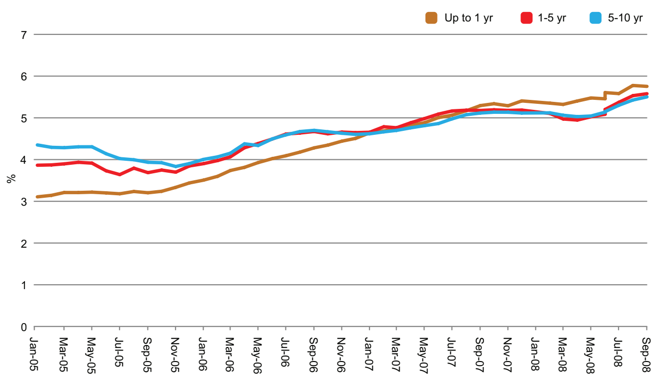
At the trough of the mortgage interest rate cycle in 2005, short-term lending rates fell to little more than 3%, substantially less than long-term interest fixations (Figure 11.6). However, first rising general interest rates and then the credit crunch pushed up the interest rates on all types of mortgage. Cuts in ECB interest rates in 2008 have had little effect on mortgage borrowing costs. Instead, short-term fixation mortgages now carry a somewhat higher interest rate than longer term ones.

Figure 11.6: Fixed and variable mortgage interest rates Jan. 2005 - Oct. 2008



Source: Netherland Central Bank

Overall, Dutch households are highly indebted. Private sector borrowing was reaching 183% of GDP at the end of 2006, a level in Europe surpassed by only Ireland. The central bank reckons that well over two-thirds of new mortgages are exposed to higher risks than the traditional product. The housing market consequently remains vulnerable. However, the ratio of housing wealth to disposable income has grown significantly over time, rising from 267% in 1998 to 453% in 2006[11].

A tightening of lending criteria pre-dates the credit crunch by a number of years, which contributed to the relatively modest growth in house prices in recent years. A Code of Conduct for Mortgage Lenders was negotiated between financial institutions and the central bank several years ago. It imposes constraints on lending criteria and the constituents of mortgage products, and recognises that default risks are concentrated amongst younger households. The Code was tightened up in 2007, specifically to limit lending at high LTV ratios and to put caps on mortgage-to-income ratios, while compliance was tightened up[12]. Even so, at the end of 2006 the average LTV ratio on new first-time buyer loans was a spectacular 114%.

A National Mortgage Guarantee ('Nationale Hypotheek Garantie') was set up by the government in the mid-1990s to encourage lower-income homeownership. Homebuyers may insure their risk of default by paying a small insurance premium (0.15% of the mortgage loan until recently) when taking out a mortgage and receive a discount on their lending rate in return (of 0.2 - 0.5%), because they then pose no default risk to the lender. About a third of mortgages are guaranteed in this way. The existence of such a guarantee must contribute to lenders' willingness to lend large sums to higher risk borrowers. Defaults may not rise significantly but if they do they will severely test this public input to the mortgage market.

Demographic influences

One of the most notable demographic factors of the past 20 years has been a large increase in household numbers. There were 7.2 million households in 2007, up 600,000 in a decade, helping to explain the intense demand pressures in the housing market as population growth is now low.

Over the same time period, the number of one-person households rose by 380,000 to 2.5m and this trend towards higher numbers of single households is expected to continue and to be the main source of rising household numbers in the future. Just over a third of all households are now single person ones; a third are two or more person households without children; and a final third contain children. The dramatic rise in one-person households is having important effects on the housing market.

10% of the population is first-generation migrants and immigration has been a significant political issue in recent elections. Net immigration was running at 0.4% of the population in 2001. Since then, it has fallen sharply as entry criteria were sharply tightened and emigration actually surpassed immigration in 2004. Net migration has been negative in recent years, though CEE arrivals reversed that trend in 2008.

The most recent overall population forecasts give widely ranging outcomes for population size by 2050, ranging from a slight fall to 15 million to a 25% rise to over 20 million, depending on the trajectory of the economy and the welfare state[13].

[11]*Netherlands Bureau for Economic Policy Analysis*
[12]*Overview of Financial Stability in the Netherlands, Netherlands Central Bank*
[13]*Netherlands Statistics*

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An ageing population is likely to begin to have a significant effect on the demographic structure from 2010 onwards, when the share of those aged 65 or over in the population is expected to rise from 15 to 22%, which will have implications for the future types of housing required. A decline of those in the economically active age ranges is going to be associated with an ageing population. This implies fiscal adjustments with higher taxes on the economically active, which may significantly impact upon the housing system as there will be increasing pressure to cut back on less essential subsidies and tax breaks.

Factfile: Netherlands

Background

Population (m) 2006	Annual Population Growth %	Fertility Rate* 2005	Years Life Expectancy 2005
16.4	0.0	1.7	79

*Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)

Economic

	2004	2005	2006	2007	2008f
GDP per capita purchasing parity standard based (EU27=100)	129	132	131	132	131
Real GDP growth %	2.2	2.0	3.4	3.5	2.3
Growth in real private consumption %	0.6	0.7	0.0	2.1	1.9
Inflation – consumer prices % (HICP)*	1.4	1.5	1.7	1.6	2.3
Labour participation rate % (15-65 yrs old in work)	-	78	79	80	81
Unemployment rate %	4.6	4.9	4.1	3.3	3.1

*2008 Oct y-o-y

Housing market

	2004	2005	2006	2007	2008f
Growth in residential investment	4.1	4.9	4.1	3.3	3.1

Taxes

Owner occupied housing: mortgage interest relief – yes

Capital gains exempt - yes

Imputed rental income - no

VAT on new dwellings - 19%

Stamp duty - 6%

Property taxes as share of all taxes 2002 - 5%

Property taxes as share of GDP 2002 - 2%

Sources: Housing Statistics in the European Union 2005/6, Eurostat, OECD, World Bank

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Overview

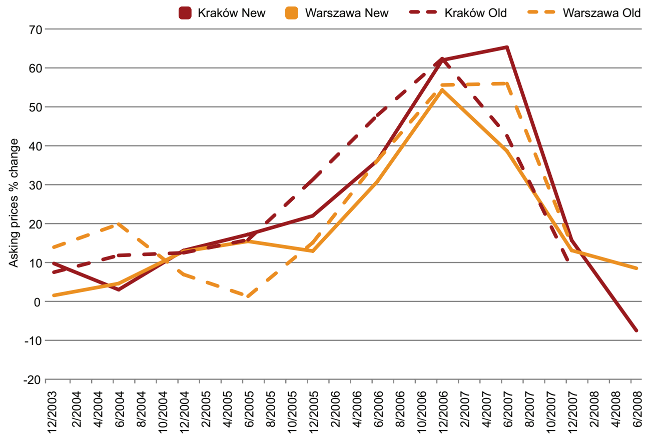
The marked boom in house prices that took place between 2005 and 2007 was well and truly over by 2008. Residential markets languished for most of 2008 with subdued sales. Prices have been falling in all the major cities. By year end asking prices for new properties were down by 7%, according to REAS. In existing homes markets, the greatest falls have occurred amongst flats at poor locations and those built during the era of concrete panel technology.

By contrast, mortgage markets continued to expand for much of the year but in the last quarter, after the intensification of the credit crunch, the supply of mortgages shrank dramatically, precipitating a much greater slowing of the market than had been seen before. The likelihood of continued constraints on mortgage availability implies that prices will continue to slide in 2009. The sheer scale of the mortgage boom of recent years, much of it at relatively high LTVs, poses significant risks for the housing market in the context of a slowing economy. However, typical mortgage repayment to income ratios are not too large, suggesting that many households still have significant financial cushions to assist them in avoiding default.

Much mortgage borrowing has been in foreign currencies, which intensifies the risks, especially as the national currency along with those in other central and eastern European countries has been on the slide, with investors withdrawing from previously buoyant equity and other investment markets. The zloty fell against the euro and especially the dollar from summer 2008. Between the end of June and mid-December 2008 the currency fell by 15% against the euro. Such exchange rate shifts significantly raise the costs of foreign currency denominated household loans and that affects two-thirds of current outstanding mortgages.

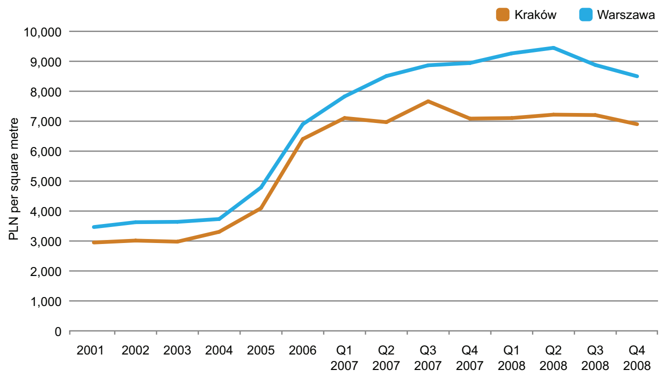
An overhang of completed new properties has been growing and it could rise further as schemes continue to be finished. The supply of newly-completed flats for purchase in the six biggest cities grew by 56% in the first half of 2008 compared to the same period in 2007, according to the central bank. This growth in properties for sale has arisen because of new completions and because investors have been putting up for sale properties they had earlier bought off-plan.

Figure 12.1: House prices Dec. 2003- June 2008

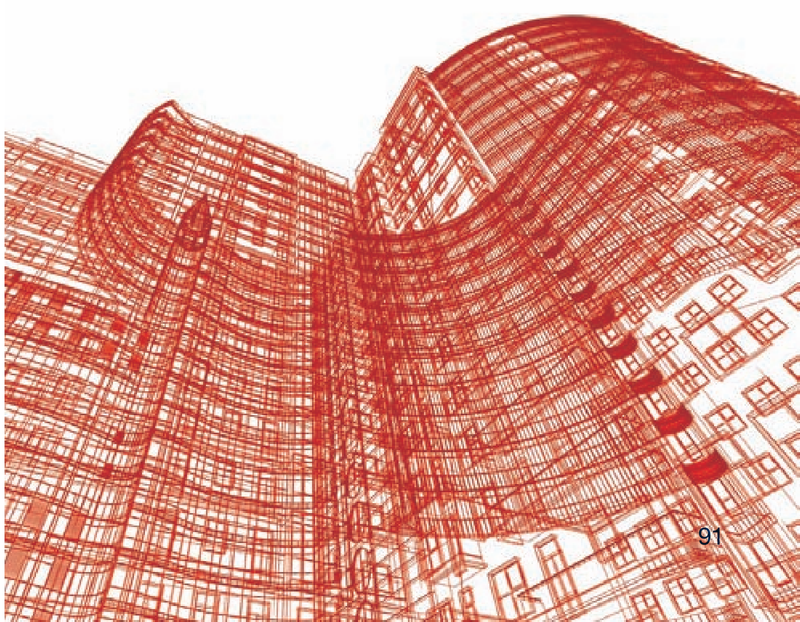


Source: Central Bank

Figure 12.2: New dwelling prices 2001-2008



Source: REAS



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To overcome buyer reluctance, firms have been offering far more facilities to incentivise buyers. Developers are now giving inducements, such as free parking space, payment of VAT, and the fitting out of the interior of apartments with flooring, tiling and bath and kitchen appliances, which were regarded as the responsibility of purchasers during the boom. So, measured asking prices exclude a variety of inducements developers now offer that effectively reduce prices by significant amounts.

Developers' margins are being further squeezed by rising costs. Building costs have been escalating rapidly and were 23% higher in 2q 2008 over the previous year.

Supply has not been slowing in the face of a cooling market. In fact, completions in the market for sale were already 15% higher than for the whole of 2007 by the end of October, at over 52,000 dwellings. Output was slowing slightly in the final months of the year and is expected to fall significantly in 2009, as the housing market continues to decline and unsold stocks of new dwellings pile up. Projects already underway are difficult to stop, so output is likely to remain substantial until they are built out, unless they are abandoned. This means that even more stock will be coming onto the market for some time, adding further to excess supply. In the circumstances, the prospect of failures amongst developers is now high.

The housing market is much larger than those of the other central and eastern European countries in the EU. In fact, it is bigger than them all combined.

Much of the existing stock is dilapidated and of poor quality and, so, needs replacement but most of it lies outside the scope of market processes. Traditional providers have faltered and the new development industry has only partially been able to take up the slack. The vast majority of the population cannot afford new housing, even with new availability of competitively priced mortgages and support for down-payments from their parents. So, their potential demand is likely to take many years to satisfy. The nascent rental market is also costly and rising prices and interest rates have narrowed investor yields. Construction costs are increasing and, in particular, there is a dire shortage of land – for which a lackadaisical and chaotic land-use planning framework must bear much blame.

The housing system

As national income per head is only 56% of the EU average, it is to be expected that housing conditions are significantly lower than in western Europe, as are many other indicators of average living standards. Even so, housing shortages are particularly acute. The housing stock relative to population is one of the smallest in Europe at only 314 per 1000 population. There are correspondingly high numbers of people per dwelling, averaging 3.2 compared to 2.3 in the UK[1]. Poland also has the highest share of apartment blocks in its housing stock in the EU, containing almost two-thirds of the dwelling stock and many of them are high-rise structures encompassing almost 40% of the overall dwelling stock.

Housing shortages

There are currently around 12 million dwellings and a crude shortage of about another 1.5 million, concentrated in the most economically dynamic cities. In addition, the population has a relatively young age profile, so household numbers will continue to rise over the next few years, adding further to demand pressures.

Despite national housing shortages, some regions have an excess of low quality dwellings and high vacancy rates. One rural province in the north had a 14% vacancy rate in 2002 and a central urban province had one of 8%, with the country overall registering a vacancy rate of 6%[2].

Dwellings are quite small. The average useable floor area is 67 square metres compared to around 90 in the old EU15. New apartment dwellings are often not that much larger than old ones, so tight living conditions are likely to remain for many years to come.

[1] *Housing Statistics in the EU 2005/6*
[2] *Housing Developments in European Countries, 2003, Department of the Environment, Dublin*

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The housing stock is relatively young, with over half of it built since 1970. Despite this, much of it unfortunately has repair and quality problems; a legacy of past policies. Quality was sacrificed for quantity during the housing output drives of the 1970s and 1980s. There was an inappropriate use of building technologies and poor product specification, which has had knock-on effects in terms of continuous high maintenance costs and a need for the renovation of the many buildings from that era. Basic repairs have been neglected over time making conditions worse. Furthermore, many buildings lack adequate insulation, with resultant high heating costs and energy wastage. Apart from environmental concerns, energy costs are an important component of direct housing costs, so such inefficiencies affect household expenditure and are especially of concern for those on low incomes. Infrastructure facilities and local amenities are also sparse in many neighbourhoods.

There is consequently high pent up demand for improved accommodation as well as chronic absolute shortages. The lack of housing in the growth regions generates significant problems for mobility and helps to exacerbate labour shortages in them.

Basic amenity standards are generally good in urban areas. In rural localities, however, the picture is different. Around a quarter of rural homes lack a bathroom and/or inside toilet and 10% have no running water[3].

The growth of owner occupation

The transformation of the structure of housing tenures since the 1980s has ostensibly not been as great as in some other previously centrally planned economies for a mixture of political and practical reasons associated with the institutional framework of property ownership. By 2004, 57% of dwellings were fully-owned by private individuals, mainly as owner occupiers, but this seems a fairly limited change when it is realised that 48% were already privately owned in 1988. However, much of the apparently limited role of dwelling privatisation relates to the institutional nature of real estate ownership in Poland.

As can be seen in Table 12.1, the second largest tenure is co-operative ownership; then successively in terms of the scale housing provided: local authorities; the state; firms providing housing for their workforces and retirees; and a small other category. The latter includes some recent social housing institutions, categorised by the Polish acronym TBS, most of which are municipal subsidiaries (of which more below).

The apparent relative stability of tenure shares belies the fact that privatisation has been taking place through the sale of individual apartments in building structures owned by municipalities, employers and co-operatives. The discounts offered have typically been up to 80% of estimated market value or sometimes higher. So, tenants have had strong incentives to switch when ownership offers lower monthly outgoings than renting. By 2001, 22% of municipal and employer housing and 67% of co-operative dwellings had actually been privatised and over 1.8 million dwellings were transferred to the private sector between 1989 and 2003[4]. Thus, the privatisation process has differed somewhat from some other central and eastern European countries in that the ownership of the building frame and common services frequently remains with the original institution rather than being passed over to the households living in the structure.

Table 12.1: Housing tenures, 2004

	%†
Privately owned outright	57
Co-operative*	21
Municipality*	11
State	2
Enterprises	2
Other	1

†Stock data
**Structure ownership, dwelling ownership may be mixed*

Most sales to tenants in co-operatives have been of tradable rights-of-occupancy, similar to those in Scandinavia, though there have been some outright sales on a condominium basis with the co-operative retaining administrative functions. So, in one block of apartments there can be three different types of property relation: tenant, right-of-occupancy and condominium. Overall, if the different types of property rights corresponding to private ownership in the generally understood sense of the word are added together, the private ownership rate rises to 76%. This is not dissimilar from experience in the other central and eastern European countries.

[3]*Housing Developments in European Countries, 2003, Department of the Environment, Dublin*
[4]*Housing Developments in European Countries, 2003, Department of the Environment, Dublin and Housing Statistics in the EU 2005/6*

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Recently, the law has been changed to allow full owner-occupancy rights in place of tradable rights in co-operative ownership. However, this change is unlikely to enhance the supply of apartments much, according to a central bank analysis. Such apartments are mostly of low standard and their owners are usually low-income and so retain the apartments outside of market relations in order to satisfy their own housing needs. In the absence of a clear market, their asset values are low and hard to realise.

Local government only originates from 1991, so its experience of administering housing is limited. Councils' housing stocks are based on decentralisations of previous state housing. Estates are heavily loss-making, given low rents and high outgoings in terms of heating, other services and maintenance. In consequence, most local authorities are keen to sell off of as much housing as they can expediently do. Council housing is geographically concentrated and in some localities municipal tenants form influential voting blocs.

Housing co-operatives can be huge organisations of up to 100,000 members, all of them set up under the aegis of the old regime. Nominally, their boards are voted for by members but turnout is low and typically little notice is taken of memberships in the larger organisations. There i s political pressure to break co-operatives up into smaller, more manageable and accountable organisations.

To date, there have been few conflicts between tenants and new apartment owners over repair costs to buildings. This is partly because the building structure is still usually owned by a third party (i.e. the co-operative or municipality) and also because everyone typically has only a low income and generally prefers the minimum necessary expenditure. It is unclear how major renovations could take place to such structures without significant subsidy, given the incomes and mixed incentives of occupants.

Investment backlogs

Overall, there is a huge backlog of work required on existing dwellings and amenity improvements in local neighbourhoods. Over 60% of the stock, 7.5 million dwellings, is in need of significant repair and over 10% requires major renovation. The 2002 Census found that housing was of poor quality for 23% of the population and of very poor quality for another 12%. Though the repairs situation has improved in recent years, the aggregate result remains a hugely expensive backlog of work requiring many years to overcome. Furthermore, the economic life of many currently 20 to 30 year old buildings could turn out to be shorter than originally expected, because the costs of renovating them are too high relative to their usefulness. Given current housing shortages, there is little chance that new building will lead to significant replacement of the existing stock in the near future.

Private renting

Formal private renting is not a category that appears within the housing stock statistics shown in Table 12.1 and most private ownership is commonly regarded as for owner occupation. A 2002 survey by a World Bank research team, relying on household interview information, suggests that the size of the privately rented sector might be significantly higher than is commonly believed[5]. The household survey approach inevitably leads to approximate results but it suggests that around a quarter of all households in the larger cities live in private rental accommodation and that around a quarter of younger households are private tenants.

Table 12.2: The household tenure mix

% households	Total	Warsaw	Urban	Rural	Starters	Young families
Owner-occupied	66	49	56	88	44	50
Public rental	14	21	20	2	32	23
Private rental	17	28	22	6	24	27
Other	3	3	2	4	-	-

Note: 2002 survey. Starters - aged 16-29 years; Young families - aged 30-44 with at least 1 child

Source: World Bank

[5]*Rental Choice and Housing Policy Realignment in Transition, World Bank, 2005*

Many landlords formally declare their property holdings and pay taxes on rents net of costs, though informal letting is still common. The regulatory situation for investors is not ideal, with a variety of rent control measures outside of the luxury sector, which typically caters to foreigners. The terms of the Tenant Protection Act discourage investment and the courts are reluctant to enforce eviction on non-paying tenants. Yet this does not seem to have halted a thriving rental market.

Barriers to change

Property rights may be confusing, uncertain or unenforced. For example, much older housing was expropriated by the state in the 1940s, in many cases without adequate legal foundation. Claims for compensation or restitution of building ownership as a result are currently slowly going through the legal process, holding back investment and repairs in the contested dwellings.

Another issue concerns a new planning regime. It has been introduced in major cities, like Warsaw, making the old plans redundant as they no longer have any legal status. However, new plans have not been formulated for most areas of cities so far (only a minority of Warsaw has new plans, for instance). This means that all development is technically frozen until the new local plans are drawn up and ratified; unless special micro-local plans are made in relationship to specific developments as they arise. This special procedure is time-consuming; raises development costs; directs development to localities where such procedures are easier; and generally is an inefficient and piecemeal way of planning urban land uses.

Such constraints have encouraged developers to concentrate on housing for the upper-to-middle sectors and in central locations because they can more easily bear the additional overheads. What is more, local authorities in those areas are used to dealing with development applications and so are more able to process them. The worst hit parts of the market are consequently likely to be at lower end.

Enforcement of existing regulations is another area of difficulty. Many building renovations have not conformed to regulations (up to 60% of them, according to informed estimates). Some have led to the illegal eviction of existing tenants, but there is little prospect of restitution for the tenant or, possibly, for the previous property owner who could have commanded a much higher price with vacant possession.

Policy-making itself may send out inappropriate signals and lead to failure to achieve objectives. An example of confused political outcomes relates to the reform of rents across the whole range of non-profit landlords. They were supposed to move from the mid-1990s towards more realistic levels, which would have led both to a more efficient use of space and provided higher incomes to housing institutions, enabling them to spend considerably more money on improving poor existing housing conditions and removing the need for continued municipal subsidy of loss-making organisations. Laws were duly passed that enabled rents to rise. However, political pressures have generally meant that co-operative and municipal rents remain low[6].

Nevertheless, a whole variety of central government subsidies to housing have been pared away over the past decade, as the responsibility for housing provision has passed to private initiative and local authorities. By 2004, the only remaining large, long-term, central government subsidies, apart from housing-related tax reliefs, were associated with mortgage subsidies, guarantees on housing savings schemes, and for social housing.

Low income housing initiatives

The National Housing Fund (the acronym KFM in Polish) is a subsidiary of the state-owned bank, Bank Gospodarstwa Krajowego. It provides subsidies on long-term mortgages that enable housing cooperatives and social housing associations to build dwellings for low income households in a programme that started in the mid-1990s, known by the Polish acronym TBS. The mortgage offered is index-linked at half the commercial rate of interest and can cover up to 70% of a project's value. The remaining 30% of the construction cost is usually raised in the form of an in-kind contribution of a plot by the local municipality and financial contributions by third parties, usually prospective tenants and their families. 10% is also written off from the debt when a project is successfully completed. Rents are then supposed to cover the rest of the loan costs, plus administration and repairs.

[6] *Muziol-Weclawowicz & Oracz 'Rents in Polish Social Housing', ENHR 2004*

Individual households in all tenures can apply for means-tested housing allowances, which are capped at 70% of total housings costs no matter the level of income. Between 1995 and 2003 the cost of these central government expenditures more than doubled and, in 2003, 850,000 households were in receipt of them[7].

Since 2004, housing allowances have become the sole financial responsibility of local government with central support entirely cut off. Municipalities can now determine their own levels of allowances and have to raise the funds from local taxpayers. This framework led to significant reductions in housing allowance programmes and considerable cross-local authority variation in them.

Taxation and property registration

The interest costs of housing loans can be deducted from income tax assessments. In addition, part of the costs of housing renovation and modernisation can be offset against income taxes for the expenditures made by both owners and tenants[8].

Caps were imposed in 2002 on interest rates based on maximum assessed dwelling values at the time of acquisition, which lowered both the exchequer burden and the bias of the subsidy towards better-off people buying the most expensive homes. The maximum tax permissible interest rate deductions are now calculated on the value at the time of acquisition of a notional mortgage for a 70 square metre dwelling based on a 100% loan to value ratio. That dwelling for tax purposes is valued at the state-declared dwelling price per square metre for the year of purchase.

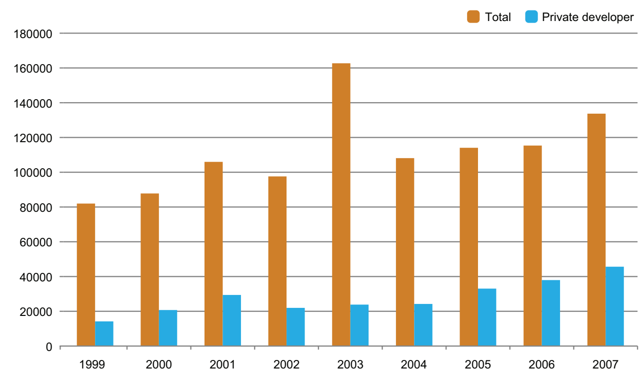
Poland's membership of the EU has altered the incidence of VAT with respect to housing. A reduced rate of 7% applies to most housing-related construction activity (new build, renovation, etc), but construction materials are subject to a 22% VAT rate. This higher rate also applies to the most spacious of new properties but all apartments up to 120 square metres and houses of up to 200 square metres are designated as having a social purpose and under EU rules therefore continue to be subject to the 7% rate.

One of the difficulties of housing and mortgage transactions is the time it takes to register them with regional courts, which can run to many months. Electronic systems are being introduced to speed up the process. Unfortunately, implementation is slow, so that delays in parts of the country remain and will do so for some time to come.

Housebuilding

Housing output averaged around 100,000 units annually in the first half of the 1990s, but then collapsed to only 60,000 in the mid-1990s, before recovering again in recent years to reach almost 135,000 dwellings in 2007 (Figure 12.3). Completions during the first ten months of 2008 were substantially above 2007 levels, as noted earlier.

Figure 12.3: Housing output 1999 - 2007



Note: The 2003 housebuilding figure is exaggerated by regulatory changes which encouraged owners of undeclared dwellings to register them in that year; correspondingly data in earlier years are under-recorded
Source: REAS

Most new housebuilding is now for the private sector. In the larger cities, professional developers are the most important source of new housing for sale, mainly producing apartments. In 2007 they built 34% of all new dwellings, up from 15% in 2003. Their output is strongly influenced by the state of the economy, with an initial expansion in the early 2000s, cutback in 2002, and then a rapid increase again subsequently (Figure 12.3). The slowdown in the market will hit developers' output particularly hard and could lead to a number failing.

A trade body, the Association of Polish Developers, was set up in 2003 to raise corporate standards and lobby government. Purchasers are expected to put down substantial deposits and purchase from plan, which helps with project working capital, but exposes buyers to significant default risks. Developer integrity is therefore important in order to avoid the loss of such deposits.

[7]Ministry of Finance
[8]Ministry of Finance

The typical development model in recent years has been for many sales to be off-plan and building only commences when the developer raises sufficient purchaser deposits. If insufficient purchasers come forward to make a scheme viable, outstanding deposits should be returned. The loss of purchaser deposits was an issue the last time the market slowed in the early 2000s. It remains to be seen whether such problems arise again in the current downturn.

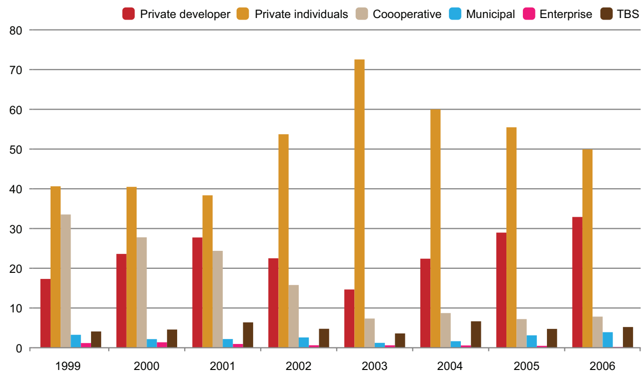
Within the private sector, small-scale building still predominates and represents 54% of all output (Figure 12.4). It mainly consists of private individuals having single-family dwellings erected on individual plots they have bought or already own.

These buildings are generally for own-use though they may be sold. This type of procurement is much easier in suburban and rural areas and smaller towns and the build quality is variable. A typical suburban house has 120 to 200 square metres net floor space, a ground floor and usable attic. There are now a number of substantial suburbs of such dwellings around the country's major cities.

Housebuilding by co-operatives has declined significantly in recent years. Much of their output since the early 1990s has been for the private market, with sales a useful source of income for them. Output has continued to fall with 8,240 co-operative completions in 2007. Co-operatives have legal problems with raising finance for development and their role has now declined to a relatively minor one, producing only 6% of new dwellings, down from a third at the turn of the century. Municipal and enterprise housebuilding is now less than 3,000 units a year. Another five thousand or so social homes are provided under TBS arrangements (as described earlier), but even their output has been declining in recent years as political support for them has waned.

It is now commonplace for Polish building workers to work in other parts of the EU. This has contributed to a growing shortage of building labour, although many have been returning home over the past year or so, as the construction booms in Ireland and the UK have subsided.

Figure 12.4: Housing output shares 1999 - 2007



Source: Central Statistical Office

Construction costs have risen substantially, because of higher labour costs, rising commodity and energy prices, additional VAT, and a generally booming construction market. As construction output is now contracting, the surge in cost inflation is likely to subside. Returning construction workers may find employment hard to come by, which may further moderate wage pressure.

The finance of new residential development requires substantial upfront funding for land, infrastructure and construction. This need is met through bank finance as well as purchaser deposits. A few years ago, banks were wary of lending to developers because of the risks involved but relaxed their lending criteria as the housing boom took off. More recently, development credit has become hard to find again.

The two main developers in Warsaw are local companies but European firms have played a part in the growth of the sector as well, such as the Swedish firm, Skanska, Bouygues from France and several developers with a UK capital base. Irish and Spanish firms have also been active. Some foreign firms initially pitched their products into a luxury sector that is too expensive for the local market. Most new building is now instead of a smaller size. Until the slowdown, it consisted of semi-finished apartment shells but now harder times are forcing developers to upgrade their market offers. A typical 1 bed unit has a floor area of 45-55 square metres and a three room one is in the 70-80 square metre range.

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There has been a move towards greater emphasis on building near urban cores as more land has become available. In Warsaw, several high rise developments have been built or are underway in the city centre, which should have a notable impact on the city skyline and housing market. So, the emphasis is still on the middle to upper range, which is now becoming saturated and that may encourage a move down-market to the more mass, suburban housing sectors, if planning and infrastructure constraints can be overcome.

Macroeconomic influences

The economy expanded rapidly in 2006 and 2007, driven by booming domestic demand, and a good pace continued in 2008 with growth at over 5%[9]. Export growth had been strong and there have been investment and consumer booms, all of which have expanded the economy. The consumer boom incorporated the housing market, at least up until 2008.

Growth is expected to slow in 2009 as exports are being hit by the slowing of the European economy and moderating expansion of investment and consumption. However, overall growth is still forecast to be relatively good by European standards at 3%. But such a rate of expansion would be hit if the European economy declined faster or if the consumer debt overhang and problems in the housing market create greater difficulties than are currently envisaged.

There is a public sector deficit of 3% and a deteriorating trade balance, which is expected to reach 6% of GDP in 2009. Inflation rose significantly in 2008 to 4% and is expected to moderate somewhat in 2009. Inflationary concerns and a weak fiscal stance encouraged the central bank to raise interest rates four times in 2007 to 5% and it continued making increases in 2008, with a final 25 basis point rise in June. Declining inflation prospects then led to a 25 basis point cut in November 2008, so the reduction in interest rates was less than elsewhere in Europe in the last quarter of 2008.

Phases of stop-go have characterised the economy. Growth in the years up to 2001was high, but then fell sharply to only 1% in 2001 and was not much better in 2002 as interest rates were set high in order to moderate inflation. The weak economy and high interest rates affected the new housing market and caused a marked downswing in it. In contrast to this experience a few years ago, the housing market has been positively affected by a strong economy over the past few years. However, rising inflation and the reactive monetary stance in 2007 and 2008 had less effect in cooling the housing market, given the prevalence of foreign currency loans.

High unemployment has been a long-term characteristic of the economy. It was running at almost a fifth of the workforce prior to 2004 but since then fell to 7% in 2008. This rate is still high and the country has a relatively low share of people of working age in employment with only 62% in work. This restricts the number of people in many families capable of contributing to housing costs. However, the recent dynamics of the housing market have been driven by better-off households where typically there is more than one income earner.

Social security payments are limited, so that widespread poverty exists with large numbers of households concentrated in un-privatised apartment blocks who can afford to pay little or nothing for their housing in the absence of housing allowances[10]. New households also face rising housing affordability difficulties as house price rises have substantially outstripped increases in earnings, so that affordability declined considerably when measured in terms of price-to-income ratios between 2005 and 2008. Purchase remains a distant prospect for the majority of households.

[9]OECD
[10]Large Housing Estates in Poland, Węcławowicz, Kozłowski and Bajek, RESTATE, Utrecht University, 2003

Mortgage market influences

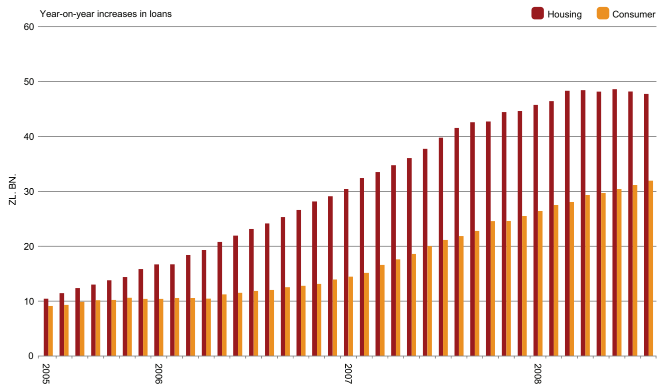
The mortgage market has been growing rapidly, rising 18-fold between 2000 and 2007 in nominal zloty terms. Even after the advent of the credit crunch in 2007 mortgage lending was still growing, although expansion tailed off after the first few months in 2008 (Figure 12.5).

The intensification of the credit crunch since October 2008 led to a sharp curtailing of mortgage lending as banks have tightened up lending criteria somewhat and raised spreads. In its October 2008 Financial Stability Report, the central bank voiced concerns about the credit risk assessment policies of some banks. It noted that in 2008 most banks eased lending policies with respect to consumer loans and had not reined in lenient policies with respect to housing. Pressure for tightening then helped to generate a sharp curtailment in loan availability in the final few months of 2008, which will continue into 2009 and possibly beyond. Nonetheless, some inappropriate lending may have occurred.

Despite the recent period of rapid growth, the Polish mortgage market is a relatively small one by western European standards, having been virtually non-existent until 2000. The mortgage debt to GDP ratio was only 11% in mid-2008, according to the central bank. Furthermore, many transactions still occur without recourse to mortgage lending, especially in the second-hand market - about which relatively little is known - and in the private individual new build sector.

Reasons why the mortgage market took so long to take off relate to inflation. In 1997 and 1998, nominal mortgage interest rates were 25%, imposing high repayment costs in the early years of a mortgage, and they were still in double figures into the early 2000s. Such high rates were a disincentive to borrowing, although indexation was widespread from the late 1990s, but complex to understand. High lending rates were caused by the large spreads on mortgages demanded by financial intermediaries as well as by the general level of nominal interest rates. Improved efficiency, greater competition in the mortgage market and falling interest rates then led to the take-off of mortgages.

Figure 12.5: Household lending Jun 2005 - Aug 2008



Source: Polish Central Bank

Mortgages are generally offered by commercial banks, issuing variable loans at short-term interest rates plus a spread. However, a full range of mortgage products is on offer, with varying terms during which interest rates are fixed. Central bank surveys show that half of all loans in 2008 were associated with loan-to-value ratios of over 80%. But typically the loan service to net income burden was below 22%, so that most borrowers have a reasonable income cushion if their mortgage costs rise. However, there is small group of borrowers that is distinctly more vulnerable.

Foreign currency lending accounts for a high proportion of outstanding loans and have been the fastest growing part of the mortgage market for several years (Figure 12.6). Two-thirds of outstanding housing loans in October 2008 were denominated in foreign currencies.

Much of the borrowing has been in Swiss francs because of the attractiveness of the interest rates on offer. Over the past two years, they have hardly changed whereas zloty-denominated loans have increased in cost. Furthermore, the interest costs of zloty-denominated variable rate mortgages have caught up with longer-term fixed interest ones (Figure 12.7). So, the widening of the interest differential in favour of foreign-denominated housing loans increasingly favoured their use in 2008.

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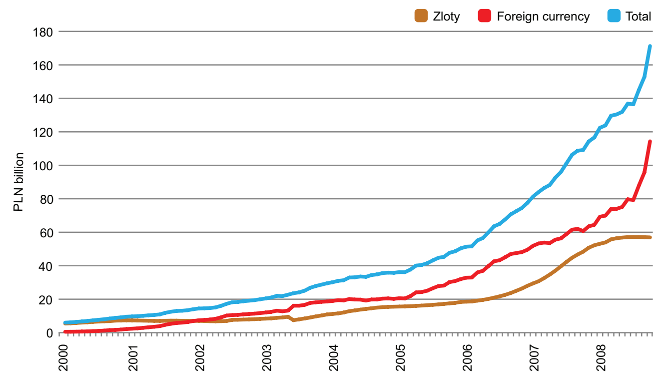
As household earnings are denominated in Polish currency, borrowers of foreign currency denominated mortgages face significant exchange rate risks, especially as the exchange rate began to move against the zloty in 2008. (This decline in the exchange rate may help to explain the sharp rise in FX loans shown in domestic currency terms in Figure 12.6.)

The downside of FX risks is quite a recent experience for Polish mortgage borrowers. There was a 20% devaluation in the early 2000s that led to them facing sharp rises in the zloty value of their mortgage repayments. Exchange rate volatility remains a significant risk for the housing market in 2009. If the currency continues to depreciate the costs of two-thirds of outstanding mortgages is going to rise.

In order to counter exchange rate risks in the mortgage market, the Commission for Banking Supervision issued in 2006 a recommendation to banks that they must assess clients' credit-worthiness on the assumption that the interest rate on foreign loans was at least equal to prevailing zloty denominated lending rates. This and other measures led to a tightening of foreign currency lending and helped to reduce its market share for a while but the widening interest rate advantage of FX loans in 2008 seems to being working against such constraints.

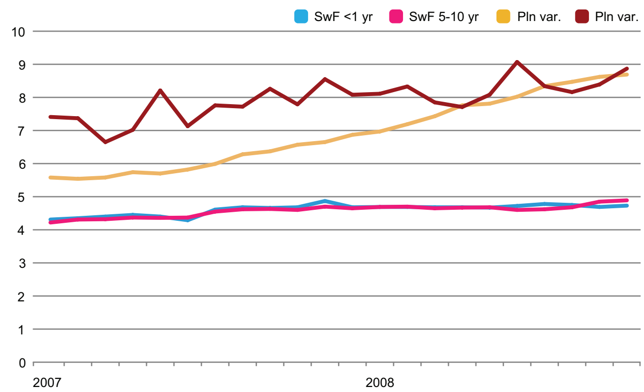
Early in 2006, the then government announced an initiative to reduce the use of foreign currency loans. It would subsidise interest payments on zloty denominated Wibor adjustable housing loans by more than half the interest cost for the first eight years of the loan for first-time buyers of new housing, subject to caps on dwelling size. This programme was expected to cost over PLN 6billion and may have contributed to increase the volume of zloty-denominated loans in 2007, shown in Figure 12.6.

Figure 12.6: Outstanding mortgage loans Jan 2004 - Oct 2008

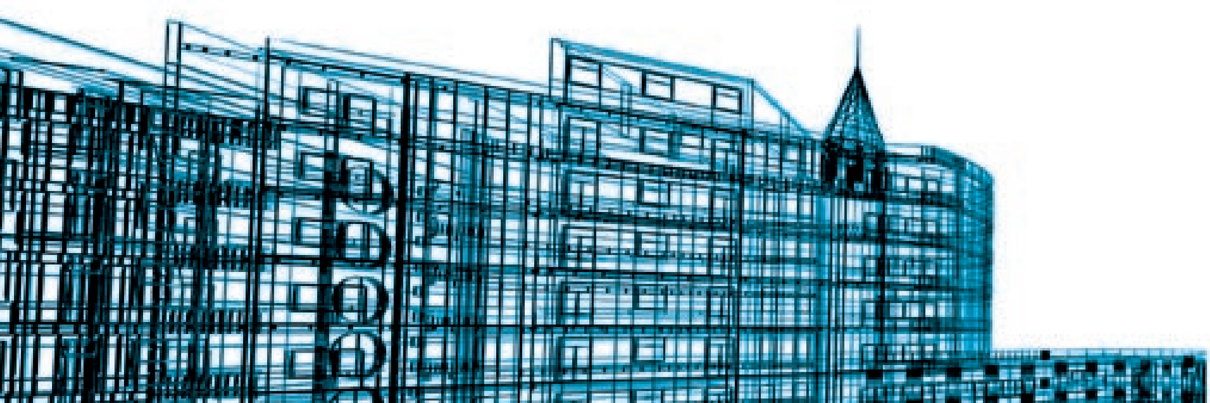


Source: Polish Central Bank

Figure 12.7: New housing loan interest rates, Jan 2007 - Oct 2008



Source: Polish Central Bank



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Average interest rates for mortgages denominated in zloty-terms fell substantially from 8.1% in February 2005 to 5.8% by the summer of 2006, helping to fuel housing demand. However, they gradually edged up again to reach 9% in October 2008[11]. Falling national interest rates may moderate the cost of mortgages in 2009, though banks have been increasing their spreads in the face of rising risks in mortgage lending.

A broking industry has developed as intermediaries and there is some concern over its lack of regulation in a country where few people have much experience of mortgage finance. The state has also encouraged the development of a mortgage bank system that raises funds on capital markets for lending to consumers on a long-term fixed interest basis. To date, it represents a small fragment of the mortgage market.

Typical due diligence data are still scant because of the limited history of competitive lending. In addition, the strength of the lenders remains to be seen. One national bank is a large player in the market, PKO BP, yet competition is growing fast but the strength of mortgage lending institutions in the face of major unexpected shocks remains to be tested. In addition, there is also a state supported housing savings scheme similar to that of the Bausparkassen in Germany. Low interest rates on savings are matched by low lending rates on loans in a mutual-support type of way. However, the expected flood of higher income groups to such schemes did not materialise and the funds remain minor players in the financial system.

Demographic influences

Population pressures, which are currently strong, are forecast to abate in the future. The population is expected roughly to stabilise until 2020 and then fall quite substantially - by over a million - in the subsequent decades because of the low birth rate and emigration. The population will also age, so that 30% of people will be 65 or older by 2050. So, the future demographic picture suggests a long-term lowering of housing needs. Many young Poles have also moved elsewhere in Europe in search of work and a higher standard of living.

Yet, even so, demographic pressures are currently pushing up housing demand strongly as there is a surge of younger people entering the initial years of household formation, a situation which is likely to last for some years to come. Migration to the economically strong major cities away from rural and declining areas is also putting intense pressure on housing provision in the booming localities.

Factfile: Poland

Background

Population (m) 2007	Annual Population Growth % 2007	Fertility Rate* 2006	Years Life Expectancy 2006
38.1	-0.2	1.3	75

*Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)

Economic

	2004	2005	2006	2007	2008f
GDP per capita purchasing parity standard based (EU27=100)	51	51	52	54	56
Real GDP growth %	5.3	3.6	6.2	6.7	5.4
Growth in real private consumption %	4.3	2.0	5.0	5.0	4.9
Inflation – consumer prices % (HICP)*	3.6	2.2	1.3	2.6	4.0
Labour participation rate % (15-65 yrs old in work)	-	64	63	62	62
Unemployment rate %	19.0	17.7	13.8	9.7	-

*2008 Oct y-o-y

Sources: Eurostat, OECD, World Bank

[11] *Central Bank*

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Overview

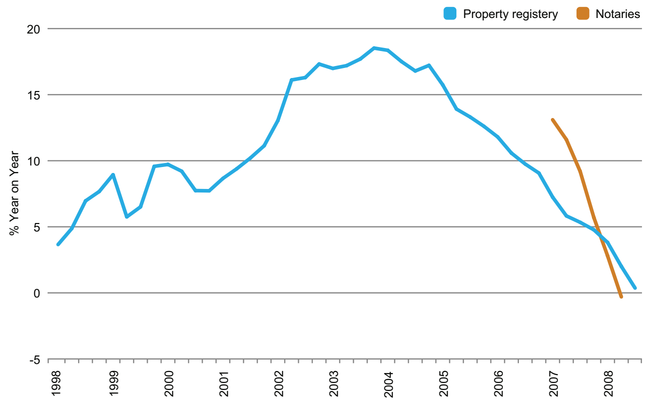
The housing market slowdown intensified during 2008, though recorded prices in the two official indices surprisingly showed only stagnation or moderate falls. The Housing Ministry information based on the property registry, which significantly lags market transactions, recorded a -3% year-on-year change in 4q 2008 and the new INE index based on data from notaries, shown a slight negative change in 2q 2008 (Figure 13.1).

Some have argued that actual falls in house prices are likely to be limited and that instead inflation will do most of the job of adjusting real house prices downwards. However, inflation is falling rapidly – even if it is expected to remain higher than in many other European countries. This makes the prospect of significant actual house price falls during the downturn more likely and the housing market slump may be a prolonged one. Others have argued that price falls for new housing in many localities have already been substantial, especially in holiday areas. More are probably in prospect for 2009 and perhaps beyond. Such falls are soon likely to feature in official price indices.

The country had one of the biggest housing market booms in Europe, so the expectation is for a marked correction, partly for domestic reasons but also because the second home market had been so strong and foreign buyers played such an important part in it. Now they are few and far between.

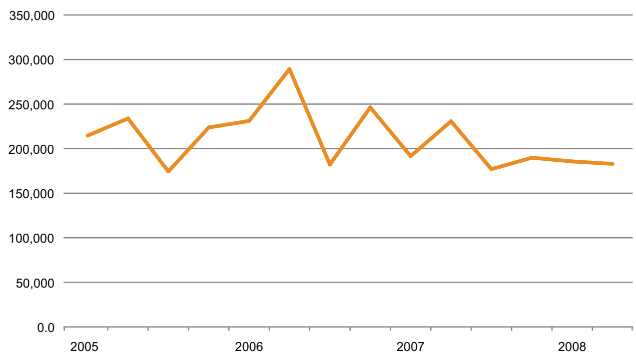
Property prices increased by 2.2 times in real terms between 1996 and 2006, housebuilding rates rose to record heights, and mortgage debt increased dramatically. Housing investment alone was 8% of GDP in 2006 and construction as a whole, much of it related to real estate, about 13% of GDP; while household debt reached 125% of personal disposable income in 2007 – three-quarters of it related to mortgages.

Figure 13.1: House price change, 1998q1 - 2008q3



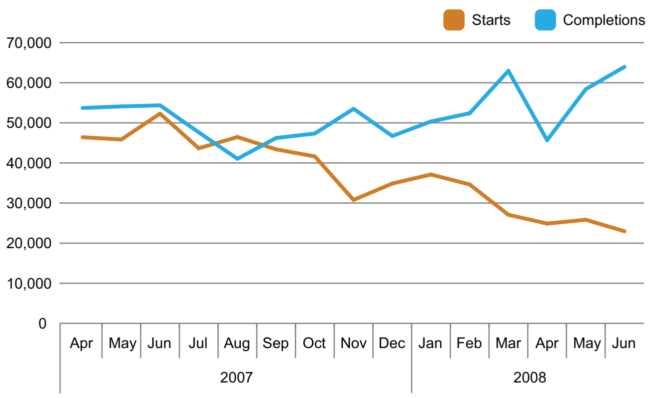
Source: Housing Ministry, INE

Figure 13.2: Transactions quarterly 2005 q1 to 2008 q3



Source: Housing Ministry

Figure 13.3: Housing starts and completions Apr 2007 - Jun 2008



Source: Housing Ministry

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Non-price data were showing the extent of the market turnaround in 2008, which seemed to accelerate significantly from the third quarter onwards. Transactions were down by 30% year-on-year in 3q 2008 (Figure 13.2). Housing starts were down by almost a half in June 2008 compared to the year before as developers dramatically cut back output. Completions in contrast were actually up by a third on the year because developments from the previous period of high output were still being built out. This continuing flow of new stock onto the market has been exacerbating an already significant supply overhang. What is more, Spain's housebuilding has been at extraordinarily high levels for a country of its size and even the mid-2008 level of starts was likely to be far higher than the market would absorb in the months to come. So, new supply will continue to put downward pressure on prices and further substantial falls in building are to be expected.

Spain is Europe's largest user of capital markets to fund mortgages. Around 30% of them utilised residential mortgage-back securities and the rest covered bonds. The impact of the credit crunch on mortgage availability has unsurprisingly been dramatic and mortgage lending had fallen almost 45% year-on-year by August 2008. The international problems with capital market funding of mortgages and the prospects of marked falls in Spanish house prices suggest that this funding problem may be around for some time to come. Without a revival in mortgage funding, it is unclear how the housing market can revive, even if euro area interest rates fall substantially.

Affordability is currently not believed to be too much of a problem. It worsened as interest rates rose between 2006 and 2008, but is now moderating as interest rates fall and prices soften. According to central bank data, mortgage repayment-to-income ratios were similar in 2007 to those at the start of the boom in the mid-1990s. More worrying factors are the impact of the credit crunch on the availability of mortgages; the ability of the housebuilding industry to continue to cut back output in order to limit supply overhang; and the weakening of an economy that is contracting because of the scale of the reduction in housebuilding and the ending of a consumer boom.

The government has introduced some fiscal measures to revive the economy and offset the decline in the housing market. For example, a temporary measure has been introduced to enable the unemployed to roll-up interest payments into the outstanding mortgage sum for up to a two year period. Public expenditure on construction activity has been increased. However, the scale of the downswing is such that any actions are only likely to moderate some effects rather than negate current housing market dynamics.

Some basic drivers of housing demand are still strong. Acute housing shortages continue, despite all the building, because of previous low housing standards and demographic pressures. There have been high levels of immigration, raising the population by over 4 million in recent years, which has put further pressure on housing. But such factors of themselves cannot put off a cyclical downswing.

Hundreds of thousands of new houses have been bought by foreigners and their presence in the second-hand market in many areas, especially near the coast, though hard to pin down, has been large. Indicators suggest that new foreign investment peaked a few years ago and is now moribund. But foreign purchase remains an important component of housing demand and there is a large stock of foreign owned properties. This adds a major uncertainty to market forecasts because it is unclear how such homeowners will behave in a softening market. On the one hand, they may wish to dispose of what may become recognised as a wasting asset; on the other hand, why sell in a poor market when you are not forced to and, at the same time, incur substantial transaction costs when the possibility exists of another upturn sometime in the future? The future of the vacation and retirement homes market is consequently more likely to be in the hands of developers. Already, many have gone to the wall but an excess of new properties will continue to blight second home markets and localities for some time to come.

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It is commonplace when evaluating the Spanish housing market to treat the second and retirement homes sectors as distinct from the primary homes market. This seems misplaced because Spanish households are the majority purchasers and owners of such property and part of that market in any case competes with potential primary home purchasers. Developers also work in both sectors. So, any negative vacancy, wealth or repayment difficulty effects arising in second homes markets are likely to spill over into primary homes ones and to affect the general level of economic activity as well.

Second homes markets are obviously not only affected by developments in Spain but also by events in the originating country of purchasers. Many buyers in Spain have been from the UK, which is expected to have the worst recession amongst the major EU economies and, furthermore, sterling has slid substantially against the euro, significant raising sterling-denominated Spanish house prices. Such factors further add to housing market woes in many parts of Spain, especially around the coast and on the islands.

The housing system

Despite having the highest overall number of dwellings per 1000 inhabitants in the EU, housing conditions for many still remain some of the most crowded in the EU with 3.0 people on average per occupied dwelling. The number of rooms per dwelling is quite high by average EU standards, yet rooms tend to be small with the usable floor area of dwellings towards the bottom of the EU rankings.

In part, this cramped lifestyle reflects cultural factors. Often several generations of families live together in dense urban accommodation. 44% of men and 30% of women aged 30 were still living in the parental home in the mid-1990s, the highest proportion in the EU; while only 5% of 65 year olds lived alone, the lowest in the EU (in contrast to over 20% of 65 year olds living alone in Denmark)[1].

Much housing is in multi-dwelling units, especially in the large urban areas. In fact, the country has the second smallest share of single-family structures in the EU at only 31% of the stock of primary residences[2]. Much of the stock, however, is relatively new - with a third being built in the last 25 years, compared to only 14% of Germany's and 10% of Italy's housing stocks[3].

There is also a high propensity to aspire to own a second home in the countryside or on the coast: over a fifth of households own one. For those that can afford it, this helps to make crowded urban conditions more tolerable.

Owner occupation and taxation

Most housing is owner occupied. Homeownership has one of the highest shares in the EU, at 82% in the last census[4]. Tax breaks for homeownership are significant, including mortgage interest and capital repayment income tax relief and tax breaks on housing savings schemes, which altogether are capped to generate maximum potential tax savings of around €1,400 a year. Imputed owner occupier rents are not taxed nor are capital gains if the proceeds are reinvested in another main residence. There is a wealth tax, with a rate rising from 0.2 to 2.5% for net assets worth more than €10.7m, with an initial exemption of approximately €150,000. Landlords are also offered tax breaks which effectively remove rental income from taxation[5]. Such tax breaks encourage investing in housing in general and favour owner occupation more than renting. Their existence helped to fuel the recent housing boom.

New housing pays VAT at a 7% reduced rate. There is also a turnover tax on purchases of existing dwellings, set by regional authorities at the same rate as the VAT on new property.

Second homes and vacant dwellings

14% of the stock was second homes in 2001 – and the share will have grown since then. Of the overall stock of 19 million dwellings, a high proportion are vacant - 21% in 2004 - often because they are either extremely run down or in the more remote locations that are losing population to the growth areas. However, low returns and restrictive regulations in the rental market are also encouraging investors to leave their properties vacant, though it is difficult to evaluate how much of the vacancy rate arises from this factor.

[1] *'Household scenarios for the EU, 1995-2025', M. Alders and D. Manting, Statistics Netherlands working paper in population*
[2] *Housing Statistics in the EU 2005/6*
[3] *Housing Statistics in the EU 2005/6*
[4] *Census 2001*
[5] *OECD County Report Spain, 2007*

Vacancies themselves are not carefully enumerated, except at times of the population census, so there is no clear way of knowing what short-term variations in vacancy rates are and where they are greatest. Nevertheless, it is likely that around a third of the stock of existing dwellings is not in the main prime residence market, almost certainly the highest share in the EU. With a substantial amount of new building produced for second or retirement residences, the apparent supply situation in the primary residence market at the national level is significantly less than it first appears.

In general, the wealth holdings of Spanish households are highly concentrated in real estate (mainly housing). 87% of wealth was held in property in the early 2000s. This wealth share is likely to have risen since then, given the subsequent boom in house prices. There is an interesting breakdown of real estate wealth, with 59% of it derived from main residences and 21% in other real estate, with the latter indicating the extent of second homes and vacant holdings as well as the existence of the privately rented and non-housing sectors. 70% of households have wealth from only their main residence or have no real estate holdings at all[6].

Subsidised housebuilding

Some newly-built owner occupied housing is given subsidies in the form of reduced interest on loans via means-tested schemes. Housing subsidies in recent years helped to finance about 60,000 new units a year and another 50,000 renovations. The recent 2009-2012 state housing and renovation plan has allocated €15billion towards this programme until 2010, a significant increase, and aims to fund stock conversions of 3,000 rental dwellings. A further €8billion of funds is being allocated for local area improvements, energy efficiency, housing rehabilitation and other urban schemes[7].

Supply-side subsidies that focus on low-income owner occupation have been criticised as inefficient and ineffective by organisations like the OECD. Households are eligible for the subsidised dwellings on their current incomes, which may only be temporarily low, and they can sell at market prices shortly afterwards; the scheme may be mis-used for secondary residences; most of the housing is provided in the private market and developers often do not find the subsidies attractive enough; the cost to the state is high; and the location of dwellings built under such schemes is unlikely to be in the areas of greatest need.

A new Land Law goes much further than the previous arrangements and specifies that 25% of all the new houses to be built should be subsidised ones, which raises the building costs of free market dwellings for developers at a time when profitability has been severely eroded. In addition, developers have to give between 5 and 15% of their land when it is classified as developable (i.e. rezoned) to the municipality (instead of a previous fixed 10%). The appropriated land is used for public purposes – roads, schools, etc - but municipalities can also sell it if they wish. The ability to sell gives municipalities an incentive to zone land for development, because they gain revenue when they do.

The fiscal incentive to rezone land for housebuilding is now weakened under the new Land Law. Under its terms, municipally-acquired land has to be sold for subsidised housing and, so, it will command lower than free market prices and, as a result, local authorities will earn lower incomes when they rezone land.

Renting

At only 11% of all housing in 2001, renting makes up one of the smallest shares in Europe. Virtually all of it, furthermore, is in the private sector with only 2% of rental dwellings classified as social. Public sector and non-profit provided social housing of the type common in many other EU countries hardly exists.

The rental market is concentrated in a few main cities, such as Madrid and Barcelona. It has been in long historical decline in the face of rent controls and pro-ownership subsidies, tax reliefs and consumer preferences. Rent increases have been limited in recent years, despite the scale of current general housing shortages. Returns are consequently generally low with the exception of windfall capital gains from sales of vacant properties to homeowners or investors.

Recent policy has tried to revive the tenure in order to meet the housing demands of mobile and single person households and those who cannot afford homeownership, such as low income and migrant families. Controls on rents in new tenancies were liberalised in 1985 – though leases still run for a minimum of five years with rents rising only by inflation during them and landlords face legal difficulties over non-payment of rents and other breaches of lease terms. Court procedures for eviction may take a year or more and reforms to the process have stalled. Tenancies taken out prior to 1985 still have security of tenure and low rents, which makes this a small return, poorly maintained sector.

[6] *Central Bank estimates 2005*
[7] *Housing Ministry*

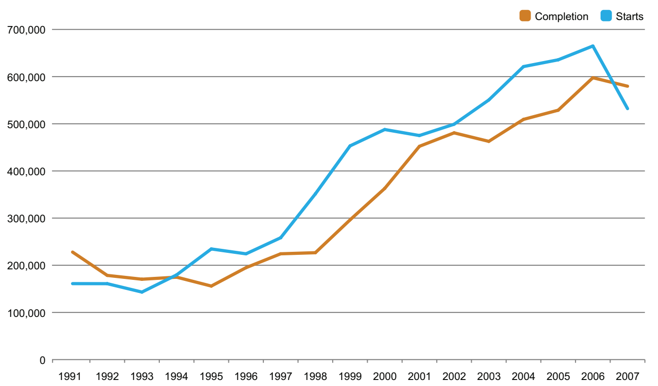
The government has announced that it wishes to double the relative size of the rental sector in a drive to improve the supply of affordable housing. Tax incentives to invest have been improved recently to cover purchase and renovation. Rent allowances for low income families have been raised but last only for a maximum period of two years.

A new scheme provides subsidies for housing to rent if it remains in the rental sector for at least ten years. Tenants would have the option to purchase properties later with some claw back of the rents they have paid.

Housebuilding

Annual housebuilding rates more than trebled during the housing boom (Figure 13.4). Output peaked in 2006 and fell as the market subsequently slowed. However, there was a further twist to the peak in that projects were brought forward to beat the introduction of a new building code introduced in October 2006. This laid out higher required construction standards and, hence, increased building costs. After the impact of this effect is discounted, the decline in the amount of homebuilding in 2007 was in reality less than it seems, so the adjustment of housing output in the downturn is slower than it appears from the peak comparison.

Figure 13.4: Housing starts & completions 1991 - 2007



Source: Housing Ministry

Builders were either being optimistic about future demand or finding it difficult to cut back on schemes quickly. Given the relatively large-scale nature of many developments, and the fact that blocks of apartments have to be built out once started, it may well take quite some time to cut back output. Once the finance is in place and contracts are signed, developers may prefer to hope for the best that market conditions will improve by the time their projects are completed, rather than incur substantial upfront losses in cancellation clauses and the certainty of being unable to repay debts.

In 2006, the number of housing completions per 1000 population was almost 15, which is 4 to 5 times the figure common in most advanced European economies, and the multiples were still huge in 2008. It must be doubted that construction firms are cutting back their outputs sufficiently rapidly in many regions of Spain to adjust to changing market conditions. The threat of continued high vacancies amongst the newly built stock is consequently high.

Some major property developers have already folded, including Martins-Fadesa, which collapsed in July owing €5.2bn, Spain's biggest failure ever. The Spanish housebuilding industry is dominated by a relatively small number of large, multi-sectoral construction firms, which are already diversifying into other countries' housing markets – such as in central and eastern Europe – and expanding their other construction operations. So, others may be able to walk the tightrope and survive debt mountains and the reduction in housebuilding in consequence.

The impact of land and planning policy on the amount of housebuilding

As was noted earlier, building land is made available in the planning system via a zoning process that designates and periodically redesignates land into zones of urban, developable and protected uses. In the decentralised political structure, there is no central co-ordination of land-use planning, so planning policies vary between regions and municipalities and delays can be extensive. Developers have to implement infrastructure works themselves and it can take years to win planning approval.

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Despite the variability, local government generally responds to the land release incentives that local government finance and the planning system give them. This has helped to propel housebuilding to such high levels. There are now concerns about the environmental degradation that has been associated with the massive amount of housebuilding that has taken place. The conditions under which building permits are issued has been recently tightened and some coastal developments built without permits are being demolished.

An important element in local government decision-making processes over residential land availability is the fact that real estate is the major source of municipal income. During the boom, local public income was substantial from sales of land appropriated during zoning processes, plus from the taxes on land sales, and also from other property value based local taxes. Given the past significance of development-based local government finance, the new era is going to lead to far lower levels of local government income from real estate, which may damage future urban development plans.

Moreover, though this local authority income factor generally acted as a stimulus to land release during booms, it can have the opposite effect. Municipalities where there are few competing development localities have an incentive to restrict land supply in order to encourage increases in local land and property prices and, so, maximise their tax take. There have been complaints that some municipalities, especially in the areas of greatest shortage around the major cities, were adept at this activity in recent years and held back land supply. One consequence was the leapfrogging of development to more distant locations and resultant long commuting times.

During the current downturn, housebuilding is likely to undershoot optimal levels considerably. It is unlikely that housebuilding will ever recover the heights of the last boom in the next upswing. In fact, quite what the equilibrium level of output should be is hard to estimate. Much depends on foreign buyers and on how much the current downturn dents the widespread belief in the financial benefits of property ownership. That in turn will be influenced by how far prices fall and how long the housing slump lasts. Yet, trend per capita building rates are likely to be at a higher level than in many other European countries because of demographic and housing quality pressures and due to the importance of the second and retirement homes markets.

Macroeconomic influences

Until 2008, economic growth had been stronger than the EU average for well over a decade; with growth rates averaging 3-4%. Taking a longer view, there has been an epoch of growth and change since joining the EU in the mid-1980s, apart from a recession in the early 1990s. Although population increases helped this expansion, GDP per capita now more than matches the EU average. Job creation was also strong, at least until 2008 and the labour participation rate has risen to almost 75%. So, many households now consist of more than one income earner, encouraging borrowing for house purchase.

As part of a general context of economic change, housing prices have risen substantially since the mid-1980s. There was a brief fall back in the early 1990s along with the economic recession that occurred then but, generally, the idea that house prices always rise is ingrained into Spanish culture. However, in principle there is no reason why house prices should actually rise over time: because that depends on the inter-relationship of long-term demand and supply.

In 2008, the economy slowed significantly with the decline in housebuilding being an important contributory factor. Growth just about remained positive; partly due to a fiscal stimulus that was equivalent to 1.5% of GDP. However, the economy will contract in 2009, though there is a chance that the recession may be short-lived, as long as the collapse in housebuilding bottoms out and the economy adjusts accordingly away from the distorted economic structure caused by the real estate and associated consumer booms.

Returning to the rates of growth seen prior to current recession may prove hard in the next recovery. For one thing, the real estate market is unlikely to roar again as it did in the recent past. Potential growth will also be held back by an expected reduction in immigration and female participation rates[8].

Spain's higher than EU average inflation rate in recent years means that it has lost international competitiveness. Furthermore, exporters face the pressures of a high euro exchange rate. So, the future of the housing market rests on how far the general growth rate can be increased through productivity improvements to overcome threats to international competiveness and to increase efficiency in service activities. If the economy stagnates for some time, the prospects for the housing market are likely to be poor.

[8] *OECD*

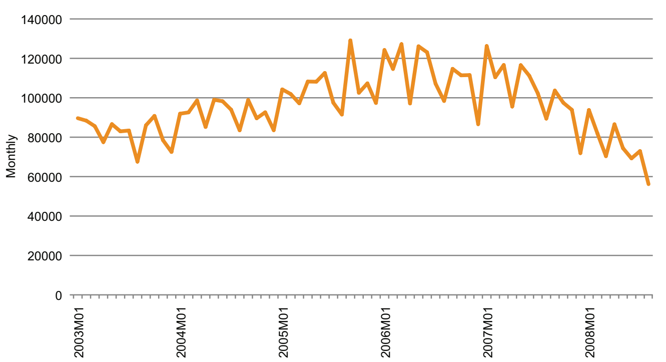
High unemployment is a characteristic of the economy. It was still 8% at the peak of the last boom a couple of years ago - though that was far less than the 24% seen in 1994. However, the economic slowdown is pushing unemployment up quickly and it is forecast to reach 15% in 2009/10. That will raise repossessions in a country where so many are homeowners with mortgages. Hopefully, the emergency measures enabling the unemployed to defer part of their mortgage payments will limit the potential onslaught of high default rates.

Labour market restrictions, including job protection legislation, are said to contribute to the high unemployment rate. The price indexation of many wage contracts also means that inflationary pressures are rapidly transmitted through the labour market.

Mortgage markets

The impact of the credit crunch was slightly delayed but by January 2008 the number of mortgages issued was falling rapidly. In August 2008 the fall had reached -43% compared to the same month a year earlier (Figure 13.5). This is on a par with crisis hit Ireland and UK, where house prices have fallen rapidly.

Figure 13.5: Number of housing mortgages, Jan 2003 - Aug 2008



Source: INE

It has been widely noted that Spain's major financial institutions have so far not been as badly hit by the credit crunch as in other countries. The biggest bank, Santandar, has even acquired stricken banks in other countries, notably Alliance and Leicester and the deposit side of Bradford and Bingley in the UK. The smaller savings banks, the local and regional Cajas, are more exposed to real estate losses. But, whatever the strength of the underlying structure of the financial system, the fall in mortgage business suggests that tight mortgage credit rationing has now come to Spain and is likely to stay for some time.

One reason for the sharp curtailment in mortgages is that Spanish financial institutions relied increasingly on securitised vehicles for finance during the housing boom. Lenders came to rely on capital markets for about 40% of loan funding through mortgage securitisation and other vehicles. By q1 2008, they had the largest share of all European capital market mortgage funding: 24% of it, which was divided between €109billion of residential mortgage-backed securities (RMBS) and €267billion of covered bonds[9]. The closure of the international RMBS market has consequently affected Spain badly. The situation may also have been worse without the protection of the euro area and the ECB's active market operations to keep up lending.

Mortgages are mainly advanced by banks. The standard mortgage product is a variable rate one, with EURIBOR typically used as the reference rate. Around three-quarters of all mortgages are issued on such terms[10].

A typical loan-to-value (LTV) ratio during the boom was 80%. However, the range is wide: 2006 data showed that for a quarter of new loans, the LTV was below 50% and another fifth were above 80%, so some recent new borrowers are heavily exposed and may suffer negative equity if prices fall significantly. By contrast, the typical LTV on the stock of outstanding mortgages is around 65%. The credit crunch will have limited the ease with which those wanting high LTVs can now borrow.

The 80% LTV ratio forms a financing threshold, because banks are required to increase their capital adequacy provisions when lending above it[11]. Default levels are currently low but will inevitably rise, especially as unemployment is growing so fast. In the last housing market downturn between 1991 to 1993, when the economy overall was also experiencing problems, banks faced high levels of mortgage default. Around 7% of the mortgage market consists of lending to foreign residents and it has a default rate twice that of households as a whole[12].

[9] *Crosby, Mortgage finance interim analysis, HM Treasury, London, 2008*
[10] *Housing Statistics in the EU 2004*
[11] *Bank of Spain Quarterly Report on the Economy, November 2006*
[12] *Bank of Spain Financial Stability Report November 2007*

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Mortgages traditionally played a small part in housing finance and have only become commonplace during the recent housing market boom. So, the current volume of outstanding mortgage debt started from a low base. Outstanding residential mortgage debt was only 14% of GDP in 1990[13]. Now total household debt, much of it mortgages, is around 130% of personal disposable incomes, one of the highest in Europe.

Along with the growth in mortgages has come considerable improvement in the terms offered to borrowers. For example, in the early 1990s, the average mortgage product had a 15 year term. By 2006, that term had stretched to over 26 years and many mortgages are offered on repayment terms of up to 40 years or more. (The legal maximum is 60 years).

Lenders have been offering extended loan periods as a way of offsetting the monthly repayment increases induced by high borrowing levels and rising interest rates. However, though this may have short-term benefits in terms of lower outgoings, it also exposes borrowers to much longer repayment periods and, therefore, greater long-term exposure to risk. Nonetheless, current defaults are low and net housing wealth is also high. Banks' mortgage exposure risks, therefore, may be primarily centred on particular types of borrower and locations. However, if the economy and housing market both enter a prolonged period of slow down, the problem is likely to become more general.

In 2004, the Finance Minister announced that borrowers would be able to switch their loans from one lender to another without having to pay fees for doing so, in a move aimed at intensifying competition in the existing mortgage market. This put pressure on the previous dominance of savings banks as commercial banks were more able to compete for their existing customers. This type of competitive interplay is likely to have encouraged some participants to take on greater lending risks than they might otherwise have done. Currently the medium-sized savings banks are believed to be most exposed to housing market default risk. As they are non-profits, consolidation in the sector may result.

Demographic influences

The reduction in the birth rate and the ageing of the population are having significant effects. Demographic data show that a surge in household numbers took place from 1997 to 2001. This rise, it should be noted, corresponded with the early years of recent housing market upswing, so demography played a key part in its development. Forecasts suggest that demographic factors will put further pressure on local housing markets in the near future because of the age profile of the population and the reduction in household size, which is gradually converging on that in many other EU countries. Furthermore, the greater affluence of younger people means that they are increasingly reluctant to stay at home with their parents until so late in life as in the past.

There is also significant movement of people towards the bigger, more economically successful parts of the country. Some of the older industrial districts and rural parts of the country are now experiencing large vacancy rates in their housing stocks, while chronic shortages remain elsewhere.

The birth rate is now the lowest in the EU, alongside that of Italy. The average number of children per woman is only 1.3, whereas it was one of the highest until the early 1980s. Less children born since 1980 will translate into less house purchasers 20 to 30 years later. Part of this dramatic change arises from the greater role of women in the labour market and in higher education, both of which encourage later child birth. Yet other important factors have been the high unemployment rate and insecurity of employment, particularly amongst younger men who fall outside of the gains from labour market regulations. This has delayed the age of marriage for many, while already married and co-habiting couples have put off having children, partly because of the difficulty of finding larger, affordable accommodation within reasonable travel-to-work distances. Other consequences of the changing age profile will raise household numbers, such as the ageing population and the resulting greater incidence of single elderly.

Overall, even without the recent surge in immigration, demographic pressures in the Spanish housing market remain strong. Even so, these pressures will not last forever. Population growth is expected to slow significantly over the next decade as the impact of the low birth rate starts to kick in.

[13] *Housing Statistics in the EU 2004*

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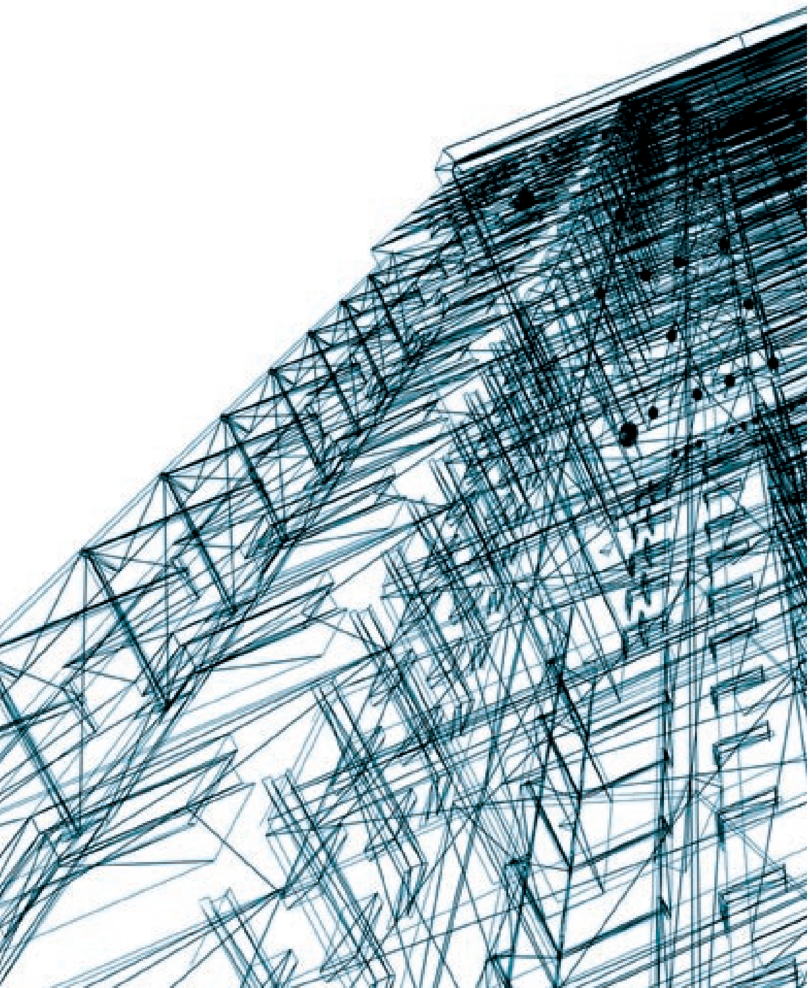
Demographic factors will gradually alter the demand for particular house types as current age cohorts move through the stages of their housing life cycles. Moreover, with less children around, the decline in average household sizes will speed up. Over the next few years, the number of people aged between 20 and 39 years old will continue to grow, however, and household numbers are likely to increase substantially as the tradition of multi-generational living in the same household weakens.

The rate of immigration into Spain is currently by far the highest in Europe. Net migration into Spain is almost half of the total of that into the EU as a whole. As a result, the resident foreign population has increased from 920,000 in 2000 to around 4.1 million in 2007, and the percentage of foreigners has risen to around 10% of the population.

There are a variety of different types of immigrant. Some are predominantly older people from north west Europe, particularly the UK, who wish to settle in Spain but do not participate in the labour market. They have been a mainstay of demand in the coastal and other tourist areas. Others come from central and eastern Europe, Africa and Latin America and migrate for economic reasons. Their typical current low incomes mean that they often have a hard time in a country where owner occupation is so predominant.

The areas experiencing the greatest increase in household numbers are predominantly those with the fastest economic expansion. Increasing immigration from abroad is creating housing problems in such areas, because understandably they are the places where work-related migrants wish to live but face affordability problems on their low incomes.

Because many immigrants come for economic reasons, the slowing of the economy will probably lower migration as well. Similarly, housing market problems are likely to dissuade some foreigners from contemplating retirement in Spain.



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Factfile: Spain

Background

Population (m) 2006	Annual Population Growth %	Fertility Rate* 2005	Years Life Expectancy 2005
44.8	1.7	1.4	81

*Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)

Economic

	2004	2005	2006	2007	2008f
GDP per capita purchasing parity standard based (EU27=100)	101	103	105	107	103
Real GDP growth %	3.2	3.5	3.9	3.7	1.3
Growth in real private consumption %	4.2	4.2	3.9	3.5	1.2
Inflation – consumer prices % (HICP)*	3.1	3.4	3.6	2.8	3.6
Labour participation rate % (15-65 yrs old in work)	-	71	72	73	-
Unemployment rate %	10.6	9.2	8.5	8.3	-

*2008 Oct y-o-y

Housing market

	2004	2005	2006	2007	2008f
Growth in residential investment	5.9	5.9	6.4	3.1	-5.9

Taxes

Owner occupied housing: mortgage interest relief – yes, with caps & exceptions

Capital gains exempt - yes

Imputed rental income - not taxed

VAT on new dwellings - 19%

Stamp duty - 0.5-1.5%

Property taxes as share of all taxes 2002 - 7%

Property taxes as share of GDP 2002 - 2%

Sources: Housing Statistics in the European Union 2005/6, Eurostat, OECD, World Bank

CHAPTER 14: SWEDEN

Overview

House prices have been growing much slower since the middle of 2007. In 3q 2008, they recorded a 4.7% annual rise. Though moderate by past standards, it was still the fastest growth in Europe but the market was rapidly slowing in the last months of the year.

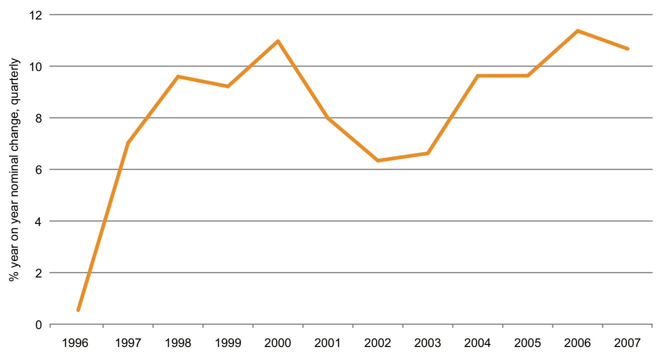
The boom had lasted from 1997 to 2007 with prices often rising annually by 10% or more, except in the aftermath of the early 2000s dot.com boom, which particularly affected the IT-oriented Swedish economy (Figure 14.1). Overall, real house prices rose by 2.3 times over the period, which places Sweden in the top European league for price growth in the last boom.

Further evidence of a slowing market can be seen in 2008 monthly price and transaction data (Figure 14.2). Transactions were notably down compared to 2007 and prices even fell slightly in October, although the winter months are slow for housing markets. Within the major cities, prices were weakest towards the end of 2008 in Malmö where they fell on an annualised basis. The Malmö market is influenced by events in nearby Denmark, but the economic slowdown suggests that 2009 might be a difficult year for the Swedish housing market as a whole and some of the past spectacular increases in prices may unwind during the forthcoming period of reduced housing market activity.

Housebuilding was also sharply down in 2008, especially since the summer with starts down by almost 60% on the previous year in 3q 2008. By contrast, mortgage growth in 2008 remained strong, up by 11% in value on the year to September, before facing greater problems from October onwards.

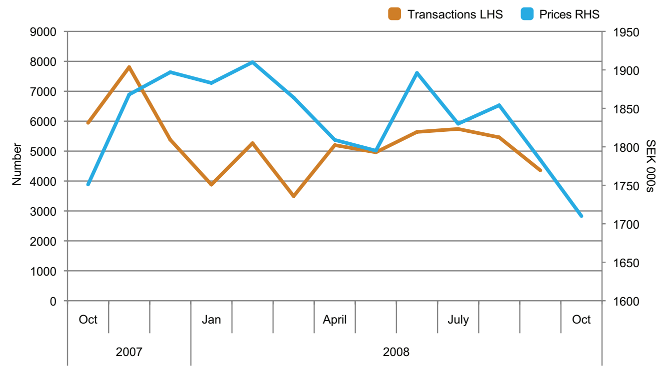
Recent years of sustained borrowing now mean that Swedish households are relatively highly indebted, with a debt to disposable income ratio of around 150%. According to the central bank, that ratio has risen by almost 30 percentage points in past four years, mainly due to extra mortgage debt.

Figure 14.1: House price growth, 1996 to 2007



Source: Statistics Sweden

Figure 14.2: Recent house prices and transactions



Source: Statistics Sweden

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At present consumer confidence is weak, with surveys showing that most consumers expect house prices to fall in 2009. The Central Bank's view is that at least a 5% fall is likely, although it could be greater if the recession is deeper than expected.

During the boom a familiar European story was played out. There were five core influences on the scale of the upswing: the increases in house prices were driven by rising incomes in a buoyant economy; rigid housing markets with poor supply responses; migration into booming regions; and falling mortgage costs. Finally, there was a greater range of mortgage products on offer and easier credit conditions, which households were keen to take advantage of in a long era of rising prices. An additional factor was associated with changes in the tax environment, which favoured ownership and were capitalised into house prices.

House price growth was strongest in the major cities – Stockholm, Gothenburg and Malmö – and in university towns, like Uppsala. These areas were the ones that experienced the greatest economic expansion.

The previous housing market cycle in Sweden during the late 1980s and early 1990s saw a major price spike and a subsequent crash that forced the Swedish government to rescue its financial system. So, the country has already had relatively recent experience of events that are affecting many others today. In that last housing market downturn real house prices fell by 30% from their previous peak. The slump was blamed on earlier inappropriate macroeconomic policies and financial liberalisation and it is now widely argued that the lessons learned then should stop a repeat of such cataclysmic events. Yet, they highlight a potential for extreme housing market volatility – caused in part by the role that owner occupation has to play in a highly-regulated and renter-skewed housing system.

Housing system

The country has long been famous for its interventionist housing policies, with a strong emphasis on social housing and market regulation. The current housing situation partly derives from huge levels of public investment in multi-family dwelling buildings, many derived from a 'million homes' programme in the 1960s and 1970s.

Between the 1950s and the 1990s, substantial subsidies and tax breaks were given to all tenures to raise the number of new dwellings built and to enable all households to exercise tenure choice. Then, during the 1990s, subsidies were slashed and housing policy was given far less government attention and even the housing ministry was symbolically abolished for a while. Responsibility for housing now resides in the environment ministry.

Yet, despite the apparent withdrawal of the state, the housing market is surrounded and structured by a series of state-led constraints, incentives and policy initiatives. So, Sweden still has one of the most overtly and complexly state-managed housing systems in the world. Whether this has led to a better overall housing situation compared to less-regulated countries with similar standards of living is a matter of debate. The issues centre on the cost, distributional and efficiency consequences, and the degree of flexibility to cope with shocks and surges and declines in demand.

The distribution of housing opportunities favouring incumbent households over newly- or recently-formed ones and others that wish to move, particularly into and within places where economic growth is strong. In other words, it is a system where lucky 'insiders' gain at the considerable expense of 'outsiders'. This not only creates unintended social consequences but also imposes significant economic costs. Added to the cocktail is a political scene with recent closely fought elections, which have encouraged government to cut property taxes and to put housing market reforms on the back burner.

Owner occupation has become the safety valve for housing aspirations in a situation of constrained supply. This has led to higher prices, which have generated wealth gains for some – either in the form of direct housing wealth or the implicit value of the right-to-live in a rental home at substantially below market value – and, so, led to inequalities that the original interventions were supposed to smooth out. Moreover, it means that variations in housing demand are predominantly borne in the relatively small owner occupied sector, which makes it prone to greater volatility than would otherwise be the case.

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The housing system is quite complex. There are four tenures: single-family owner occupied, tenant owner co-operatives, and private and public rental. 39% of all dwellings are single-family owner occupied, 19% are in the tenant-owned co-operative sector (which are owner occupied on a specific basis, see below) and 42% are rented – almost half of which are in the private sector[1]. Therefore, slightly under 60% of the housing stock is now owner occupied, far less than the EU average of 70%.

Statistics on tenure shares have to rely on limited surveys but it does seem as though owner occupation is growing, albeit at a relatively slow rate[2]. The proportion of single-family homeownership has expanded by around 5% of the housing stock since the early 1980s. Tenant-owned co-operatives have also grown in importance by a similar amount.

Tenant-owner may seem like a contradiction in terms to many but make sense under the Swedish system of property law, under which parts of built structures cannot be subject to multiple ownerships. So, legally, tenant-owned co-operative associations 'own' the buildings in which apartments exist but their owner member households can sell their memberships of the co-operatives and the associated 'right to occupy' a given apartment on the open market.

Co-operatives typically own only one estate or apartment building. This means that a new one is generally formed for every project, be it new build or the physical and ownership conversion and modernisation of an existing rental property. In either case, the new association takes out a mortgage for most of the cost, with part financed through contributions from co-operative members in exchange for a tradable right to occupy a specific dwelling. These contributions may be self-financed or funded by personal mortgages, provided under similar conditions to mortgages on single family houses.

Housing co-operative members are charged monthly fees to cover the costs of the mortgage taken by the association and maintenance and repair costs. The right of occupancy asset traded in the market for co-operative dwellings includes an obligation to pay the monthly fees associated with the dwelling. Traded prices consequently depend not only on the market value of the dwelling but also on the outstanding debt of the co-operative, on how well it is managed, the management and other charges imposed on co-operative members and the default risk of other co-operative members. Many of these items, of course, are not transparent. But as this tenure form is relatively recent in popularity its robustness through a period of housing market downturn has not really been tested until today.

The building and purchase of tenant-owned co-operative dwellings has been substantial and is growing. They are playing an important part in slowly increasing the role of owner occupation in Stockholm and other major cities, where renting predominates and the cost of single family housing is particularly high by Swedish standards. New co-operatives arise through the takeover of previously rented property as well as through new build.

Most conversions are now from previously privately rented properties rather than public ones. The inability of public housing bodies to make profits or to transfer sales receipts to municipalities' accounts means that there is limited incentive for large-scale social housing sales. Central government has also put caps on transfer numbers in locations where they are likely to affect the subsequent determination of average rents in areas of high demand (see later).

Taxes and subsidies

Overall, the tax system encourages house purchase over other investment options[3]. In general for owner occupiers, 30% of mortgage interest can be deducted at the purchaser's marginal rate of tax. Offsetting this, until recently, was a 1% real estate tax on the capital value of the property. In addition, there is a capital gains tax of 30% on two-thirds of any price rises. This can be deferred as long as another owner occupied property is bought and the rule applies to heirs as well. These deferral provisions discourage owners from ever switching to renting. Finally, there is wealth tax of 1.5% of wealth above SEK 1.5 million (SEK 3 million for couples). Although the array of taxes looks substantial, the overall incidence of property taxation is actually quite low by international standards at under 2% of GDP in 2004[4].

Tenant-owner apartments have a somewhat distinctive tax regime, though it roughly approximates in average incidence to that for owner occupation. Individual members can claim tax allowances corresponding to 30% of the interest payments on the mortgages they take out personally. Some allowances are also given for the mortgages held by the co-operatives. Co-operatives' imputed rental income is taxed on the basis of the

[1] *Regular National Report on Housing Development in Sweden 2005*
[2] *Partly, this is because there has been no available Census data since 1990*
[3] *'The Swedish housing market – better allocation via less regulation' OECD Economics Department Working Paper no 559, 2007*
[4] *OECD data.*

assessed value of the property, though, in practice, the tax rate is far from uniform because the relationship between assessed value and market value varies greatly.

The national real estate tax was reduced following the 2007 Budget and abolished with effect from the beginning of 2008. It has been replaced with a municipal property fee amounting to SEK 6,000 for a small house and SEK 1,220 with caps on the share of assessed property values. This tax reduction has partly been offset by increasing capital gains taxation at the time of sale from 20% to 22%. Whatever benefit there is to homeowners has presumably been already been capitalised into house prices and, so, encouraged price buoyancy in the already booming market prior to the credit crunch. The outcome is that this tax break provided a windfall to existing owners but only limited or even negative benefit to first-time buyers and those wishing to trade up.

Housing cost assistance of up to a third of outgoings is provided for low income households, other families with children, and pensioners. Around a fifth of all households are in receipt of them, mainly in the rental sectors[5]. Such means-tested allowances generate significant implicit tax rates on such households when their incomes rise and the allowances are withdrawn. They also do not encourage their recipients to economise on their housing costs.

Rental housing

Social housing is predominantly owned by municipal housing companies (MHC), which are independent, non-profit housing organisations owned by local authorities. Anybody can apply to live in a social rented dwelling, because traditionally the means-tested criteria that are common elsewhere in the EU do not apply. Strong long-term policy emphasis has been put on equality of access and avoidance of spatial differentiation by income or social group. However, recently, MHCs in areas of high housing demand have been operating screening policies that weed out potentially high cost tenants by refusing lettings to those with records of eviction or poor rental payments.

Rents are set in aggregate in order to ensure that MHCs do not make a profit from their housing stock. The patterns of relative rents for individual apartments reflect quality differences. Rents, therefore, are largely historic-cost based, dependent on outstanding debts, management and maintenance costs, and they consequently reflect the age composition of the social housing stock rather than prevailing market rent levels.

The legally determined system of rent setting in both the private and social sectors requires that there are local negotiations between tenant organisations and MHCs for social housing, and with private landlord organisations for the private sector. As rents have to be comparable across both sectors, and private tenants can appeal to a rent tribunal if they are not, the overall costs of local MHCs essentially set the average rent level. One unfortunate side-effect is to limit the incentives MHCs have to be efficient, because they always know that rents will be set to cover their costs. Negotiations then determine rents for the different dwelling types and locations within stock.

There has been some change in recent years, because any subsidy element (as defined through a court ruling rather than in economic terms) in public housing cannot be used in the comparison between public and private sector rents. However, as many MHC-owned dwellings are no longer in receipt of subsidies, the impact of the change is fairly limited in many localities.

Obviously, prevailing rental values are reflected in the capital values of residential investments, so that the returns earned on existing residential properties can be relatively high even though rents are low. This seems to be the case for the 3,000 plus properties covered in the IPD Sweden residential index[6]. Returns in 2007 were almost 9%, though much of it was derived from capital growth, with valuations reflecting the, until recently, booming housing market, as rental income returns were only 2.9%.

The regulated rent setting process means that rents in attractive urban locations are often well below market clearing levels. As housing shortages have grown in the major cities, this has encouraged intricate rationing procedures to deal with excess demand and black-market transactions. Such procedures greatly raise search and other costs for prospective renters. Existing tenants can enjoy substantial windfalls by sub-letting or by requiring undercover (‘key’ or ‘furniture’ money) payments from new tenants before agreeing to vacate the property.

[5] *Housing and Housing Policy in the Nordic Countries, M. Lujanen (ed.) Nord, Copenhagen, 2004*
[6] *www.ipd.com*

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The cost-based rents of the social sector are low because the stock was mainly built before the mid-1970s and most of the debt on it is now paid off. Such rent levels do not encourage efficient use of the stock. Existing tenants have limited incentive to economise on housing consumption or to move to cheaper locations. Because the criteria for entry to the tenure has been very broad in the past, people from a wide variety of social strata and income levels can end up with substantial implicit gains, whose social cost is questionable. Queues to enter social housing are long in areas of high demand. The general allocation process has detrimental effects on labour mobility.

There has been a gradual tendency for rents to rise in nominal terms, because costs are increasing as a result of the removal of subsidies, through the limited incentives MHCs have to lower their costs, and in response to general price inflation. However, there are variations across regions, with Stockholm having the greatest divergence of actual from potential market rents. As rents have not risen to reflect prevailing market shortages in an era when house prices are rising, investment in new rental housing is generally unprofitable.

There is no equivalent of the buy-to-let booms and the resultant expansion of rental housing in the equally strong housing markets of Ireland and the UK. Instead, the low profitability of new rental construction has constrained overall housebuilding rates, which is particularly important in a country where rented housing represents such a large share of housing at 42% of the stock.

Household and housing sizes

Sweden has the smallest average household size in the EU at 2.1 persons per dwelling. This is partly due to the very high number of single person households, which at 41% is the highest in the EU, compared, for example, to 29% in the UK. Even so, the average number of rooms per dwelling is good at 4.3 and the overall quality of the housing stock high – reflecting the years of high housing investment up to the 1990s[7].

Single-family owner-occupied dwellings are exclusively found in one or two family houses, which represent 45% of the housing stock, while most rented and co-operative dwellings are apartments. In general, one and two-family houses are more spacious than apartment dwellings. A typical owner-occupied house consists of five rooms, kitchen excluded, while an average apartment consists of three rooms. Hence, owner occupied housing is predominantly inhabited by families with children, while rented and co-operative dwellings contain a higher proportion of childless households.

Housebuilding

Housing completions were rising quite significantly in last years of the boom but were still some of the lowest in the European Union in relation to population size. Sweden's low housebuilding rate is on a par with the Netherlands and the UK and so is one of the true European laggards.

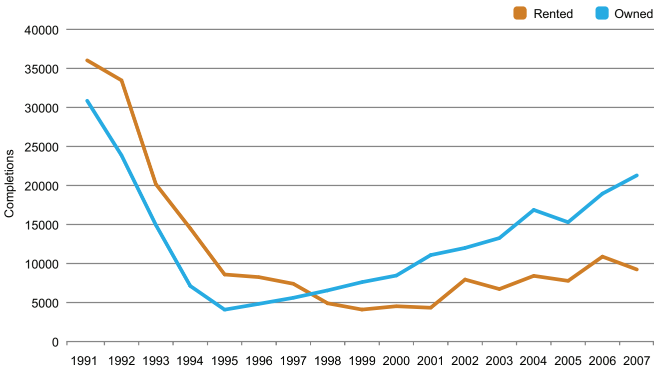
The collapse in housebuilding in the early 1990s was spectacular and rental housebuilding since then has only partly revived (Figure 14.3). Owner occupied output has improved more and it reached over 21,000 completions in 2007: representing 70% of new production. Within the owner sector, in the last years of the boom a surge in apartment building in tenant-owner co-operatives boosted output (Figure 14.4).

The improvement in housing supply seems to have ended in 2008 because starts in the first nine months of 2008 were 30% down on the previous year. The decline on a year-by-year basis was greatest in the third quarter, indicating an accelerating slowdown, with multi-storey building down a huge 78% and single family housing down 59%[8]. The collapse in multi-storey building was particularly marked in Stockholm, signalling the end of the boom there in the tenant-cooperative sector. However, it should be noted that subsequent revisions to these data may reduce considerably the apparent decline, because there are often substantial upward revisions to the published information.

Housing construction costs are the highest in Europe, according to Eurostat, at around 55% above the EU average. The OECD attributes high house building costs to market structures that evolved in the era of high housing subsidies, low levels of construction imports, and heavy regulations – all of which limited competition and innovation[9].

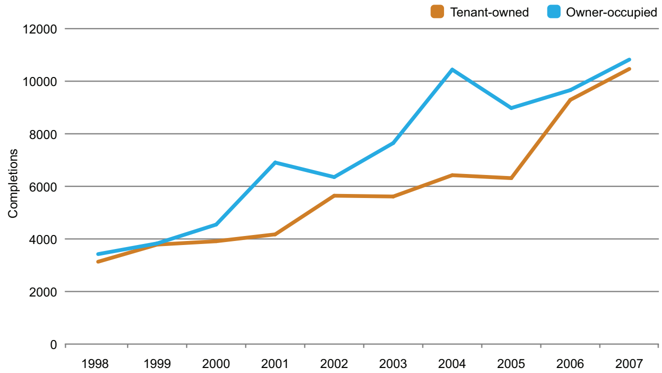
[7] *Housing Statistics in the EU, 2004*
[8] *Statistics Sweden*
[9] *'The Swedish housing market – better allocation via less regulation' OECD Economics Department Working Paper no 559, 2007*

Figure 14.3: New housebuilding by tenure



Source: Statistics Sweden
Note: Owned includes single family houses and tenant-owned apartments

Figure 14.4: New owned dwellings



Source: Statistics Sweden

Supply responsiveness is also limited because of land constraints. Land shortages occur for NIMBY reasons and because of the structure of local authority finance. Until the 2008 reforms, no local taxation was derived from property and it remains to be seen what the net long-run effect of the net municipal flat rate property tax will be on local authority finances. So, at present, municipalities have a financial incentive to discourage housebuilding in their localities, as extra housing imposes costs on local infrastructure provision and services with no commensurate increase in revenues. Consequently, municipalities have large upfront costs, with little prospect of a payback for many years to come.

There is a land shortage for new housing in the boom regions. Traditionally, land prices have been low and land costs were only a small proportion of total house building costs. But this era is now long gone. Complex and lengthy processes of plan formulation and appeals procedures generate considerable delay even where residential development is permitted.

Supply-side delays can spring up for ostensibly unexpected reasons. For example, the owner co-operative form of housebuilding was the fastest growing tenure, as noted earlier. This means that it should be an important source of new supply, either through new building or the renovation of existing structures. However, the process of setting up a co-operative is slow and cumbersome so that the tenure is a tardy means of getting new housing on stream, which helped to push up prices in the sector.

Macroeconomic influences

The economy is at its weakest for 30 years as growth ground to a halt in spring 2008 and the finance ministry expects the economy to be in recession in 2009 with GDP growth of minus 0.8% and unemployment to rise in consequence. The economy had been expanding at a high rate for a long period, surviving a minor blip in 2001 and 2002. This strong economic performance underpinned housing demand during the boom years.

Inflation rose to over 3% in 2008, after gradually rising in previous years, which encouraged the central bank to have an increasing restrictive monetary policy until late in 2008. As a result, the central bank's repo rate was gradually increased from a low of 1.5% in the summer of 2005, reaching 4% by autumn 2007, with a full 100 basis point increase applied in steps over the course of 2007. Monetary tightening continued in 2008 with three rate rises up to 4.75% in September 2008. Interest rates were finally loosened from October, with a major cut in December of 1.75% to 2% as the central bank belatedly responded to the scale of the economic slowdown.

Until 2008, job creation had been high in the booming regions and unemployment fell rapidly. The country has one of the highest shares of employed people in the working age population at 79%. Participation rates are particularly high for women and older age groups.

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The state is an important conduit within the economy and general government expenditure represents a high share of GDP. Associated with such state involvement are high taxes, a variety of tax deductions and a sensitivity of consumption and investment patterns to them. The centre-right government is midway through a major privatisation programme but has put it on hold until stock market conditions improve.

The government announced a SEK 23billion spending package in December 2008 in an attempt to counteract the recession. It focused on employment and training and included an increase in the tax deduction available for home repairs and maintenance, including energy efficiency measures. These tax breaks are proposed to become a permanent part of the tax code.

Mortgage market influences

In recent years, the covered bond market has come to be the largest source of funding for mortgage lending. Banks and other credit institutions have only been able to issue them since July 2004 but they now amount to SEK 900billion, 30% of the outstanding securities issued by banks. Covered bonds are more secure than residential-mortgage backed securities for a variety of reasons, including that fact that defaulting loans have to be removed from the underlying mortgage pool and replaced with new collateral and that only loans with an LTV ratio of 75% or less may be included. Nevertheless, the credit crunch has affected Swedish mortgage securities markets, so that few covered bonds have been issued over the past 18 months.

In fact, the situation has been worsening and deteriorated badly in the six months up to October 2008. The central bank's survey of 50 participants in the country's fixed-income markets in that month found that almost three-quarters said that the mortgage part of market was functioning poorly – whereas only 14% HAD felt like that in the spring. Difficulties were concentrated in mortgage-backed securities, because less than a third felt that the government securities market faced the same problems. At the same time, the spread between mortgage bonds and 3 year government bonds rose from 60 basis points in January 2008 to 180bp in November, touching 200bp in September in the aftermath of the collapse of Lehman Brothers.

The government has taken strong action to protect the financial system. As well as stepping up the provision of liquidity, the stability plan of 20 October 2008 included a guarantee programme up to a maximum of SEK 1,500billion to support the medium-term financing of the banks and mortgage institutions and set up as a long-term measyre a stability fund to deal with any future solvency problems which, along with the deposit guarantee fund, will average 2.5% of GDP within 15 years[11].

Lending grew strongly during the course of the long housing market upswing, aided by loosing credit conditions and competition between mortgage providers. The sharpest increases were associated with lending for tenant-owned properties; where borrowing is now over nine times the size it was in 1998[12].

Recourse to flexible interest mortgages and the five year renegotiation clause in fixed interest contracts meant that there has been limited mortgage churning caused by households refinancing their debt. There also does not seem to have been a large amount of equity withdrawal as there has been in some other European countries.

Despite the problems generated by the credit crunch mortgage lending has remained strong. Lending to households for housing purposes was set to growth by almost 12% in 2008, in contrast to the recent peak year of 16% in 2005[13]. So, the mortgage famine experienced in some countries, like the UK, has not occurred in Sweden, which helps to explain the contemporary relative price stability of its housing market. Nonetheless, lending institutions have become more cautious and are tightening up their lending criteria, including the limiting of maximum LTVs and the withdrawal of interest-only loans for new borrowers.

This tightening of credit conditions is likely to have significant implications, because first-time buyers' average loan-to-value ratios rose significantly during the boom years: from 75% in 2000 to 89% in 2005. Many homeowners take out a mixed package of mortgage and other housing finance products with different term-structures when negotiating their home finance. In the years up to the onset of the credit crunch, loans were normally granted up to 90 to 95% of property value, although on a case by case basis banks offered 100%+ loans. Interest-only loans also became more common, prior to the crunch[14].

[11]Swedish Central Bank Financial Stability Report 2/2008
[12]Swedish Central Bank
[13]Statistics Sweden
[14]Financial Stability Review December 2007, Swedish Central Bank

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Average mortgage interest rates fell from just under 6% in 2002 to less than 3% at the end of 2005. This unsurprisingly helped to fuel the demand for mortgage credit and to push up house prices. From 2005 to 2008, mortgage interest rates then steadily rose again to reach at the end of 2008, virtually the same level they were in 2002. The cut in the central bank's repo rate in coordination with other central banks in the autumn of 2008 was not fully reflected in mortgage interest rates – nor was the subsequent fall in 3 month interbank rates. This indicates that mortgage lenders were increasing their spreads in light of growing housing market risks and less competition.

Traditionally, single-family owner occupied housing was generally financed through long-term mortgages, with interest rates fixed on a five year or longer term basis. More recently, shorter term and variable interest rates have become popular. Their uptake obviously varies with expectations about the future of interest rates, but in the years of falling nominal interest rates they rapidly gained market share. With gradual rises in interest rates in recent years, their market share has fallen somewhat. It was 45% in September 2007, when expectations of future interest rate rises were high and spreads between short and long-term interest rates were narrowing. With the more recent reductions in interest rates, the share of variable rate mortgages has surged to over 60% of new loans. Even the fixed interest rate market is now dominated by terms of less than five years, so loans fixed for five years or more typically represent less than a fifth of total mortgage business.

Mortgages are provided by Housing Credit Institutions (HCIs), a type of mortgage bank, and commercial banks. HCIs finance themselves by issuing bonds and other instruments on the capital markets. These are predominantly purchased by the domestic institutions that manage financial assets, such as insurance companies, pension funds and banks, though about a quarter of bonds issued in 2006 were denominated in foreign currencies indicating foreign interest as well. Mortgage institutions try to match the maturities of their assets and liabilities in order to limit interest rate risk.

A small sector of 'building societies' exists, which are unlike either the British ones or the Austrian/German Bausparkassen. Instead, they consist of a variety of specialist lenders. At the end of 2007, HCIs accounted for 87% of outstanding lending for housing, which itself represented 71% of all financial lending to households, with commercial banks' direct products accounting for most of the rest of the market[16].

There is some guaranteeing of mortgage loans by a self-financing system run by a state institution, the National Housing Credit Guarantee Board. There is also a state-owned mortgage lender, SBAB, the mandate of which is to ensure diversity and competition in the residential mortgage market, whilst operating on commercial principles. It currently has a market share of around 7%. The current centre-right government was planning to dispose of this body but this has been put on hold by the credit crisis[17].

Five mortgage institutions are owned by commercial banks in a similar way to the situation in other Nordic countries and Germany, but two are state owned (SBAB and Venantius AB) with a joint market share of 14%. The two largest HCIs, Stadshypotek and Swedbank Hypotek, have about 60% of total HCI business between them[18]. There are five major HCIs, which compete fiercely with each other.

Demographic influences

Household formation is low and the birth rate is 1.8 per woman of childbearing age. Immigration is also relatively low. The result is that the current population of around 9 million is only expected to grow by around 1% by 2010 and increase slowly after that to reach 6% in 2020.

The share of the population over 65 is only expected to grow by 5% by 2050, so that ageing problems are less than elsewhere in Europe. As so many households already consist of one or two people, household numbers are not expected to rise much either.

The biggest demographic impact on the housing market is migration from economically declining areas to the booming ones. Most population growth is scattered across the south of the country with declines in the north and, even within the south, population is moving towards a limited number of regional centres and the Greater Stockholm area. Research has shown that there is a clear positive correlation between the rate of inward migration to a local area and the rate of change in house prices. The level of vacant socially rented dwellings is also far lower in the growth areas and local incomes are higher.

[15] *Swedish Central Bank & Statistics Sweden*
[16] *Swedish Central Bank & Statistics Sweden*
[17] *Standard & Poors*
[18] *The financial market in 2007, Swedish Central Bank*

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Factfile: Sweden

Background

Population (m) 2006	Annual Population Growth %	Fertility Rate* 2005	Years Life Expectancy 2005
9.0	0.2	1.8	80.5

*Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)

Economic

	2004	2005	2006	2007	2008f
GDP per capita purchasing parity standard based (EU27=100)	125	123	124	126	123
Real GDP growth %	3.6	2.9	4.4	2.9	0.8
Growth in real private consumption %	2.2	2.4	2.5	3.0	1.9
Inflation – consumer prices % (HICP)*	1.0	0.8	1.5	1.7	3.4
Labour participation rate % (15-65 yrs old in work)	-	78	79	79	-
Unemployment rate %	-	5.8	7.1	6.1	6.1

*2008 Oct y-o-y

Housing market

	2004	2005	2006	2007	2008f
Growth in residential investment	15.4	15.7	13.8	8.7	1.7

Taxes

Owner occupied housing: mortgage interest relief – yes, with caps & exceptions

Capital gains exempt - no but reductions

Imputed rental income - not taxed for single family homes

VAT on new dwellings - 25% (though with variations)

Stamp duty - 0.5-1.5%

Property taxes as share of all taxes 2002 - 7%

Property taxes as share of GDP 2002 - 2%

Sources: Swedish Central Bank, Eurostat, OECD, World Bank

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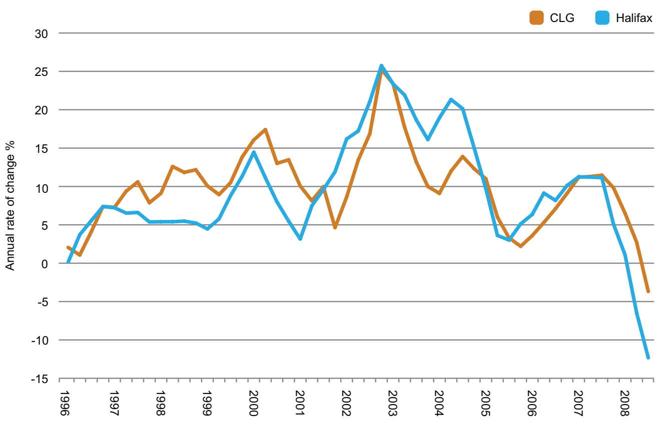
Overview

After the longest and strongest house price boom on record, the housing market was badly hit by the onset of the credit crunch in 2007 and the subsequent rapid downturn of the economy. The resultant cutback in mortgage finance rapidly sent the market into freefall. Mounting economic woes and expectations of substantial falls in house prices then helped to intensify the decline.

According to the Halifax house price index, by December 2008 house prices were 16% lower than a year earlier and back to the level they were three years before in summer 2005. The Land Registry price index suggested somewhat lower falls at 13.5% over the year up to October. Yet, whichever measure is used, prices clearly are falling rapidly.

Other housing market indicators highlighted a dramatic collapse in activity. Sales volumes were 64% down in August 2008 compared to the same month in the previous year, according to the Land Registry. The regular RICS housing market survey, a leading indicator, mapped the rapid decline. By November 2008, sales levels were at record lows, with only 10.6 completed sales per surveyor over the previous 3 months. Mortgage lending in November was less than half the level it was before the credit crunch started. Mortgage defaults began to rise, although from low levels, but there were fears that they would rise rapidly in 2009. The Council of Mortgage Lenders has forecast that mortgage arrears will more than double to 500,000 in 2009, with repossessions rising to 75,000 from 45,000 in 2008.

Figure 15.1: House price inflation 1996q1 - 2008q3



Source: CLG, HBOS

The new homes market was severely affected. Both the net balance of site visits and reservations were around 80% down by mid-summer 2008 on the previous year, according to the Home Builders Federation. Private housing starts in England in 2008 3q were 55% down on the previous year[1]. Many sites have been mothballed, thousands of staff laid off and billions wiped off the value of housebuilders' shares.

The loss of mortgage supply was caused by the closure of the market for residential mortgage backed securities (RMBS), where UK banks had been the most active in Europe using them to finance 40% of mortgage lending, and by subsequent difficulties in inter-bank lending. The impact was most directly seen in the collapse of some major mortgage providers, their nationalisation or forced takeover by others. This was seen spectacularly in the announcement of the sale of HBOS - by far the country's largest mortgage lender with a fifth of the market prior to the credit crunch - to Lloyds TSB in September 2008 after the collapse of its share price and a threatened run on its deposits, almost exactly a year after the collapse of Northern Rock. Around the same time, the Bradford and Bingley was broken up between Banco Santander of Spain and the UK government. Santander also took over Alliance and Leicester, while over the course of the previous year several specialist lenders had ceased to provide new mortgages.

Weakening housing market prospects made lenders cautious. Risk is being squeezed out of the mortgage market through high pricing or sheer unavailability. While it may be the case that risk was mispriced during the earlier credit boom, it is not clear whether the current developments simply reflect the return to better pricing or a flight to safety in which many potential borrowers are squeezed out altogether until markets settle down again.

[1]CLG

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The government announced a £500billion financial rescue plan early in October 2008 but this failed to halt the mortgage famine or to improve bank lending to either businesses or consumers. It was also by then considering guaranteeing mortgages as part of a package designed to restart the RMBS market, following the recommendations of the Crosby Report, though nothing had been agreed by year end[2]. A substantial package of reflationary fiscal measures was announced in November, partly directly aimed at the housing market. Government and housebuilders also set up a joint scheme to provide interest free equity loans for first-time buyers of new housing.

The problems of the housing market helped to push the economy rapidly into a major recession. The Bank of England finally started to cut interest rates aggressively from October 2008. From being 5.75% in July 2007, they were down to 2% by December 2008 and were expected to fall towards one per cent or less during in the opening months of 2009.

The measures taken to date are not expected to lead to a sudden revival of the housing market. Instead, the prospect for 2009 is for further declines in house prices and new building. A consensus has emerged that prices would fall by around a quarter and that the market would pick up in 2010 as the economy moves out of recession.

In reality, it is hard to predict either prices or the length of the housing market slump, because so much depends on an increased availability of mortgage finance. The fear is that mortgage availability fails to revive for a long time. If that occurred, the downturn will be severe and prolonged. Much depends on how successful the authorities are in revitalising credit markets. The measures to date have had little expansionary effect, though undoubtedly they have avoided financial catastrophe[3].

Gross mortgage lending fell from £363billion in 2007 to £258billion in 2008 and is forecast by the Council of Mortgage Lenders to fall by another 44% in 2009 to only £145billion. As mortgage debt is continuously being paid off, net lending actually turned negative in 2008 and the amount will grow to a possible minus £25billion net lending in 2009.

The housing system

Most Britons are homeowners with 70% of households in the tenure. In many parts of the country, the share is even higher but in the big cities, especially London, it is much lower. Nationally, 18% of dwellings are socially rented and 11% are rented privately.

There is no tax relief on mortgage interest for owner occupiers since the gradual abolition of the tax-break during the 1990s but capital gains are tax-free as is imputed rental income. There is a stamp duty tax on transactions which rises in steps up to 4%, although there is currently remission of stamp duty costs for lower priced dwellings for a fixed period. After each threshold, the whole of the purchase price incurs the new higher rate, so the tax creates pricing and transaction anomalies around the thresholds. There is no VAT on new housing, as is common elsewhere in Europe, but expenditure on home improvements and extensions are subject to VAT at the normal rate of 17.5%. (VAT has temporarily been reduced by 2.5% until the end of 2009).

The majority of dwellings are single-family houses. In England in 2000, 82% of households lived in houses, 16% in self-contained flats and 2% in bed-sits and other non- self-contained accommodation[4]. The housing stock is relatively old in comparison to many other European countries – with 41% built before 1945, another 45% between 1945 and 1984; and only 13% since the mid-1980s.

Owner occupation

Homeowners have been rapidly growing in number over the past 25 years. By 2006, there were 18.5 million owner occupied dwellings in the UK, 50% more than 25 years earlier. Typically, they were houses, with only 9% of them flats.

Homeowners tend to be settled. Over 80% have lived where they are for at least 3 years and a third have not moved for over 20 years. In particular, those over 50 tend to stay put. In the face of such sedentary behaviour, most homeowners have few worries about the threat of negative equity. Almost 45% do not have a mortgage at all. Of those 55% of home owners with mortgages, the average loan-to value (LTV) ratio is currently 54%, according to Standard and Poor's, so even many of those with borrowings will not have particularly high levels of mortgage debt. Debt concerns are concentrated amongst a relatively small proportion of owners but

[2] *Crosby Report - Mortgage finance: final report and recommendations, UK Treasury, 2008*
[3] *M. Ball The UK Housing Market. Origins and Prospects. National Association of Estate Agents, 2008*
[4] *Survey of English Housing, Communities and Local Government.*

they are the ones who have a disproportionate impact on the housing market as they are more likely to be contemplating moving and some of them may be financially stretched and, so, are most likely to default or be forced to sell.

Private renting

The UK now has probably the most liberalised private renting sector in Europe since the 1989 abolition for new tenancies of previous controls. There is only limited security of tenure for the first six months of a tenancy in the most common types of rental contract and rents are freely negotiable.

Tenant demand has grown substantially in recent years, with the number of private tenants rising by a quarter since the late 1990s. Younger and more mobile people in work are the main clients of the modern private rented sector. Even the quarter of private tenants on lower incomes that claim housing benefit tend to be far younger than the general age structure of the country's population. Once households become less mobile, they tend to move into owner occupation when they have saved enough for the down payment or, less commonly, move into social housing.

Higher house prices during the boom held back moves by younger households into owner occupation because of the need to save up equity to meet borrowing constraints. The average age of first time-buyers has not actually risen over the past decade, but their number fell significantly as the boom progressed. The average annual number of mortgages taken out by first-time buyers between 2003 and 2007 was over 40% lower than in the previous four years[5]. The number fell again after the start of the credit crunch.

The typical rental property is a terraced house in an outer or inner suburb of a town or city. The property will rarely be new, only 13% are post-1985, and almost two-thirds are pre-1945, although most will have been recently modernised.

Nowadays, three-quarters of landlords are private individuals and couples; about 10% are property companies and the rest a mix of other organisations[6]. There has been a substantial shift away from companies to individual landlords, because in the mid-1990s less than half of landlords were individuals. The long housing boom saw many firms sell up or run down their property holdings, while the Buy-to-Let revolution encouraged many thousands of new investors to become landlords.

Buy-to-Let mortgages have grown rapidly over the decade of their existence. Over a million were outstanding by the first quarter of 2008, worth £126bn, but their expansion peaked in the second half of 2006 and faltered after the middle of 2007. New gross advances for house purchase were down by 28% in the first half of 2008 compared to a year earlier, though this fall was much less than that for owner occupier borrowers over the same period[7].

Many small landlords have limited amounts of debt on their properties, despite the gearing and taxation advantages of doing so. Despite all the mortgage borrowing of recent years, the total amount of Buy-to-Let mortgage debt is actually worth only a quarter of the value of the private rented sector. Other forms of debt are unlikely to take the total amount of debt to much above 30% of total asset value[8].

Housing for rent is the UK's biggest property investment asset class. Its value rose rapidly in the recent long housing boom and with the expansion of Buy-to-Let, so that by 2006 it was worth over £500bn. In fact, the value of the private rented sector is now worth more than the sum of all of the privately-owned commercial property in the UK: offices, shops, hotels, factories, warehouses, leisure facilities - including both owner-occupied and rented buildings[9].

Some tenants are attracted to renting by the ease of moving and the low transaction costs. Others are more sensitive to the relative costs of owning and renting. House price expectations influence tenure choice. Periods when rising prices are expected encourage households to enter owner occupation and the opposite occurs when prices are expected to stagnate or fall. Demand cycles for owning and renting consequently tend to vary over time. Currently, more people are renting because of expectations of continuing falling prices as well as because of greater problems in finding mortgages and raising deposits.

[5] *Based on CML data*
[6] *English House Condition Survey 2006 Private Landlords Survey, CLG*
[7] *CML*
[8] *M. Ball The UK Housing Market. Origins and Prospects. National Association of Estate Agents, 2008*
[9] *2006 figures, own estimates based on Office of National Statistics data.*

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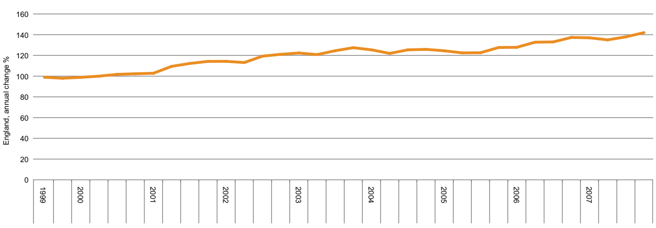
More flexible labour markets and a surge of foreign workers pushed up renting in London and elsewhere. Rent increases in the privately rented sector have fluctuated in recent years, depending on the balance of demand and supply. Market rent levels tend to percolate through to existing tenancies quite quickly, although existing rents are likely to be sticky in a downwards direction.

Rental growth was strong in 2006 and 2007, according to the RICS Lettings Survey and other sources, but weakened in 2008 as owners that could not sell rented out their properties instead. For most of the 2000s rental growth has significantly outpaced inflation, with rents rising by around 40% overall since 2000 (Figure 15.2).

Landlords' yields from rental income in recent years have not been particularly high, because house price rises have eroded any uplift in rental income. The yields recorded by the Association of Residential Lettings Agents (ARLA) have hovered around 5% for some years; Paragons' are somewhat higher; and IPD's income return for large-scale investors is only 3%. Each is measured on different bases but overall they suggest that pure rental returns are low. However, overall yields were greatly enhanced by rises in capital values during the house price boom, which encouraged many investors to enter the sector. Prices are currently falling but many investors expect prices to rise over the long-term and so have little incentive to sell. Rents are also likely to rise in view of reduced investment in buy-to-let.

Figure 15.2: Private sector rent index 1999q3 – 2007q4



Note: Indicative only, due to small sample size
Source: CLG

Social housing

Social housing is divided between local authorities and registered social landlords (RSLs), non-profit housing associations and trusts. By the early 1980s, the UK had almost a third of its housing stock in the social sector – one of the highest shares in Europe. Sharply reduced new building rates and sales of existing dwellings have substantially lowered social housing's role since then. By 2006, council housing's tenure share had declined by almost two-thirds from its peak level a quarter of a century earlier. However, the growth of RSLs, partly through acquiring ex-council housing, has meant that social housing overall still accounts for 18% of the total housing stock – still one of the highest shares in Europe.

Discounted sales to sitting tenants and others have been substantial. Over 3 million council dwellings have been sold since the early 1980s, either into owner occupation or transferred to RSLs. The sell-off has continued in recent years. Between 2000/1 and 2006/7 almost 330,000 dwellings were bought by sitting tenants in England alone, at an average discount ranging from 50% in the late 1990s down to 27% by 2006/7. Council house sales have been an important contributor to the growth of owner occupation during the past 25 years.

Social housing, as in several other EU countries, is now increasingly the home for lower income groups outside or on the margins of the labour market and recent immigrants. Part of the private rental sector also plays a similar role by accommodating households whose rent is fully or partly paid through means-tested housing benefit.

Around a fifth of the private rental sector's and over two-thirds of the social sector's tenants rely on 'housing benefit', the UK's term for means-tested housing rent allowances. Housing benefit pays up to 100% of the rent depending on the financial circumstances of the claimant. Around 3 million households were receiving housing benefit in 2006 and this item of public expenditure represents a much greater share of GDP than do equivalent programmes in other EU countries.

For many years social housing rents did not rise much in real terms, however recent years have seen somewhat faster rises. Even so, in 2005 the average council rent before housing benefit deductions was around half of those in the private sector nationally, and far less in high cost areas like London, and RSL rents were not much more[10].

[10]*Communities and Local Government*

Housebuilding

By international standards, UK per capita housebuilding rates are low, reflecting the degree of planning constraint that exists. Between 1996 and 2002 private housing starts were actually flat, despite the rapid rise in the house prices over the period (Figure 15.3). Housebuilding rates did improve in the latter years of the boom, with starts a fifth higher in its last three years than they had been around the turn of the century.

Much of the increase in building since 2000 was due to higher housebuilding densities, because the amount of land used for housebuilding actually fell. Brownfield acreages were static on a trend basis but there has been a precipitous fall in the amount of greenfield land used, with the area used declining by a half between 1994 and 2005. Regeneration and other brownfield land areas were playing an increasing part in providing new housing supply with brownfield land rising to 75% of all dwellings built in 2007, up from 59% in 1999.

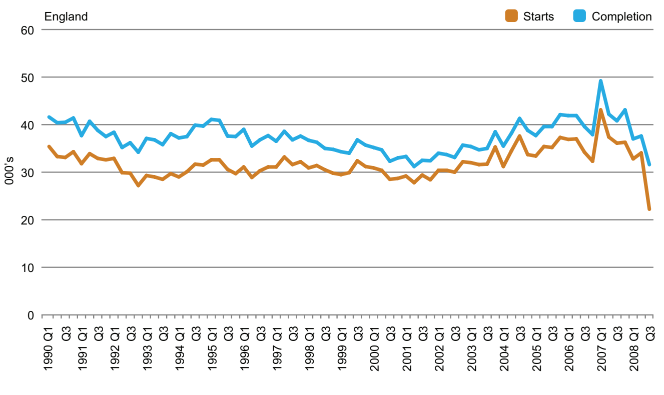
Housebuilding densities per hectare rose substantially in the first half of the 2000s, enabling the number of dwellings built to expand, while the acreage of land used decline. In respect of all residential land, densities rose by 42% between 1999-2002 and 2003-2006 (the published statistics provide density measures on a three-year average basis). However, this overall change belies significant differences between classic greenfield land, i.e. that previously in agricultural use, which experienced a 20% rise in densities, and classic brownfield land, i.e. that which was previously vacant or derelict, where densities rose by a substantial 71% over the same period to 53 dwellings per hectare. (Brownfield overall rose to 44 dwellings per hectare: a 52% increase in densities).

The type as well as the location of housing being built in England change substantially over the course of the past decade. Higher densities were achieved by greatly increasing the ratio of small flats being built. In the late 1990s, 3-4 bed houses represented 70% of new building; their share had fallen to 47% by 2007. At the same time, the share of 1-2 bed flats grew to 44% of all output, up from only 12% in the late 1990s.

During the upturn, the rate of increase in new build was uneven across the country. Rates were by far the lowest in London, which both does and does not have a land shortage – in that there is hardly any greenfield land yet a plentiful supply of brownfield land but it is in areas, especially in the east of London, where people are less keen to live or where infrastructure needs radical upgrading. Building rates were also relatively low in a number of other regions, including the South East. So, the area of the country with the highest house prices and greatest housing demand – South East England, including London – had the lowest building rate in an already dismal national figure.

This poor supply record exists despite the fact that the country has ostensibly one of the most market-oriented housing systems in Europe with a high share of owner occupation, a decontrolled private rental sector and a highly competitive mortgage market. However, such a market perspective does not extend to the key input of land, which is strongly regulated by planning and other state controls over greenfield development, building densities and urban regeneration.

Figure 15.3: Housing starts and completions 1990q1 - 2008q3



Source: CLG

There has seen a substantial slump in housebuilding. Private housing starts in England in 2008 3q were 55% down on the previous year and only around 85,000 dwellings were expected to be built in 2008, the lowest number for decades. The building slump is likely to continue in 2009 and output could fall below 50,000 dwellings.

Macroeconomic influences

Economic growth was strong up to 2008, with annual expansion in both 2006 and 2007 of around 3%. However, the economy moved into recession in the second half of 2008 and the consensus of the latest independent forecasts was that output would fall by 1.7% in 2009[11]. The speed of the economic slowdown was rapid and the impact widely felt throughout the economy.

The negative consequences of the credit crunch on the real economy and the housing market collapse on economic activity in general have been severe. Most of the fall in investment during 2008 was caused by the fall in housebuilding. The dramatic decline in housing market turnover has affected ancillary business services and retail activity. Consumer expectations have also been dented by the fall in house prices and associated negative wealth effects of falling asset values. Unemployment is expected to rise sharply, which is threatening to increase house repossessions significantly.

Inflation was beginning to rise at the end of 2007 and peaked at over 5% in the autumn of 2008. This encouraged the Bank of England to be cautious in its interest rate policy in face of the mounting problems of economic decline but eventually it started to cut rates aggressively in the autumn: first as part of a co-ordinated world response in October, then by substantial amounts in November and December 2008. These reductions directly affect the mortgage costs of around a third of borrowers on tracker products linked to bank rate and more are indirectly affected, so that existing borrowers' mortgage costs are falling as are the cost of new borrowings.

With forecasts pointing to a sharp fall in inflation in 2009 and even the possibility of deflation in the latter part of the year, the Bank still has considerable scope to reduce interest rates further. However, if mortgage credit is still heavily rationed these measures might have little effect on demand in the housing market.

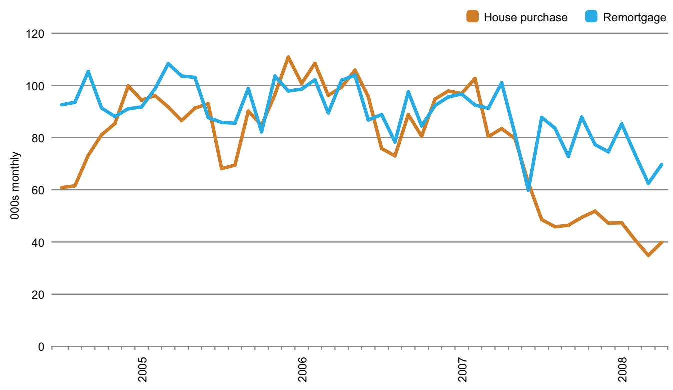
In addition, the government has encouraged banks to limit repossessions and to increase borrowing, so far with limited success. Emergency fiscal policy measures were announced in the autumn. Those directed at the housing market have centred on a small, temporary removal of stamp duty on a price band of cheaper properties, a joint scheme with housebuilders to provide finance for new house purchase, and small-scale programmes involving the purchase of existing unsold, new properties for use as social housing. None of these are likely to have much impact on the housing market given the scale of the collapse that has occurred.

Mortgage market influences

The decline in mortgage lending following the start of the credit crunch in 2007 was dramatic and unprecedented. The number of mortgage advances for house purchase dropped from around 100,000 a month in summer 2007 to 40,000 a month or less in autumn 2008 (Figure 15.4).

Remortgages held up slightly better than new purchasers. There was a huge increase in remortgaging from 2000 onwards. In part, this reflected growth in equity withdrawal but was mainly associated with housing renovations and the rising prevalence of introductory 'teaser' deals. Remortgaging is likely to drop substantially over the next couple of years. Equity withdrawal turned negative in 2q 2008 (Figure 15.5) and renovation is less attractive to either home owners or lenders in a declining housing market. The final and perhaps greatest impact will be the effect of the near total withdrawal of 'teaser' deals from 2007 onwards.

Figure 15.4: Mortgage loans for purchase and remortgage Jan 2005 – Oct 2008



Source: CML

[11] *UK Treasury*

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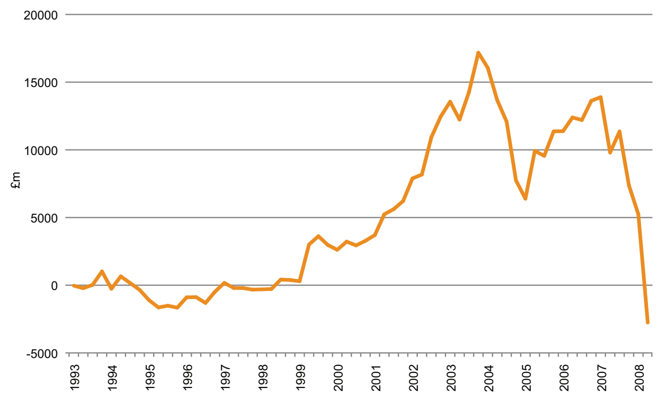
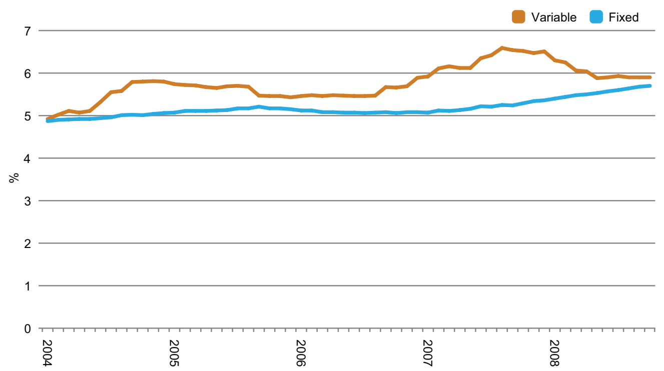
Figure 15.5: Equity withdrawal 1993q1 – 2008 q2



Source: Bank of England

Figure 15.6: Effective interest rates on mortgage loans Jan 2004 - Oct 2008



Source: Bank of England

Mortgages are traditionally of the variable rate type. Under British practice, lenders' standard mortgage terms enable them to alter interest rates at any time with no caps on the rate changes. A wide variety of new mortgage products have been introduced in the past decade. Some track the Bank of England bank rate, others offer discounts for a fixed time period before reverting to a standard variable rate loan. There has also been a marked increase in the use of 'fixed' interest rate mortgages, although these typically differ from the long-term contracts used in many other countries. Generally, the interest rate is only fixed for a few years, after which the mortgage reverts to the lending institution's prevailing variable rate for the remainder of the loan period.

Interest rates had been rising in the year prior to the crunch particularly on variable rate loans, slowing the market somewhat. They levelled off in summer 2007 and, at least for variable rate mortgages, had come down again by summer 2008 (Figure 15.6). Variable mortgage rate cuts did not fully reflect Bank of England base rate falls from 5.75% in mid-2007 to 2% in the last few months of 2008 as lenders became concerned about improving spreads and sustaining depositors' savings rates, which have reached very low levels. Therefore, additional further cuts in base rate may have little further effect on mortgages. (Some variable rate mortgages are linked in any case to LIBOR, especially for buy-to-let).

Now that mortgage markets are supply constrained, lender interest rate spreads and mortgage set up fees have risen. Higher risk borrowers face greatly increased costs or denial of a loan altogether. According to the website Money facts, the number of mortgage products on offer in the UK dropped from 13,027 in August 2007 to only 3,748 a year later, with average maximum loan-to-value (LTV) ratios falling from 90% to 80% and many products offered at even lower LTVs. 100% LTV mortgages have virtually disappeared and people with poor credit histories had experienced the sharpest rises in mortgage interest rates of 2 to 2.75% (200-275 basis points), whereas their rates were virtually the same as standard ones the year before.

The credit crunch so dramatically affected the UK mortgage market because prior to the credit crunch lenders had increasingly relied on capital markets for funding. In fact, UK lenders were responsible for over half of the total European issuance of residential mortgage-backed securities (RMBS). Between 2000 and 2007, the top ten mortgage lenders' reliance on customer deposit funding for net lending declined from 72% to 55%, while overall gross mortgage lending trebled from £119billion to £364billion[12]. The running was made by specialist lenders as well as banks. So, by 2006, the once dominant building societies had slipped to approving only a fifth of new mortgages for house purchase - many of them through the last remaining large society, the Nationwide - and specialist lenders were originating more loans than them.

[12] *CML & Crosby, Mortgage finance interim analysis, HM Treasury, London, 2008*

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Furthermore, many UK RMBS had relatively short-time frames and so needed refinancing within one or two years. They were also bought by a narrow range of investors. 85% of the UK RMBS transactions between 2004 and 2006 were purchased by US and UK investors, almost entirely by banks and fund managers[13].

Of the top 10 UK mortgage lenders in 2007, which between them then had 78% of the market, the ones that were most exposed to RMBS failed to survive beyond the autumn of 2008. Lenders with a total mortgage market share of 36% in 2007 were subsequently either nationalised or forced into ignominious takeovers.

The mortgage debt to GDP ratio stood at 83% in 2006, according to the European Mortgage Federation. This was the third highest in the EU, after Denmark and the Netherlands, which had ratios of around 100%, along with Switzerland. Expressed as a share of disposable income, the amount of mortgage debt has risen from around 85% of income at the turn of the century to a substantial 139% in 2007 the highest ratio amongst the world's leading economies[14].

Demographic influences

Demographic projections for the UK have been sharply revised upwards recently, highlighting that pressure on the housing market from demographic factors will continue for many years to come in contrast to some other EU countries, like Germany and Italy. The population as a whole of 60.5 million is expected to increase by 4.4 million by 2016 and to reach 71 million by 2031, if past trends continue[15].

Government household projections suggest that there will be a further 4.8 million households by 2026 – an annual growth rate of over 200,000. The majority of them will be one person households in older age groups, with 60% of the growth in the southern part of the country[16]. As this is the area of greatest housing shortage, pressure on accommodation is likely to intensify unless there are much higher rates of housebuilding than currently exist. These household projections do not take account of the recent increased estimates for future population and, so, themselves are likely to be revised upwards.

The population is also growing older. Those aged 60 and over are likely to rise from 16% of the population in 2006 to 22% in 2031. Along with this increase, the number of working people for every person of state pensionable age will fall from 3.3 to 2.9. The increase in the share of the elderly is not as fast as in some other European countries but will still have a significant influence on future housing demand. Most of the growth in single person households, for example, will take place amongst those aged 50 or more.

Net immigration has risen in recent years with approximately 500-600,000 people annually settling in the country between 2000 and 2006. Emigration has also been high, so the net contribution of migration has been of the order of 150-200,000 a year since the late 1990s with a spike in 2005 of more than 250,000. This extra population has helped to stimulate housing demand through the direct impact of extra housing need and indirectly through the stimulus to the economy and the weakening of inflationary pressures. Immigration puts particular pressure on the areas of greatest housing shortage because migrants move into the most economically dynamic areas, whereas emigrants are more likely to come from across the country. While the economy is in recession many recent migrants from central and eastern Europe may return home, weakening housing demand particularly in the private rented sector.

[13] *ibid*
[14] *OECD*
[15] *ONS*
[16] *CLG.*

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Factfile: United Kingdom

Background

Population (m) 2006	Annual Population Growth %	Fertility Rate* 2005	Years Life Expectancy 2005
61.0	0.7	1.9	79

*Fertility Rate – average number of babies born to women during their reproductive years (2.1 = replacement rate)

Economic

	2004	2005	2006	2007	2008f
GDP per capita purchasing parity standard based (EU27=100)	124	121	119	117	114
Real GDP growth %	3.3	1.9	2.8	3.0	0.8
Growth in real private consumption %	3.4	1.4	2.1	3.0	1.8
Inflation – consumer prices % (HICP)*	1.3	2.0	2.3	2.3	5.2
Labour participation rate % (15-65 yrs old in work)	-	76	76	76	-
Employment growth	-	1.1	0.9	0.7	0.8
Unemployment rate %	5.5	5.1	4.6	4.6	-

*2008 Oct y-o-y

Housing market

	2004	2005	2006	2007	2008f
Growth in residential investment	13.0	-1.2	8.9	3.3	-16.1

Taxes

Owner occupied housing: mortgage interest relief – no

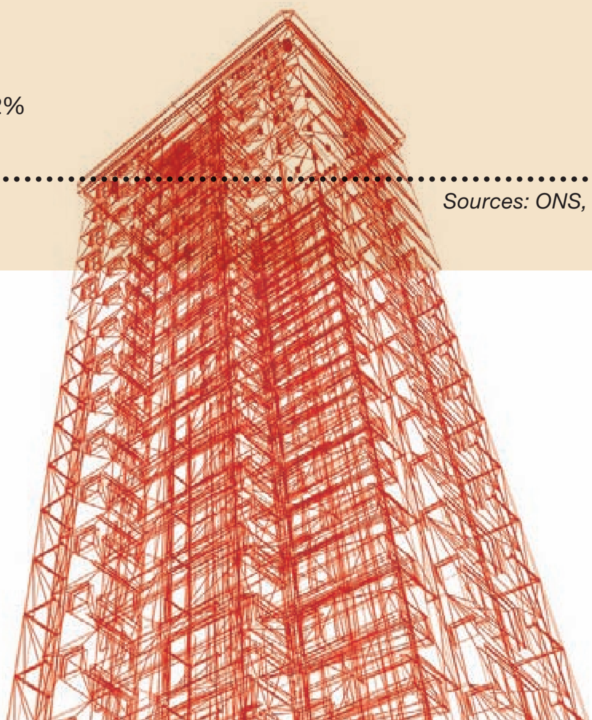
Capital gains exempt - yes

Imputed rental income - not taxed

Property taxes as share of all taxes 2002 - 12%

Property taxes as share of GDP 2002 - 4%

Sources: ONS, Eurostat, OECD, World Bank



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