2011 EUROPEAN HOUSING REVIEW

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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 related 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

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

This Review aims to:

- offer coverage of 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 housing markets
- enable evaluation of the growth of homeownership
- 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 an introductory comparative chapter presenting an overview of recent developments. It is 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 large number of countries in Europe, it is not feasible to provide individual chapters on all countries. Instead, after the initial pan-European analysis, 9 countries are examined in detail.

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Housing markets are continually changing and there is a danger that information becomes out of date quickly.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 2010 and, so, obviously cannot comment on or describe any events occurring later than that. Headline price data in Chapter 1 were updated early in February 2011.

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 thirteenth 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 Chief Economist, Simon Rubinsohn.

KEY MESSAGES

- The majority of Europe's housing markets are undergoing recovery, though some are in dire straits still, while others are positively booming:
- Hot north, cold south is the simple geographic description of Europe's housing markets:
  - The Nordic countries, Germany and its southern neighbours, France and Belgium all saw rises in real house prices in 2010
  - Ireland, Hungary and Cyprus experienced falls
  - Spain, Greece & Portugal saw moderate falls despite their economic difficulties
  - Prices were slightly down in the UK, Netherlands, Poland and Italy
  - The Baltic States were recovering from their major crashes.
- Unlike previous housing market upswings, prices increases are leading other market indicators, such as transactions and housebuilding
- Mortgage constraints are affecting many markets, but interest rates are low
- There is little evidence of substantial mortgage debt deleveraging by households in countries with high levels of mortgage debt
- Housebuilding is down all across Europe and is severely lagging recovery in most places.

CHAPTER 1: HOUSING MARKET DEVELOPMENTS IN EUROPE

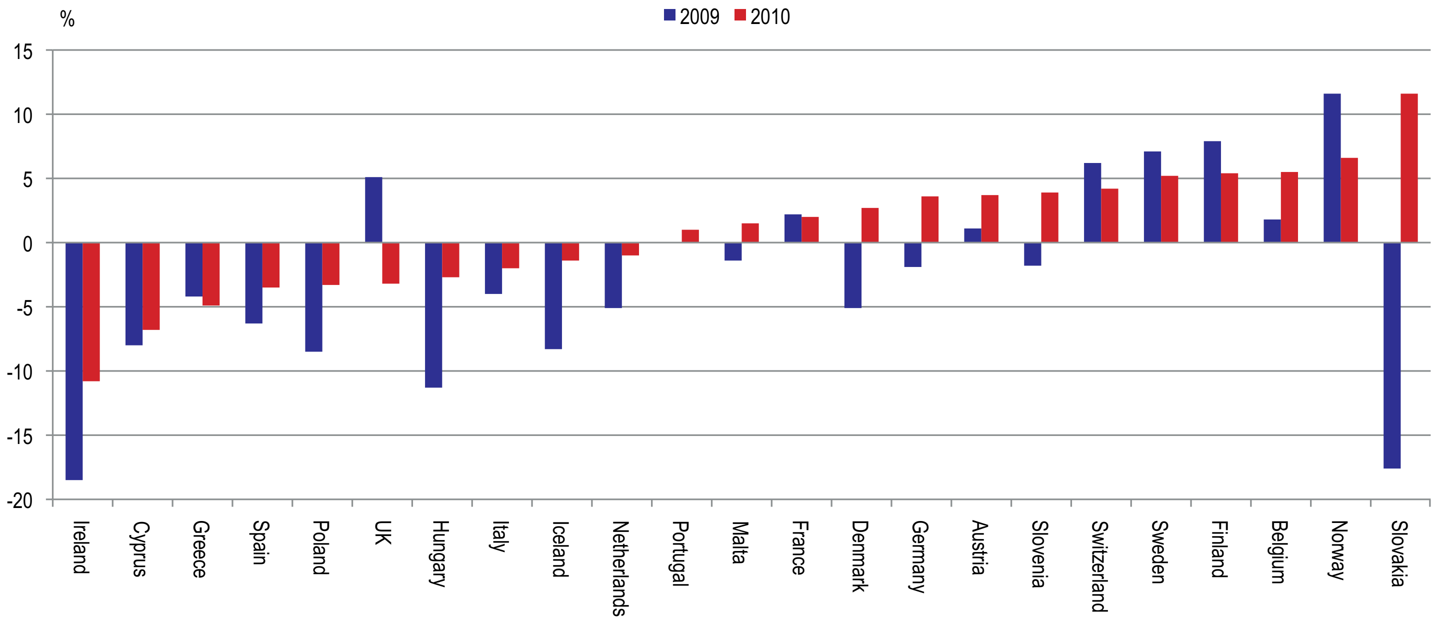

Figure 1.1: House price growth in Europe, 2009 and 2010[1]

December or last quarter of year, annualised rates

Variety and fragility

Europe's housing markets in 2010 exhibited considerable variation. As a result, a tour needs to be undertaken around Europe to derive a picture of what is happening. The good news is that many are undergoing recovery, though some are in dire straits still, while others are positively booming.

It does not look as though Europe as a whole is following the USA into many years of housing market mire. But, all the same, there are worrying aspects to the recovery. Perhaps, that is unsurprisingly, given the scale of the financial crisis and of the more European specific sovereign wealth crises that followed. But all the same there are several distinctive issues over and above the normal uncertainties that surround the initial phase of an upturn:

- the recovery is often being led by prices
- the recovery is likely to be highly sensitive to an increase in interest rates
- there seems to have been little deleveraging of mortgage debt in most of the countries where it rose so high in the 2000s. In fact, in some places more is being added
- mortgage markets have yet to normalise
- new supply in places where it was already short has been much reduced and housebuilding is faring badly in the recovery.

Geographic clustering of market developments

As is usual, there is geographic bunching of market outcomes, amidst all the diversity. The Nordic countries, Germany and its southern neighbours, Central and Eastern European, and the Mediterranean littoral all have had different experiences.

Figure 1.1 shows house price change in 2009 and 2010 for 26 countries, ranked from the lowest to the highest in 2010. It should be remembered that such a comparison is not as clear-cut as, say, comparing cross-country birth rates or economic characteristics like growth rates and inflation, because of the variable nature and quality of the information. However, a reasonably broad picture of house price developments can be seen.

[1]Reported here are all housing price indices or, if not available, single-family ones. Data are year-on-year 4th quarter or December information, except for q3 for Greece, Malta, Denmark, Austria and Belgium. Sources: National Statistics Offices; Central Banks; and Housing Ministries. Plus: RICS Cyprus, Cyprus; FNAIM, France; Hypoport, Germany; FHB, Hungary; ESRI-Permanenttsb, Ireland; Scenari Immobiliari, Italy; REAS, Poland; Ci-Iberica, Portugal; Wüest, Switzerland; and Lloyds-Halifax, UK.

CHAPTER 1: HOUSING MARKET DEVELOPMENTS IN EUROPE

A 'prices up first' recovery

Before going into detail about the nature of house price changes in Europe over the past year, the special nature of this European upturn should be noted. The majority of markets are recovering and in them house price increases are leading other activity indicators; whereas in most previous cycles prices tended to rise last.

This 'prices up first' outcome seems odd in simple market terms. Normally, prices only rise when demand outpaces supply and, in housing markets, that typically takes some time after a crisis. That is what transpired after the last major European housing downturn in the early 1990s but apparently not this time in Europe.

Why is a delayed price upturn not occurring everywhere now? Well, it probably says something about the nature of this European recovery and its underlying fragility. An inducement to house purchase at present in Europe are the extremely low rates of interest on offer for mortgage loans. So, for those that can obtain loans, this seems like the time to buy. But fewer people than before can borrow in the new world of credit constraints, intense lender scrutiny and high down payments, including many potential first-time buyers. Those able to borrow are the more wealthy, with good own savings or existing housing equity. They will also often want to trade-up and buy the 'cream of the crop': the better properties in the more desirable locations.

As well as a group flush with cheap mortgages and eager to buy, there is another larger group that are moving much less than they would normally do. Without those moves, the selection of existing properties to buy is diminished. Moreover, as interest rates are so low, defaults are generally few in number, even amongst the heavily mortgaged. As a result, few forced sales are coming onto the market, as they would have done in the early stages of recovery in previous upturns. Housebuilding is also way down and coming back only very slowly, partly because of difficulties in obtaining development finance. Except in a few countries, there is also no supply overhang.

The consequence of all this in both existing home and new build markets is that the demand of those that can borrow, or who are cash-rich, is chasing only a limited supply from housebuilders and sellers of existing homes. Supply is much more limited than it would be in more normal market conditions and transaction levels become fixed at a relatively low level in which average and more marginal properties find few takers. This is likely to make measured short-term price variations quite volatile, because of the noise generated by lower transactions and the scramble for the better properties when they come on offer, while the mundane find few sellers unless priced very competitively. Transaction based price indices pick up the deals, not the languishing 'no sale' properties.

Such a tight market context is probably common across Europe, outside of the crisis countries. It can be seen in the low level of market transactions in most countries compared to the past. Any significant rise in demand within these low velocity markets tends to speed up higher price bids and any decline tends to go to a price plateau while sellers wait for better offers. Prices do not fall that much because sellers have limited incentive to sell and are not distressed but prices can be bid up quickly, though the supply response is then slow.

Complete recovery will not occur until housing markets are fully functioning again: with plentiful mortgage finance, revived housebuilding and extensive market turnover throughout all sectors. Unfortunately, at present the foundations for such a recovery are still not in place in many parts of Europe. Of course, the longer prices remain strong, the greater the likelihood of a more in-depth recovery. However, the 'prices first' approach to market recovery is fraught with risks, which may make this particular housing market upswing more fragile than was typical in the past.

CHAPTER 1: HOUSING MARKET DEVELOPMENTS IN EUROPE

Hot North, cold South

For the second year running in 2010 Sweden and Norway and Finland were at the top of the price increases in Europe (Figure 1.1). All three recorded real house price rises of 5% or more and they were joined by Denmark, which in 2009 had been experiencing falls. Interest rates were a major stimulus. In Sweden, variable rate mortgages could be obtained for less than 2% from most of the year. In addition, the Nordic countries and their financial systems had in general weathered the downturn well and mortgages remained plentiful, unlike in some other countries. There were some signs of a slowing towards the end of the year but that could be seasonal.

The next group of countries experiencing rising house prices in 2010 were Austria, Germany and Switzerland. They saw their highest price growth for over a decade, because unlike the rest of Europe they had not had a boom in the 2000s. Like further north, their markets were boosted by attractive borrowing rates and good economic growth.

Belgium and France are the other two European countries in 2010, which experienced significant real house price growth. France's financial system weathered the crisis well, but Belgium's did not. Even so, economic recovery in Belgium was faster than the EU average in 2010 and, although growth was slower in France, it was good enough there too. So, once again, positive economic growth and attractive interest rates pushed up demand against limited supply, particularly in the major cities such as Paris. By year-end, the prices of France's existing homes seemed, according to the official index, to be rising faster than in any of the other major European economies..

In all, 10 of European countries listed in Figure 1.1 experienced sustained positive real house price growth during 2010; pushing house prices towards, or even above, the levels reached prior to the 2007/8 downturn. Not too far behind them was the UK, which had seen a substantial price bounce back in 2009 and early 2010, but prices softened there somewhat in the second half of 2010, as mortgage rationing and market uncertainty held back demand.

Few of the countries discussed have experienced significant reductions in house prices below their pre-crisis peak levels. Rather, in each country prices dipped moderately, following the onset of the financial crisis, and then recovered, completely or partially, soon afterwards. This is also the aggregate picture described in the ECB's new residential property price indicator for the Euro area, which is heavily weighted towards Germany (27% weighting), France (22% weighting) and Italy (17% weighting). The UK has had a higher rate of inflation than most of the other countries discussed and, so, has seen one of the greatest 'corrections' in real house prices of the order of -25% since their late 2007 peak. However, there are marked regional disparities with London and its surrounds have much less of a decline.

The Netherlands' house price history over the past two years is not that different either. Moderate house price falls occurred mainly in the course of a few months between 2008 and 2009 and since then prices have been pretty much flat, dipping somewhat in 2010 at year end into negative territory. The actual fall in prices in the Netherlands has in total only been around 8% from their peak in 2008. Italy followed a similar small nominal house price fall pattern as well.

It has been in some of the well flagged crisis economies of Europe that house price falls have been the greatest over the past two years. In them, the pattern of 2010 was similar to that of 2009. Amongst this group, Ireland stands out as the one with the most sustained price falls, after many years of dramatic increases during its earlier property boom. There, house prices have fallen by 38% since their peak at the end of 2006. The late 2010 bailout of the country, the continuing economic problems, and the substantial overhang of newly built properties mean that the end is unlikely to be in sight quite yet. Whether this spills over into large-scale mortgage defaults is unclear, because at present they are very low.

Spain is also in the grip of continuing economic and financial difficulties. Its housing supply overhang may be as large as 4% of the total housing stock, circa 1 million dwellings. Many Caja mortgage providers and the national government also face funding problems. Its house prices have fallen by around a quarter in real terms but, even so, may still have some way to go.

More surprisingly, in light of the sovereign debt issues raised in 2010, neither Greece nor Portugal has seen substantial house price falls. Portugal did not have a previous house price boom but, rationally, that should not protect its housing market from the adverse events currently befalling it.

Amongst the holiday islands in the Mediterranean, such as Malta and Cyprus, and along the coasts there was a substantial boom in holiday and retirement homes in the 2000s.This boom drove both prices and new building ever higher and an ending to that boom with a subsequent period of excess supply and falling prices was perhaps inevitable. This experience has been visible in the holiday areas of Cyprus, where quality and location have mattered much in terms of supporting house values. What is more, the knock-on effect on the rest of the local economy in terms of much reduced construction and other linked activities has helped to reduce housing demand in the main towns. By contrast, Malta does not seem to have experienced much of a price correction; at least according to the central bank's house price index.

CHAPTER 1: HOUSING MARKET DEVELOPMENTS IN EUROPE

Turning to Central and Eastern Europe, amongst the countries being surveyed here Hungary has had one of the worst housing market downturns. This has been very much associated with on-going economic problems, government financial difficulties, and a substantial amount of mortgage borrowing in foreign currencies, particularly Swiss francs, until such practices were banned in 2010. The new Hungarian government has abandoned previous programmes of austerity and adopted a program of radical tax cuts in the hope that they will provide a major supply-side stimulus to growth. If that strategy works, it will benefit the housing market; if it does not, the housing market is likely to suffer further.

In other countries like Poland that saw much use of foreign currency loans during the boom years, 2010 saw a sharp reduction in such borrowing and a much greater use of domestic currency loans. However, along with domestic currency borrowing has come higher interest rates for purchasers. There is also a substantial backlog of apartments being built by developers. These two circumstances have counteracted the relatively strong growth of the Polish economy and led to falling prices for a couple of years in the new apartment buildings market in the country's six major cities. However, demand began to grow again in 2010.

What is clear is that the surge of investors and speculators from abroad that was so great in Central and Eastern Europe in the years leading up to the end of the boom no longer exists. Yet, inward financial flows still matter for housing markets. For example, remittances from Poles working abroad have significant effects on the ability of some buyers to raise sufficient down payments on orders for new homes.

Slovakia and Slovenia both saw a partial revival of prices in 2010 after earlier falls. They differ from Poland in that both countries recently became members of the euro area and have seen mortgage use grow substantially as a result. This has underpinned housing market activity.

The most spectacular collapses in house prices with the onset of the crisis occurred in the Baltic States. As their economies and financial systems were buffeted, house prices fell dramatically. But in 2010, those markets started to bounce back. Figure 1.2 shows huge variations in the direction of price change in these countries between 2009 and 2010. The data reported in them refer to transactions of existing flats. During the depths of the crisis in the Baltic States, property markets must have been extremely thin in terms of transactions, especially of existing homes, which would have only been sold in extremely distressed circumstances. So, some of the price volatility observed between 2009 and 2010 is the result of markets that essentially froze for a number of months and then started to open up again, rather than reflecting the pattern of valuations of a large number of properties. Residential markets in the Baltic States seem to be recovering, albeit falteringly and with a new realisation that house prices really can go down as well as up, which should bring a new realism. Prices are still well down on the heady heights they achieved during their short lived mid-2000s booms.

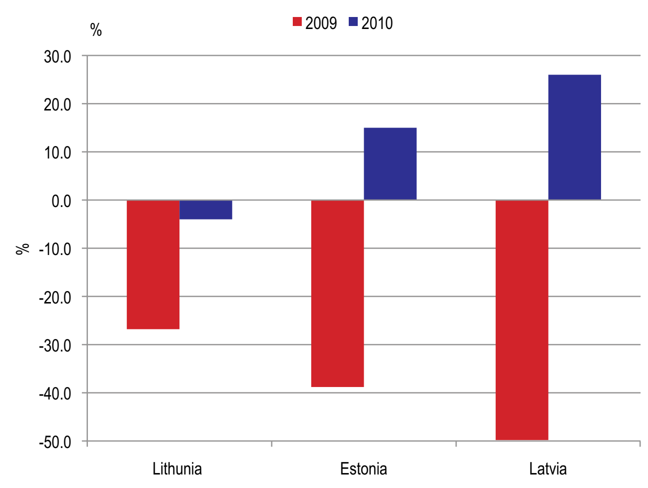

Figure 1.2: House price growth in the Baltic States, 2009 and 2010[2]

[2]Existing dwellings in the major cities: BPE – Baltic Property Expert, Estonia; Ober-Haus Real Estate, Lithuania; Arco Real Estate, Latvia.

Mortgage interest rates

Changes in mortgage interest rates have been important influences on European housing markets over the past five years. This can be seen by looking at general trends within the euro area. Up until the autumn of 2008, interest rates had been on a rising trend and short-term rates were actually notably above those for longer term loans during the worst of the financial crisis. After the collapse of Lehman, in common with other central banks the ECB adopted a much looser monetary policy. This meant that the average rates on variable interest mortgages in the euro area fell from almost 6% in 2008 to well below 3% in 2010. Fixed interest loans also fell significantly to below 4%.

As soon as economies picked up, such attractive rates of interest are bound to stimulate interest in house purchase. However, new loan criteria often made it difficult to borrow. So, the impact of low interest rates on housing markets depended on the extent to which mortgages could be accessed by typical purchases. In some countries, such as the UK, the barriers to borrowing have been quite substantial, with first-time buyers having to save very high ratios of their personal disposable income in down payments, or using parental gifts, when trying to access loan finance. Some countries, like France, have focused state aid on facilitating first-time buyer entry into the housing market. In this and other ways, more restrictive lending criteria by banks has not actually let to reductions in housing loans.

Home lending rates in the euro area and many other parts of Europe was so low by the autumn of 2010 that they had only one direction in which to go: upwards. Looking at housing from a simplified asset perspective, the price of housing represents the real or notional net rental stream associated with a dwelling divided by the yield. So, as interest rates rise, downward pressure will be applied to house prices.

Mortgage lending

Underpinning the long housing boom in Europe until 2007 was a very substantial increase in mortgage borrowing by owner occupiers and investors. By the end of the boom, loan ratios in some European countries were amongst the highest in the world. With the onset of crisis, the initial expectation was that many of these loans would prove unsustainable. In practice, this turned out not to be the case and loan default rates have continued to be very low in most European countries - much lower than in previous housing market downturns.

Another expectation was that, once the downturn started, highly leveraged households would gradually run down their borrowings in order to achieve a better balance of personal assets, debts and income. To an extent, this has been occurring. Yet, the aggregate data do not suggest that personal sector deleveraging of housing loans has been substantial in most parts of Europe. Many European households are consequently entering the next upswing with much higher levels of debt than was the case for borrowers in the mid-1990s.

Mortgage lending was highly constrained at the height of the financial crisis but loans were expanding once again in 2009 and 2010. The distribution of mortgage expansion has not been even across the euro area but, instead, varied widely from country to country. In the depressed markets of Ireland and Spain, there was no increase. Neither was there much in Germany. Yet, in many of the countries noted earlier where house prices are rising, housing loans are expanding and stimulating that price growth. In addition, in the small nations that have recently joined the Eurozone, mortgage growth has been very substantial since they have adopted the euro: for example, they were rising in Slovenia by over 20% in 2010. These countries are therefore experiencing similar mortgage growth experiences to places like Greece and Spain after the initial advent of the euro.

Mortgage supply may worsen in 2011. ECB has already wound down some of its previous support positions, such as its covered bond purchase programme between summer 2009 and summer 2010. It wants to disengage from emergency measures even further. Regulation is tightening and, although there has been some improvement in capital market transactions, it is by no means clear that banking and mortgage systems are able to fund sufficient mortgages and sustain lender competition unaided.

Other central banks outside of the euro area, such as the Bank of England, are acutely aware of the huge funding gaps that potentially face mortgage finance over the next year and beyond. The funding needs of governments with large deficits will also compete for investor interest. Not to mention the potential ramifications from sovereign debt crises. So, the future of Europe's housing markets remains subject to considerable uncertainties stemming from the financial system, from economies, fiscal tightening and their own initial dynamics.

Housing investment

Housebuilding continued to fall across Europe well after markets seemed to be entering periods of recovery in 2009 and 2010. The way in which loan criteria were tightened up often damaged housebuilding industries because the restrictions particularly adversely affected core client groups, such as first-time buyers. Furthermore, it takes a long time to set up new developments and this is exacerbated in many European countries by the strong regulation of new development and land supply restrictions. However, the situation in general seems much worse in this recovery than simply a long building process.

Land availability is always a worry, particularly in north-west Europe. But another, more alarming, aspect is holding back new building: the perceived riskiness of real estate development by banks and other lenders. Banks' loan criteria are often broad-brush so that sure fire housebuilding projects get categorised with the same risk scoring as much riskier commercial schemes. Excluded from their traditional sources of development finance, housebuilders find themselves unable to raise sufficient finance to fund new land assembly or building.

Conclusion

As many of Europe's housing markets edge their way out of the worst of the downturn their individual performances inevitably show variations and uncertainties. Extensive cross-country differentiation across Europe's housing markets is also the norm, which the simultaneous boom through much of Europe in the mid-2000s tended to obscure.

When looking at the housing market recovery that is occurring in the majority of European countries, this time is different because of the severity of the downturn, the consequences of the previous boom and the financial crisis. Europe's housing markets are not yet in equilibrium and there are likely to be continuing surprises along the way until housing markets return to a broader and more stable footing.

CHAPTER 2: RECENT MARKET PERFORMANCE: COUNTRY SUMMARIES

Cyprus

The slowdown in the housing market observed from 2009 continued in 2010. The new RICS Cyprus index reported that apartment prices were 9% down in the first nine months of 2010 and houses prices down 5%, with the overall fall expected to be 7% for the year. This was around the level of the previous year and there is little prospect of a significant pick-up in the market in 2011.

The housing market is actually a series of sub-markets. The biggest division is between the holiday-second home areas and the five main towns where most Cypriots live. The available house price indices refer to the domestic rather than the second home market. House prices in tourist areas are difficult to generalise about, but prices in these market sectors have been much more volatile than in the urban areas of the country: rising more in the boom but now falling much faster. Local experts suggest that prices in these areas have dropped by approximately 20-25% for good quality/ good locations, 30-35% for good quality/ secondary locations, and 40-50% for bad quality/ secondary locations.

Other indicators are mixed. Mortgages have been expanding quite rapidly at double digit rates. Growth has been encouraged by accession to the euro, lower mortgage interest rates and by an economy that, although it has slowed, has weathered the global slowdown comparatively well. Transactions data from the Cyprus property registries have been the starkest indicator of a sharp decline. The biggest fall-offs were related to foreign buyers.

Building permits, a forward indicator of housebuilding, showed a relatively moderate fall to September 2010 of 9% year-on-year. Housebuilding levels from 2005 to 2008 were extremely high, peaking at 22.8 dwellings per 1,000 population in 2008, but building began to fall off after that and has still not bottomed out. Excess supply is particularity apparent in the holiday homes markets.

France

2010 saw recovery in the housing market but the various price indices are reporting somewhat distinctive results in terms of its strength. The FNAIM existing homes asking price index shows some fluctuations throughout 2010 but around a flat trend. By contrast, the official Notaires-INSEE existing house price index suggested more significant house price rises of 9% over the year up to 2010 q3. Both are hedonic indices but the INSEE index tends to lag the FNAIM one by 3-6 months, because it is based on notaries' transactions rather than initial sales asking prices.

The prices of new dwellings add further distinctiveness to the picture of house price movements. The square metre prices of new flats were up 7% on the year in 2010 q3, according to the regular CGEDD survey, which is in line with the INSEE existing housing figure. Yet the price of single-family houses fell by -5% over the same period, which was lower than even the FNAIM measure.

Transaction levels have improved substantially, with half of the loss in the downswing recovered again by August 2010, according to CGEDD. New homes sales have also rebounded from their trough to levels that were similar by autumn 2010 to those prevailing in 2006 and 2007. The biggest sales growth was in new flats and small houses, while sales of larger properties continued to decline.

Mortgage interest rates have been low and consequently affordability has been improving. Nonetheless, economic growth is only weak and financial situation remains precarious in its effects upon the housing market. Furthermore, recovery has been encouraged by a substantial range of stimulus measures. They were focused on the entry level buyers and rental investors and would have spurred the higher price growth observed in apartment markets over houses, particularly in the higher priced parts of the country. But fiscal austerity is now the order of the day and, as these stimulus measures wind down, the surge in demand they encouraged will disappear. Added to that, demand will have been brought forward to take advantage of them, which will now have to be replaced if the market is to continue to recover.

Germany

House prices grew by around 4% in 2010 compared to falls of around 2% in the previous year, according to the Hypoport index. The vdp index suggested a slightly slower rate of 2% but still positive. Housing demand and confidence were boosted by the strength of the economy and there were attractive mortgage interest rates on offer. So, by German standards over the past decade, demand-side conditions were relatively strong in 2010.

The housing market has behaved like no other in the recent decades. Nominal price changes in it had been relatively moderate and steady in recent years in contrast to most markets around the world. Prices had been trending downwards for some time up to 2009, especially in real terms, so the revival in demand in 2010 may have marked a significant turning point.

Housebuilding rates have been declining almost continuously from their high, post-unification, mid-1990s levels and now stand at around a third of that peak. Though housebuilding was relatively weak in 2010, there were indications that the long building decline was finally over. Continued strength in housing demand in 2011 will be needed to ensure that outcome.

It seems that the housing market is broadly in balance between supply and demand, even though housing supply is short in some cities and regions and consumers remain highly sensitive to adverse changes in housing costs. The demographic outlook is one of falling populations across many parts of the country. Both investors and homeowners are likely to have stable expectations of market conditions. So, there seems to be limited prospects of significant price rises in the near future.

CHAPTER 2: RECENT MARKET PERFORMANCE: COUNTRY SUMMARIES

Hungary

The downswing in the housing market showed few signs of abating in 2010. Prices had started to slide in real terms in 2007 with the onset of the world financial crisis. The price decline accelerated in 2009 and then prices continued to fall significantly in 2010 at an annual rate of around 3%. Overall, prices were then down by about a quarter in real terms since their peak early in 2007.

Housebuilding has also been tumbling and housing transactions low. Vacancies have risen as well. As well as reflecting the continued problems of the housing market, some of the downswing was a rebound as a consequence of earlier policies that had encouraged purchases to be brought forward into 2009.

Borrowing in foreign currencies eclipsed borrowing in Hungarian forints (HUF) in the years from 2005 to 2008. Outstanding loans denominated in foreign currencies (FX) rose to over 66% of all mortgage loans by the middle of 2010. New FX lending remained high until 2009. Foreign exchange markets continued to be volatile throughout 2010 and the risks of borrowing costs rising further were high at year end.

The risk of growing mortgage defaults and the extent of foreign currency mortgages have led to drastic policy action. From August 2010, it became illegal to register a mortgage under a foreign currency loan. However, there is a large outstanding stock of household mortgages and consumer loans in foreign currencies.

A number of responses have been made to the growing default crisis. The government announced an extension of the moratorium on eviction until mid-April 2011. The legal details are complicated but the measures were, first, a 6-month ban on foreclosures until the end of 2010 and the further enforcement of a ban on 'winter' evictions that has been around since 2003.

Italy

The decline in house prices moderated in 2010, with around a 2% fall in nominal terms, according to Scenari Immobiliari, and a similar 1.6% drop in Nosmisma's 13 city average index. The overall price decline since the 2008 peak has been about 10% in real terms. This is relatively moderate compared to some other European countries, despite the country experiencing one of the sharpest recessions of the major economies.

Signs of the housing market stabilising were beginning to appear in 2010. This was suggested in a key market survey, the quarterly survey of estate agents by the Bank of Italy and Technoborsa. The balance of agents expecting price rises or falls turned positive in autumn 2010 for the first time since January 2009, although respondents did express a sense of uncertainty about future market prospects.

Italy was directly affected by the Eurozone financial crisis at the end of 2010 and this heightened uncertainty and damaged already weak lender and consumer confidence. The government debt ratio at 120% of GDP is virtually the highest in Europe. So, intense market uncertainty exists about the future short-run direction of prices though forecasters are expecting level or even modest house price growth in 2011. More positively, home owners are relatively debt unencumbered, credit remains available, interest rates on housing loans are historically cheap, and there is no housing supply overhang to worry about. The problems besetting some other European housing markets are therefore not apparent in Italy.

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 institutional setting helps to keep housing supply relatively plentiful. What is more, informal building is undertaken to order, which limits the threat of supply overhangs. Physical shortages, which drive up prices, are greatest in the major cities of the centre and north.

House sales plunged as the economy fell into recession in 2008. The decline then continued in 2009 but then turned up by around 10% in 2010. Yet, transactions are still a fifth less than before the downturn. Interest rates dropped sharply in 2009 and stayed low in 2010. This has helped to encourage the signs of modest recovery.

CHAPTER 2: RECENT MARKET PERFORMANCE: COUNTRY SUMMARIES

Netherlands

The housing market remains subdued. House prices are down, but the change is moderate. In October, 2010 prices were down by 1.1% on the previous year. However, rather than highlighting a price decline, it may be more reasonable to say that the market was flat in price terms for most of 2010, with some weakening in the final months of the year which may be due to seasonal factors. Overall, prices have not fallen by much since their peak in 2008: down by 7%, with most of the fall occurring between autumn 2008 and autumn 2009.

In contrast to relatively stable prices, transactions have dropped quite sharply. They were 10% down in the third quarter, 2010, compared to the previous year, and by then had fallen by around 40% from their 2006 peak. The principal cause of the reduction in transactions remains subdued consumer confidence and weak demand. Mortgage lenders also remain cautious about market prospects and have continued to tighten lending criteria.

Housebuilding continues to be affected by the slowdown. Completions fell by around a fifth compared to the previous year in the first half of 2010. With temporary housebuilding subsidies being withdrawn, the housebuilding decline has probably yet to bottom out.

Over a third of households live in social housing but a recent ruling by the European Union has forced the social housing institutions to adopt a more focused remit on lower income groups. As a result, rents for many will rise, a sales programme has been sped up, and many who might have expected to be housed in the sector will no longer be able to do so. All this represents a sea change in the housing scene and the full consequences are unlikely to be seen for some time. But a stimulus to the private sector is underway, particularly with regard to owner occupation.

The housing market was sustained by record levels of borrowing throughout the 2000s, at high average loan to value ratios, and mortgage borrowing continues to be high. As a result, the level of mortgage indebtedness of many owner occupiers is exceptionally high by international standards.

Poland

The decline in the new housing market abated in 2010, after prices had fallen by 8% in 2009. There was a slight price decline in 2010 by around 3% according to REAS, but sales and housebuilding were both up on the previous year. In fact, developer starts were 50% higher. A stronger economy underpinned this, though much uncertainty remains.

There is neither an official house price index nor a quality-adjusted one, so reliance has to be made on non-quality adjusted asking price measures for new housing in the country's major cities. Both sources suggest that new housing prices were down by around 3%, with most of the decline concentrated in the first half of the year.

The scale of the earlier price boom was dramatic. Prices doubled in the short period from 2004 to 2007 and foreign investors and speculators crowded in but are nowhere to be seen now. So, the decline from the peak so far is only a small one in comparison to the early upsurge.

Turnover in new residential markets across the six largest cities in 2010 was still lower than two years before but had recovered by around a fifth from the worst period in early 2009, according to REAS. However, extensive stocks of unsold dwellings continue to exist, which puts a dampener on any potential price increases in 2011.

Mortgage markets continued to expand in 2010 though at a reduced rate. The move away from foreign currency borrowing that started in 2009 continued in 2010, due to demand, regulatory and subsidy factors. PLN denominated loans now account for 80% of new loans, with euro denominated ones accounting for most of the rest.

One of the government supports for housing demand is a "family in its own home" programme, which provides significant mortgage interest subsidies for first time buyers. Amendments introduced during the crisis now make it much more attractive and feasible as a borrowing option for many more purchasers and it covers a large share of their mortgage interest costs. The central bank reckoned that almost a fifth of all mortgages were issued under its framework in the first half of 2010.

CHAPTER 2: RECENT MARKET PERFORMANCE: COUNTRY SUMMARIES

Spain

The housing market downturn continued during 2010, though there was some evidence that the decline was slowing, with the INE index in particular showing only modest price weakness and some moderate quarter to quarter strengthening. However, other indices were producing more pessimistic results with around a 4% decline on the year. As the wider economy and financial markets still face substantial problems, it is by no means certain that the end of the housing market downturn has actually yet been reached.

There has been a 15% price fall from the peak of the boom for existing housing and probably somewhat less for new. Taking account of general price inflation, this suggests a roughly 22% real decline in values for existing homes, which is one of the largest in Europe to date.

It is hard to measure the vacancy overhang but it is substantial. Some unsold new properties are holiday homes but many are potential primary residences. The number may be a substantial 3 to 4% of the housing stock as a whole – 0.75 million to 1 million dwellings.

Housebuilding peaked at extraordinarily high levels in the final years of the boom. Since then, output has fallen sharply and starts were expected to be below 80,000 by year end 2010 and this may not yet be the bottom.

The scale of the price changes that have occurred and the risks of further downward adjustments vary across the country and by market segment. Tax measures brought forward property purchase to 2010, including the announced partial withdrawal of personal income tax deductions for the principal residence to take effect from January 2011.

Overall, the prognosis is that the problems of the Eurozone, high private sector debt, continuing excess housing supply, and the sluggish rate of economic recovery suggest unhopeful housing market prospects for 2011.

Sweden

The boom in the Swedish housing market continued through 2010, with house prices up 5% on the year on year according to Statistics Sweden. By the third quarter, house prices were up 6% on the year. There was some moderation of the high price growth in the spring and summer by the autumn. This suggests that the market may have been affected by rising interest rates and a recently introduced cap on loan-to-value ratios.

Economic growth is also likely to stay high, which will continue to boost housing demand. Meanwhile, supply continues to be extremely short. It remains to be seen whether declining affordability, consumer concerns about future rises in interest rates, and any further policy measures are enough to offset expansionary forces fully.

In contrast to prices, other indicators highlight that the housing market remains at a lower scale of activity than prior to the recession. Sales of houses fell sharply in the crisis period, especially in the second half of 2008 and into 2009. Even though they did increase again in early 2010, they then faltered and still trail behind their pre-2008 levels.

Housebuilding has not picked up much, following earlier sharp falls, which began in 2007. Initially that downswing had been caused by policy change, as long existing subsidies were withdrawn at the end of 2006 causing a bunching of housing starts in that year, and then starts fell because of the financial crisis. Housing output now remains at low levels and with stimulus packages at an end prospects for sustained expansion are poor.

CHAPTER 3: CYPRUS

Overview

The slowdown in the housing market observed through 2009 continued into 2010. The new RICS Cyprus index reported that apartment prices were 9% down in the first nine months of 2010 and house prices down 5%, with the overall fall estimated to be 7% for the year. This was around the level of the previous year. The central bank has also been developing a house price index. It suggests that dwelling prices doubled between 2003 and 2008 but then fell by around 15% through 2009 and into 2010.

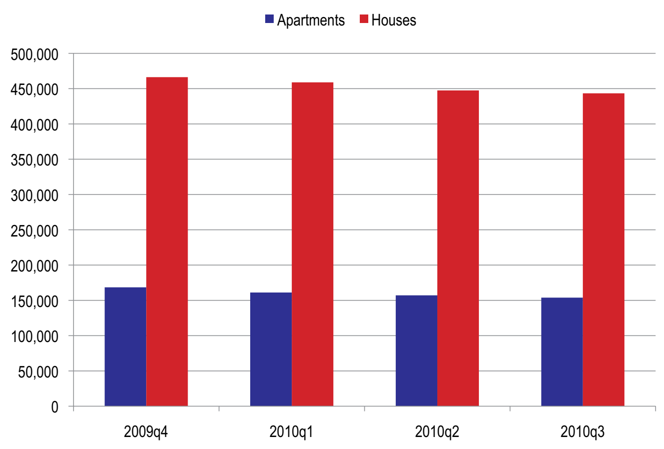

Figure 3.1: House prices RICS Cyprus house price index 2009q4–2010q3

Source: RICS Cyprus

However, the housing market of Cyprus is actually a series of sub-markets. The biggest division is between the holiday-second home areas and the five main towns of Nicosia, Limassol, Larnaca, Paphos and Famagusta-Paralimni, where most Cypriots live. The RICS Cyprus and the central bank indices both refer to the domestic rather than the second home market. The RICS Cyprus index is based on a standard dwelling type and the central bank index is a modified, quality-adjusted one based on information from mortgage providers and subsequent adjustments on the basis of other market information.

House prices in tourist areas are difficult to generalise about, because there is much variability due to property characteristics and the presence or not of sea views, proximity to the beach and the size of development that the property forms a part of, amongst other factors. However, prices in these market sectors have been much more volatile than in the urban areas of the country, rising more in the boom but now falling much faster. Local experts suggest that prices in these areas have dropped by approximately 20-25% for good quality/ good locations, 30-35% for good quality/ secondary locations, and 40-50% for bad quality/secondary locations. Unfortunately, many overseas buyers during the boom years bought in the last category and, so, are now experiencing difficulty in selling homes which have fallen so substantially in price.

Other indicators are mixed. Mortgages have been expanding quite rapidly at double digit rates. Growth has been encouraged by accession to the euro and the associated lower mortgage interest rates and by an economy that, although it has slowed, has weathered the global slowdown comparatively well. Building permits, a rough forward indicator of housebuilding, showed a relatively moderate fall to September 2010 of 9% year-on-year.

Transactions data from the Cyprus property registries have been the starkest indicator of a sharp decline. The biggest declines were related to foreign buyers, whose presence in the market place had fallen by 80% since the peak in mid-2010. This fall reflects the problems of the economies of places where prospective purchasers come from within Europe but also difficulties that affected those who have already bought, due to fluctuating exchange rates and loss of income. However, the registries are frequently criticised for being slow and inefficient, so the data may not be that good an indicator of current market conditions, though they are widely used in that role.

The housing market had experienced buoyant conditions in earlier years. When Cyprus[1] 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 zone in 2008. In the run up to the euro, the housing market was very active and prices rose rapidly, reaching 20% annual growth rates in the quarters around the introduction of the euro. Estimates quoted by the Finance Ministry have suggested that house prices rose by 2.8 times between 2000 and 2008. Such growth rates are not expected to return.

The earlier housing boom had been driven both by domestic and foreign demand. Cypriots were more able to buy in a buoyant economy and with a major expansion of mortgage lending in a climate of apparently greater economic certainty and stability in the euro zone. The main source of overseas buyers has traditionally been the UK, attracted by the climate, cheap lifestyle, good public facilities and widespread use of English. Towards the end of the housing boom, Russian and other purchasers became more prevalent.

The boom was most easily identified on the supply side. Housebuilding levels from 2005 to 2008 were extremely high. From an already high building rate of 7.4 dwellings per 1,000 population, they rose to peak at 22.8 dwellings per 1,000 population in 2008, a European record, but began to fall off as the global economic crisis cut into demand. The country's housing stock has expanded by over 30% in the past decade. Falling tax revenues from house sales and capital gains taxes have in the past two years had a big impact on government income, so the government deficit has grown to 6% of GDP.

[1]This chapter refers only to the Greek part of the island

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Housing system

General housing quality is high. 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.[2]

Owner occupation is around the EU average at 68% and many houses are owned outright. A further 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.

40% of the 340,000 dwellings are detached, another 30% are semis, 20% are apartments and a further 10% are in mixed-used buildings. Census data indicate that household sizes are typically much higher than in northern Europe, although this characteristic is masked by the 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 had been rising at 3-4% in the recent boom years, somewhat above the general rate of price inflation, but have been falling slightly in the downturn, according to the RICS Cyprus survey.

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 a handful 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. New building is subject to the standard rate of VAT, but this is offset by government grants for properties of less than 250 square metres. Capital gains are taxed at the time of sale. There is also an annual property tax, rising in steps up to the most expensive properties. The valuation basis for the tax and the stepped rates of the property tax were both raised in 2010 in programmes aimed at reducing the government deficit. Incomes taxes vary between 20-30% which attracts Europeans to move to the country. Business taxes are similarly low, with a flat 10% rate of corporation tax.

Transactions difficulties have been reported. There are complaints of delays in registering title in the Land Registry, said to run into years in some cases and criticism continues. The Government's stability programme published in 2010 proposes a town planning amnesty for buildings constructed with minor irregularities and accelerated deed issuances to overcome the substantial backlog.[3]

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 low interest loans. There are also programmes to improve the housing conditions of those 12,000 or so households still living on refugee estates. Overall, public expenditure on housing and public amenities took 2.5% of GDP in 2008 and that is forecast to rise to 3.4% by 2012.[4]

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

Table 3.1: Tenure patterns

Source: 2001 Census

[2] *Cystat*
[3] *Stability Programme of the Republic of Cyprus 2009-2013, Ministry of Finance.*
[4] *Ministry of Finance.*

CHAPTER 3: CYPRUS

Housebuilding

Permits data highlighted the continuing decline of housebuilding in 2010. The number of dwelling units recorded a decrease of 8% up to September compared to the previous year.[5]

In the boom years, more than 6% of GDP was devoted to housing investment annually, significantly more than the EU average. This high level of building reflected 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, peaking in 2007 at over three times the 2000 trough level (Figure 3.2).

The high rate of building put pressure on per square metre residential construction costs during the boom years. They rose by 29% between 2002 and 2007 but then levelled off from late 2008 as the downswing in the housing market got underway.[6]

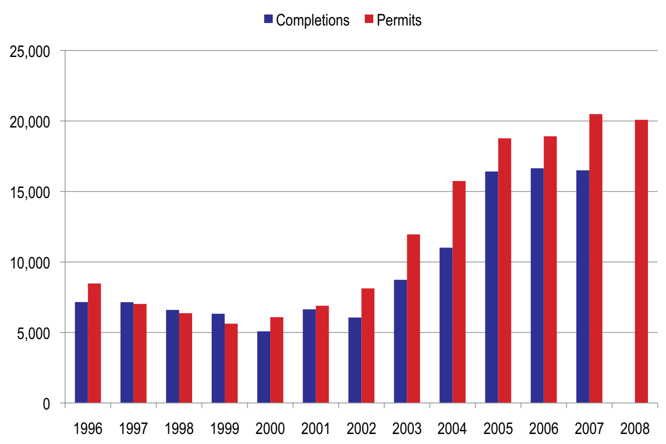

Figure 3.2: Housebuilding, 1996–2008

Source: Cystat

Macroeconomic influences

Up to the world financial crisis, the economy grew strongly, so that by 2009 GDP per capita was only 2 percentage points less than the EU average.[7] But the economy contracted by 1.7% in 2009 and was stagnant in 2010 and is only expected to recover fully in 2013, according to Finance Ministry forecasts. However, the economic decline was far less than in many other small, peripheral economies.

High euro exchange rates have affected core tourist markets. This has been particularly important in relation to the UK, the largest tourist market, because the pound has fallen significantly against the euro. Increased competition in tourism has also been felt from destinations such as Turkey and Egypt. However, financial services are growing and helping to diversify the economy.

Inflation averaged around 2% for the four years up to and including 2007. However, the country's reliance on imports meant that it surged to 4.4% in 2008 in the aftermath of the commodity price boom, before turning negative in summer 2009 as commodity prices weakened and the economy slowed. But the price falls were relatively short-lived and inflation rose again in 2010 by 2.5%, influenced by rising oil prices.[8]

During the boom years, the trade balance deteriorated. It was in deficit by a substantial 12% of GDP in 2008 but with the slowdown, narrowed significantly in 2009 to 5%. The government deficit has risen as tax revenues have fallen, particularly from the real estate market, and public expenditure has grown, including a series of targeted stimulus programmes. The Stability Programme aims to reduce the deficit to 4.5% in 2011.

The level of male participation in the labour market is quite high, though female participation rates are quite low. The population is ageing and pension's costs will rise significantly in the next few decades.

[5] *Cystat*
[6] *Cystat*
[7] *Eurostat*
[8] *Cystat*

CHAPTER 3: CYPRUS

Mortgage market influences

Traditionally, limited recourse was made to mortgage borrowing but that has now changed. In the past few years, housing lending has been rising fast, so that outstanding housing loans were almost three times higher in September 2009 than they had been in December 2005.[9] Mortgage growth slowed somewhat in 2009. It was still above 10% but that was far less than in previous years, as banks tightened lending criteria and demand fell in the face of the housing market and economic decline (Figure 3.3).

However, mortgage growth accelerated again in 2010 to around 15% on a yearly basis, as banks loosened their lending criteria again following improvements in liquidity caused by Eurosystem bond purchases.

Unsurprisingly with such rapid expansion over the past five years, the mortgage debt to GDP ratio has risen fast. It reached 50% in 2008 from a very modest level only a few years previously.[10] Consumers have been borrowing heavily for non-housing reasons as well, as just over a half of their total borrowings are related to loans for house purchase. The household debt ratio as a percentage of GDP reached 128% at the end of 2009, up from around 100% in March 2006.[11] Around 4% of household loans are denominated in foreign currencies, mainly in Swiss francs. Non-performing loans were 8% of outstanding loans to private households in March 2010, around the same as in the year before.[12] However, many of these will be non-housing loans.

Commercial banks are the main providers of loans. They have been offering extended repayment terms with lower down payment ratios. Competition between lenders has helped to account for the large rise in lending.

Interest rates rose from spring 2008 to peak at 7% in February 2009, which helped to slow housing demand (Figure 3.4). They gradually fell by 273 basis points up to April 2010, but then rose by 47bp up to September 2010. Loans are typically offered on a variable or short-term fixed basis and tend to be noticeably more expensive than for similar products in many other euro zone countries.

Figure 3.3: Housing loan growth rates, Nov 2006–Sep 2010

Source: Central Bank

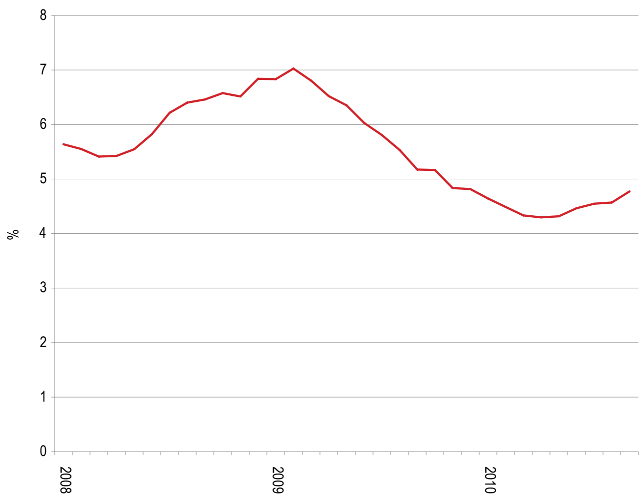

Figure 3.4: Housing lending rates, Nov 2007–Sep 2010

Source: Central Bank

[9]Central Bank.
[10]European Mortgage Federation.
[11]Central Bank.
[12]Central Bank research paper.

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Demographic influences

Population growth has been fast in recent years but it is slowing now, mainly through less inward migration. There was a surge in net migration in the years up to joining the EU but it has tailed off since then and was forecast by Eurostat to drop below a thousand in 2009. Over the past decade, the number of people living in Cyprus has risen by 14%, while the number of households has grown by a quarter. Net migration surged during the boom years from 2003 to 2007 but tailed off in the downturn with under 2,000 in 2009 compared with 14,400 in 2005.[13]

Population forecasts now date from 2004 and assume continued high rates of immigration. 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 1.5 births per woman in 2009, down from 2.5 in 1980. Furthermore, most immigrants are middle-aged or older. The consequence is that the population is ageing rapidly. The current dependency ratio is 18 (i.e. number of over 65s as a percentage of those aged between 18 and 65) and it is expected to more than double to 38 by 2050.[14] Those aged over 80 will quadruple 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.

[13] *Cystat*
[14] *Stability Programme of the Republic of Cyprus 2009-2013, Ministry of Finance.*

CHAPTER 4: FRANCE

Overview

2010 saw a recovery in the housing market but the various price indices are reporting somewhat distinctive results in terms of its strength. The FNAIM existing homes asking price index shows some fluctuations throughout 2010 but around a flat trend. By contrast, the official Notaires-INSEE existing house price index suggested more significant house price rises of 9% over the year up to 2010 q3 (Figure 4.1). Both are hedonic indices but the INSEE index tends to lag the FNAIM index by 3-6 months, because it is based on notaries' transactions rather than initial asking prices.

A potential explanation for the difference in the results of the two price measures is that sellers no longer had to discount their asking prices to strike a deal as the market picked up in 2010. Unfortunately, however, this argument is weakened by the observation that the INSEE index did not drop further than the FNAIM index earlier in the slump as would be expected if major discounts on asking prices were observed in the agreed prices in notaries' documents. So, the difference may be simply due to the statistical noise that is inevitable in short-term changes in house price indices.

The prices of new dwellings add further distinctiveness to the picture of house price movements. The square metre prices of new flats were up 7% on the year in 2010 q3, according to the regular CGEDD survey, which is in line with the INSEE existing housing figure. Yet the price of single-family houses fell by 5% over the same period, which was lower than even the FNAIM measure.

Taking the measures overall, it may be reasonable to take a mid-point perspective that the market seems to have recovered but this is not so far driving substantial increases in prices. FNAIM consumer surveys highlight that buyers seem to think the recovery is now firmly in place.

Nonetheless, the economic and financial situation remains precarious in its effects upon the housing market. The economy did expand moderately in 2010 but there was some slowing in the second half of the year and growth is not expected to accelerate in 2011. Furthermore, the housing market recovery has been encouraged by a range of stimulus measures that are described in more detail later. These stimulus measures were focused on the entry level to the housing market and would have spurred the higher price growth observed in apartment markets over houses, particularly in the higher priced parts of the country. Such price growth was strongest in the Paris region, with 2010 q3 annualised prices growing by 12% for flats and only 8% for houses, according to the INSEE index. But fiscal austerity is now the order of the day and as these stimulus measures wind down, the surge in demand they encouraged will disappear. Added to that, demand will have been brought forward to take advantage of them, which will now have to be replaced if the market is to continue to recover.

Transaction levels have improved substantially, which further suggests that the market recovery so far has been marked. During the 18 month downswing up to the trough in 2009, transactions of existing homes fell by 30%, but half of that loss had been recovered again by August 2010, according to CGEDD. New homes sales have also rebounded from their trough levels and were by autumn 2010 similar to those prevailing in 2006 and 2007. This building recovery was encouraged by temporary tax breaks for landlords that bought many investors into the market, purchasing almost two-thirds of all the new homes sold. With this demand profile, it is unsurprising that the biggest sales growth was in new flats and small houses, while sales of larger properties continued to decline. For example, in 2010 q3 sales of houses with 6 or more rooms were actually a quarter down on the previous year.

The stimulus measures offered in the housing market during the recession were substantial and had considerable impact. In a 2008 package, the government aimed to spend €340 million on a variety of schemes to boost the housing market and housebuilding as part of a wider stimulus package. They include a major social homes building programme during 2009 and 2010. Private housebuilding was boosted through extra subsidies for private investors to buy new homes for renting. A two-fold increase in the issuing of zero interest rate (PTZ) mortgages for the purchase of new housing by first-time buyers was planned until the end of 2009 and a new PTZ+ scheme was introduced after that. €50 million of support was given for local authorities to fund 30,000 "Pass-Foncier" (these schemes are explained in more detail later). Matched funding of €350 million was also made available to restart stalled private housing projects and a further €200 million for repairs and energy improvements to existing homes. With much of the stimulus directed specifically at housebuilding, it is perhaps unsurprising that housebuilding kept up in contrast to the experience in some other countries.

In addition, mortgage interest rates have been low and consequently, affordability has been improving. As most mortgages have interest rates fixed for five years or more, purchasers can lock in good borrowing rates for some time to come. The government has also encouraged banks to keep up the flow of mortgages, which has been made easier by limited poor lending during the boom years and a low current level of defaults.

CHAPTER 4: FRANCE

However, much of this broad range of stimulus measures is coming to an end, so that economic growth and rising consumer confidence will have to underpin any continued revival of housing demand. Because stimulus measures were temporary by their nature, their influence is now waning. In addition, fiscal tightening has seen a reduction and refocusing from 2011 of state aid in the housing sphere towards housebuilding and first-time buyers. For example, the mortgage interest tax relief measures introduced after the last presidential election have now been withdrawn.

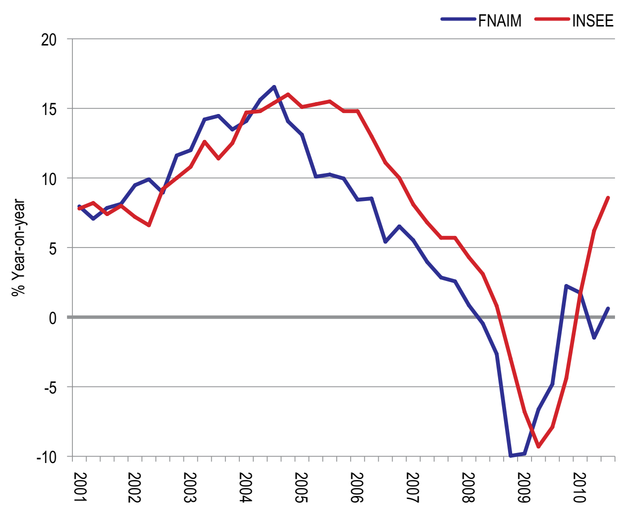

Figure 4.1: Changes in house prices, 2001q1–2010q3

Source: FNAIM, INSEE

Prior to 2007, the housing market had been booming, 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 4.1).

The French housing market, like most others, is no stranger to booms and slumps. House prices in the first half of 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, so the recent downturn was a relatively mild one, assuming that no further shocks come along. The peak to trough fall in nominal house prices in France was around 9% from the middle of 2008 to the middle of 2009, according to FNAIM data. Yet, with stimulus measures winding down and a relatively sluggish economic recovery from recession, the expectation is that house price growth will continue to be moderate.

The housing system

France has 32 million dwellings: 84% are prime residences, 10% second homes and 6% are vacant. Of prime residences, 57% are owner occupied, 24% privately rented and 18% social rented. The basic quality of housing is good, although there are some notable problems as indicated, for example, by the fact that a fifth of dwellings show signs of dampness.[1]

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 tradition of a strong state remains – as seen in active programmes with regard to 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, which was once again used during the last recession. The aim is a stated goal of housing policy in a way rarely mentioned in other countries.

State aid is disbursed under a number of policy rubrics. There are significant programmes of urban regeneration and housing renovation as well as with respect to new build. Renovation and modernisation of the existing stock currently represents around half of all housing investment.

Previously, subsidies had peaked at the end of the 1990s after which they declined in the face of public expenditure pressures, but they then grew again from 2005 with national concern over social cohesion, rundown neighbourhoods and then the downturn. However, with a high fiscal deficit and the worst of the downturn over reductions are now on the agenda, though subsidy will remain high even after that.

The urban riots of 2005 led to a strong policy response with regard to housing, which continues. 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. An urban renovation agency manages many of the schemes (ANRU - Agence Nationale Pour La Rénovation Urbaine).

[1] *National Housing Agency.*

CHAPTER 4: FRANCE

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 number 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 6-7% 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 those taxes were 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 per 1,000 people in 2004 and it grew significantly after that during the final years of the boom.[2] 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, rising near to 350,000. But, despite this high rate of building, shortages have remained, particularly of affordable housing in the main urban areas.

Almost 60% of the stock is individual houses – mainly owner occupied – and the rest are flats located in multi-dwelling structures, most of which are rented. 16% of the total stock exists as dwellings in high-rise buildings of 4 storeys or more. Much of the social sector is located in unattractive suburban areas, many of which 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 2006, 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. Between 1990 and 2005, there were 3 million extra owner occupiers in total, accounting for two-thirds of the total net increase in the stock.

Expansion of owner occupation reflects a notably higher propensity amongst the 35 to 54 age group to opt for that tenure. Purchasing is spreading to younger households as well.

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. However, sales in recent years have actually been running at a much lower, though still significant, annual rate of 15–16,000.[2]

Housebuilding receives a variety of subsidies. They include potential exemption from property taxes on buildings, general tax credits and specific tax breaks for sustainable development. Renovations are also funded, especially when related to energy efficiency. A subsidised mortgage loans policy exists in the form of an interest-free loan programme, known in France as the 'prêt à zero %' programme (PTZ). This scheme provides loans to lower income first-time buyers. Applicants are processed through the usual mortgage channels as parts of mortgage packages. This has made lending to such applicants more attractive for commercial firms, as the PTZ loan element is state funded, offering in practice a boost to the down payments that first-time buyers can make. This gives greater confidence to lenders as it lowers the default risk on their elements of the 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 through the 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.

The zero-interest loan policy has been growing in significance over the past five years. Early in 2005 a revised PTZ scheme was introduced and the scope of the programme was extended significantly by making it available for existing as well as new housing. Further reforms in 2006 increased the loan and income caps in the more expensive areas of the country. The monthly income caps on PTZ loans were then raised until the end of 2009 as part of crisis-induced emergency package of housing measures. By 2009, €700 million was being spent on it.[4] Under a new PTZ+ scheme, income caps have now been abolished and loan length and terms improved, meanwhile the previous general tax credits on loans were abolished at the end of 2010, giving first-time buyers a fiscal edge. The maximum size of the loan depends on which region of France the dwelling is being purchased in, the amount of other borrowings and whether the dwelling is new.

Another source of financial aid to newly built owner occupied housing is the Pass-Foncier scheme, which provides up to €65,000 to facilitate new house purchases. The scheme is currently not applicable for apartments.

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[2] *INSEE.*
[3] *Housing Ministry.*
[4] *National Housing Agency.*

Private renting

Almost a quarter of households rent privately and renters 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 average quality has greatly improved over that time. The stock is relatively new in contrast to several other European countries. Nearly 60% of private rented dwellings were built after 1948 and as many as 14% after 1990, with new building encouraged by attractive renovation subsidies and land allocations. The individual investment purchase tax breaks were reformed into the 'Scellier' scheme from the beginning of 2010, with depreciation allowances replaced by direct tax cuts. The benefits are attractive but will be somewhat reduced from 2011, suggesting that investors may have frontloaded their purchases. 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. About 5% of the privately rented stock is subject to strict rent control under the terms of the rental law of 1948.

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 2007 and 2008, reaching almost 3% in the third quarter reflecting general inflationary pressures. In 2009, as inflation subsided, it flattened off but rose somewhat in 2010 (Figure 4.2).

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 financial situation of the owners of such properties has been improved as well.

In the social sector, the prime determinant of rent levels is historic cost i.e. construction and other costs at the time the housing development was built. A recent study found that average social rents were 40% less than equivalent market rents.[5]

IPD had reported strong returns for investment in residential properties up to 2007 in line with house price rises. However, in 2009 falling house prices offset the 3.7% income return to give a total return of only 0.1%. 2010 is likely to show improvement as capital values have stopped falling.

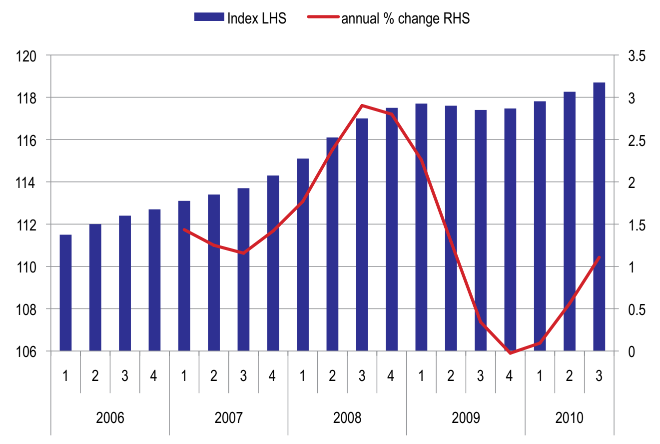

Figure 4.2: Rent reference index (IRL), 2006–2010

Source: INSEE
Note: IRL index 4q1998=100

[5]*INSEE.*

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Social Housing

Social housing is estimated to represent 19% of principal dwellings, 4.5 million units. They consist mainly of estates of flats and are concentrated in the Paris region and industrial areas in the north of the country. Around 10% of tenants move each year.

Social housing standards have 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 20% social housing in new constructions permitted in their areas and they are subject to central government scrutiny if they fail to meet it.

A major programme of social housebuilding and renovation was begun after the urban riots of the mid-2000s. Between 2005 and 2007, the construction of 276,000 social dwellings under a variety of programmes was agreed and funded. 2009 saw funding for a further 100,000, as part of the emergency expenditure package. Around 60,000 new social dwellings were added, of which 80% were new buildings, in 2008 (the latest available data), although the net increase was less due to 16,500 demolitions and 11,600 sales.[6]

Housing allowances are paid to tenants and to homeowners as a consequence of several pieces of legislation. The most common one, APL,[7] 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: approximately 6 million households in total funded from programmes which cost €14 billion in 2007. ALF[8] is paid to households with children, and to young couples with no children, when household income is below specified levels, while ALS[9] 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 proportion of large, low-income families and they experience some of the poorest housing conditions.

[5]*Housing Ministry.*
[6]*Aide personnalisée au logement.*

[7]*Allocation de logement à caractère familial.*
[8]*Allocation de logement à caractère social.*

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Housebuilding

Previously high rates of housebuilding were clipped by the onset of the recession but have partly recovered. Housebuilding peaked at almost 420,000 dwellings in 2007. After that starts declined as the recession mounted but still remain high in relation to most of the rest of Europe.[10] There was a surge in starts following the introduction of the emergency housebuilding subsidies in 2008 but starts have levelled off since then (Figure 4.3). The reduction in building subsidies from 2011 may hold back expansion.

The increase in housebuilding after 2003 was particularly marked with regard to the building of blocks of apartments. 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 and they have held up better in the downturn. The resilience of houses in new building reflects the growth of owner occupation, general demand for higher space standards and the suburbanised nature of modern French society.

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 owned for some time. As a result, large-scale developers have a much smaller market share than in countries like Britain, Ireland and Spain.

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 but budgetary pressures are now beginning to bite.

Macroeconomic influences

The recession was relatively moderate compared to most other European countries and the financial system has weathered the crisis well. There was a 2.5% fall in GDP in 2009 and then a 1.6% increase in growth in 2010. The prospect is for continued slow expansion over the next couple of years.[11]

The state plays a large role in economic activity. Fiscal stimuli and the existence of significant automatic stabilisers helped to limit the extent and duration of the decline. That increased the government deficit to 7-8% of GDP in 2009 and 2010, so fiscal tightening began in 2010 and is likely to continue in 2011 by curbing spending and widening the tax base.

Inflation is low and excess capacity is likely to keep down prices for some time to come. Unemployment remains stubbornly high at 9% and is not expected to improve much in the near future. The overall share of people of working age in employment is one of the lowest of the advanced economies with older and less skilled people more often than not in work. 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.

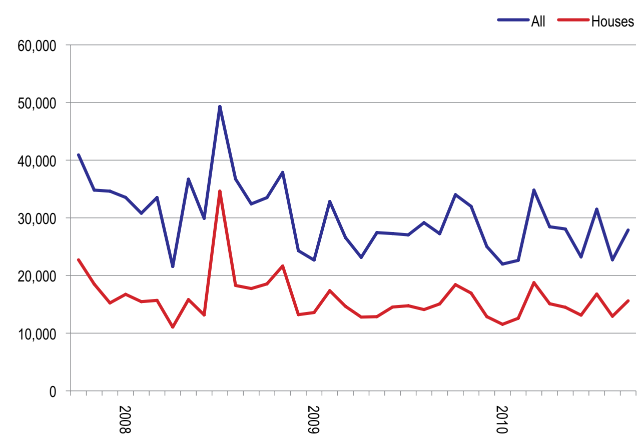

Figure 4.3: Housing starts, Oct 2007–Sep 2010

Source: MEEDAT

[10] *Housing Ministry*
[11] *OECD*

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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. Most mortgages (over 90%) are taken out on a fixed interest basis with an average term of 25 years.

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 four years. The interest they receive is below market the rate, but it is topped with additional government subsidies although there are with caps on how much can be saved and borrowed. At the end of the contractual period, people 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. There are around 11 million separate 'pass book' participants in the savings scheme and all members of a household may open one, regardless of age, including minors. The share of housing loans financed by these schemes has declined substantially in recent years, due to the expansion of more attractive savings and loans options, especially in an era of low interest rates.

There are other 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. There are further subsidised loans, such as the PTZ 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 and other financial companies.[12] Competition increased during the boom years within the highly regulated, nationally-orientated, banking system. The outcome was 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 and other related expenditure has contributed to a low share of mortgage finance to GDP at 35% in 2008.[13] The figure of long-term loans to households, most of which will be housing related, is higher at 76% of household disposable income in 2008. It has been rising fast in recent years, as elsewhere, up from a half of disposable income in 1997 to three-quarters in 2008.[14] But it is still noticeably lower than in most other advanced economies.

Although the government was obliged to intervene to prop up French banks during the financial crisis, none of the major financial institutions faced the same funding difficulties experienced by providers in some other European countries, such as the UK. In addition, few foreign players were active in the French market during the boom years, so that withdrawals from the market by them have had no appreciable effect on the availability of finance. These factors probably account for why there has not been a sharp reduction in mortgage funding. In addition, when the government injected capital into banks in 2008 it expected them to lend additional funds to house purchasers. Given the country's institutional framework, this probably had more effect than similar exhortations elsewhere.

Although housing-related debt is low by the standards of many of the other leading EU economies, it still expanded significantly in the boom years, doubling in nominal terms between 2002 and 2009. The biggest surge came between 2003 and 2007 and then fell with the onset of the financial crisis as the housing market began to slow (Figure 4.4). Mortgage growth has picked up somewhat since the housing market bottomed out in the middle of 2009 but, as housing demand remains weak, it is unlikely to grow rapidly again in the near future.

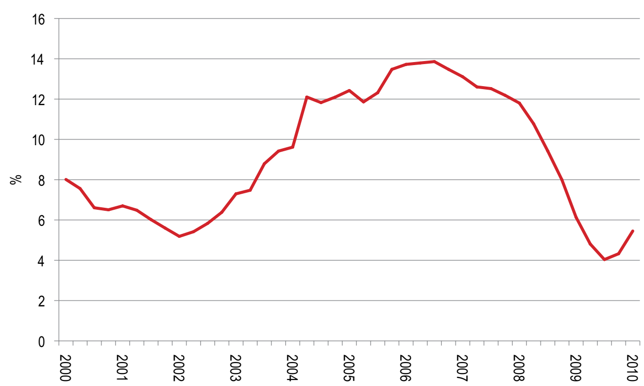

Figure 4.4: Growth of new housing loans, 2000q1–2010q1

Source: Bank of France

[12] *Bank of France.*
[13] *EMF.*
[14] *OECD.*

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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 downturn in the housing market was exacerbated by rising mortgage interest rates until the end of 2008 but since then they have fallen markedly (Figure 4.5). This has helped the housing market to recover, encouraging both investors and owner occupiers to borrow. The low returns on other saving and investment vehicles have also increased the attraction of house purchase, especially as the expectation of further price falls is now low.

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.[15] Making assumptions about items such as immigration, vacancy rates and demolitions and renewals, it is estimated that 320-370,000 new dwellings a year will be needed up to 2020. 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. Neither do they take account of affordability problems, which have been significant in recent years, though they have improved over the last few years.

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. By 2050 over a third of the population will, on current trends, 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. It will also induce major structural changes within the economy and public sector, which in turn, will have long run consequences for housing taxes and subsidies as well as broader housing policies.

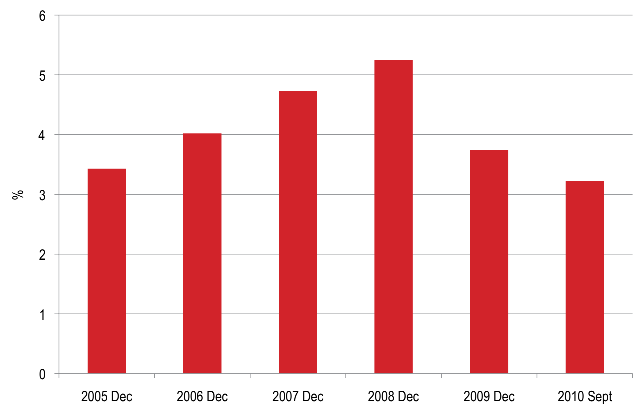

Figure 4.5: Interest rates on loans for house purchase, 2005–Sep 2010

Source: Bank of France

[15] *SESP Note No 165.*

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Overview

House prices grew by around 4% in 2010 compared to falls of around 2% in the previous year, according to the Hypoport index. The vdp index suggested a slower rate of 2% but was still positive. Housing demand and confidence were boosted by the strength of the economy and there were attractive mortgage interest rates. So, by German standards over the past decade, demand-side conditions were relatively strong in 2010. By contrast, housebuilding was relatively weak. There were indications that the long decline was finally over, but that point has been predicted as imminent for a number of years now. Continued strength in housing demand in 2011 will be needed to ensure that outcome.

The housing market has behaved like no other in the recent decades. Nominal house price changes in it had been relatively moderate and steady in recent years in contrast to most markets around the world. This moderation is due to a variety of causes. German homeowners traditionally take a long-term life-cycle view of entry into homeownership and that, plus limited transactions of existing dwellings, limits the impact of short-term events on prices. Prices had been trending downwards for some time up to 2009, especially in real terms, so the revival in demand in 2010 may have marked a significant turning point.

It is hard to get an accurate measure of prices, because there is no comprehensive quality-adjusted official price index. Two new ones have been launched in recent years, based on mortgage data, and were quoted above. They each give a somewhat different picture, although much of that is due to the fact that they define terms in slightly different ways, so it is useful to describe in more detail what they report. The first index is that by Hypoport, which utilises data from its trades in private mortgages that it says cover 10% of all such transactions. The other is by the Association of German Mortgage Banks' offshoot, vdpResearch. It publishes indices based on the mortgages offered to home owners by vdp members – which have totalled over 600,000 since 2003. Both are quality-adjusted (hedonic) indices.

Furthermore, when interpreting house price movements, it is worth remembering that for several reasons the German owner occupied market is quite a distinctive one. Condominium purchase is a relatively recent phenomenon and is often associated with buying new dwellings from schemes where developers as a marketing strategy tend to hold sales prices steady. Moreover, a single-family home is usually lived in for long periods of time once bought. Because of that, the proportion of second-hand sales in market transactions is far less than in most other mature housing markets. This means that the impact of newly built homes in recent mortgage borrowing data is more significant than in many other countries. The new single-family home market itself is also distinctive because many houses are 'self-build', where the purchaser buys a plot of land and commissions a home to be built on it. New house price indices pick up many mortgages issued in relation to such completed 'self-build' dwellings. Those new home prices, in reality, track a weighted mix of construction costs and land prices lagged over a number of years, depending on when the land was bought and how long construction took. Composite house price indices covering the whole market therefore have outcomes that have been smoothed for several reasons. Although German house prices clearly do not fluctuate wildly over time, some of their observed smoothness compared to other countries' experiences has statistical and institutional reasons.

The Hypoport index shows notable price variations between types of housing at the national level (Figure 5.1). From 2006 to early 2010, the prices of existing houses fell by around 15% but then picked up again in 2010. By contrast, the prices of new homes seem to have risen fairly consistently over the same period, rising by around 8% overall. Finally, flats – which are sold on a condominium basis – have experienced only moderate price variation. They did fall by around 5% but then grew from mid-2009 onwards back to their 2006 level.

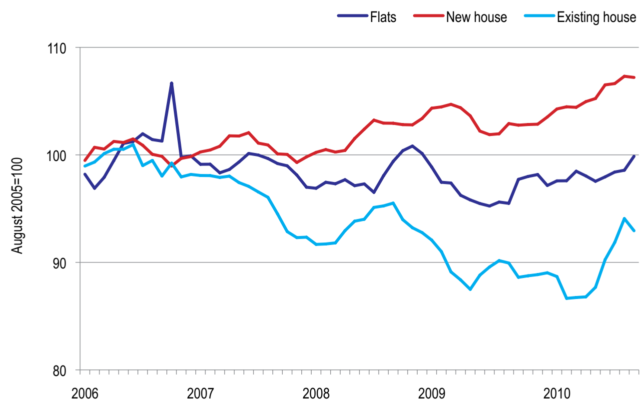

Figure 5.1: Changes in house prices by type, Aug 2005–Sep 2010

Source: Hypoport

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Turning to the vdp index, it shows steady price growth throughout the period from 2003 to 2010 (Figure 5.2). It suggests that over the period owner occupied house prices rose by around 8%, which in real terms was about a 4% fall. Both price indices indicate an upswing during 2010.

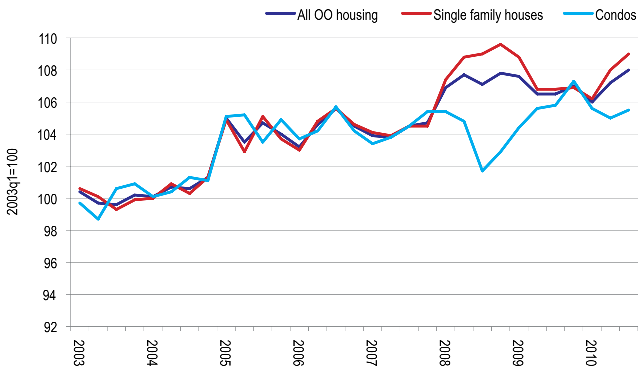

Figure 5.2: Changes in owner occupied house prices by type 2003q1–2010q2

Source: vdpResearch

The housing market has been distinctive in its long-run price performance as well. Real house prices slowly fell on a year by year basis from the mid-1990s until 2010.This situation led to some starkly different trends from most other countries. German house price to income ratios have fallen by almost a third since the early 1990s. The price-to-rent ratio has also dropped significantly over time. Obviously, these observations are at the national level and are partly affected by experience in the new Länder. Some cities, like Munich, have experienced more buoyant situations but nothing on the scale of other major European cities.

With long-term falling house prices, it is unsurprising that there has not been a rush towards owner occupation over the past decades, because of the potential capital losses from purchase. So, the size of the tenure remains low. The most recent official survey showed the homeownership rate remaining stable: having dropped slightly from 43% in 2002 to 42% in 2006.[1] In addition, long-term tax and subsidy changes have depressed both investor and owner occupied housing demand. Expansion of owner occupation in a country with a majority of renters is also likely to remain a gradual process at best, though successive governments pay lip-service to the benefits of ownership and the desirability of its expansion.

The world financial crisis did not pass Germany by. Fears of bank runs in autumn 2008 forced the government to offer guarantees on bank deposits. Some institutions also had to be rescued, such as the major mortgage lender Hypo Real Estate and the major savings bank WestLB. Other banks have had state injections of capital and have been heavily loss-making. However, the ‘pfandbrief’ covered bond market, which is central to mortgage finance, was again functioning effectively from 2009, after severe problems in autumn 2008.

Given relatively plentiful housing supply, except in a handful of city regions, the prognosis is still for only limited house price change over the next few years. This perspective is suggested by five factors:

1. The large and competitive role played by renting, with owner occupation the minority tenure.
2. New supply seems elastic and plentiful by European standards.
3. The country’s population is set to decline quite rapidly. The economically weaker regions are likely to be far more affected by this change than the stronger ones. However, the economic geography of the country is not so highly dependent on one or two major lead growth regions as is often the case elsewhere in Europe. Stagnant or falling populations are therefore going to be quite common over large tracts of the country, with only limited increases elsewhere.
4. The country’s mortgage market has been subject to few significant structural or competitive changes in recent years and borrowing terms were not loosened much so the credit surges seen elsewhere did not occur. Yet, the problems faced by the country’s bond markets in 2008 and more generally stricter financial regulation mean that no easing of conditions is in prospect.
5. Fiscal retrenchment is very much in fashion so that subsidies and tax breaks related to housing have fallen significantly in recent years, unlike the situation in most other countries.

Housebuilding rates have been declining almost continuously from their high, post-unification mid-1990s levels and now stand at around a third of that peak. They are not expected to grow much over the next few years because of the relatively quiescent state of the housing market and poor demographics.

It seems that the housing market is broadly in balance between supply and demand, even though housing supply is short in some cities and regions and consumers remain highly sensitive to adverse changes in housing costs. So, there seems to be limited prospects of significant price rises in the German housing market in the near future, especially given the problems in the Eurozone and a potential slowdown in the country’s export markets.

[1] *Federal Statistical Office.*

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Homeownership

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, but it is still low.[2]

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, sales and as debt is paid off. Germany has a unique time-dependent definition of social housing; 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 Germany, 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. This is not simply due to the old differences between the East and West but also due to city politics. For example, policies in Hamburg and West Berlin traditionally emphasised rental housing. Due to these histories, they both remain predominantly renter cities, with homeownership rates of only 20% and 14% respectively.

Homeownership does not seem to be growing. In fact, in several regions it is falling. A decline in home ownership of almost 4% occurred between 2002 and 2006 in the new Länder. This was the area where house prices dropped the most following a brief boom after reunification. This makes home ownership an unattractive prospect, which suggests that the relative user costs of other tenure options has been an important consideration in consumer housing choices.

There are social and demographic distinctions in tenure choice. Only a quarter of singles 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.

The proportion of non-family households in the total is substantial, which meshes in with the high share of flats in the total stock. 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. Around 70% of households consist of only 1 or 2 persons and average household size will continue to decline as the population ages. Some of the major cities have very high proportions of singles. In Berlin, currently half of all households consist of one person only, while in Munich the figure is 46%.[3] 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.

Local housing shortages are more often than not associated with specific housing types, locations and qualities rather 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.

Thin and specific markets hinder clear consumer understandings of relative market prices and they raise home search costs which dissuades potential house purchasers from making market transactions. Price information is harder to acquire in such market contexts and is of variable quality. Because of the low level of existing home sales, estate agents listings of owner occupied housing are much more limited than in countries which much higher levels of activity.

[2]Federal Statistical Office.
[3]Federal Statistical Office.

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So, when contemplating purchasing, the range of choice is typically less than in countries with bigger homeownership markets. It is often difficult to find appropriate, readily available properties, because there are relatively few transactions in local homeowner markets. Agent fees and other transactions costs are high, which further discourages high frequency trading. The lack of choice in the existing housing stock, in turn, means that potential homeowners typically have to purchase new properties or commonly arrange for bespoke ones to be built. Often new build sites are available only in far flung locations where land is designated for such projects in local plans. Local new build markets are themselves often limited in scope and involve considerable consumer effort. The small scale of the new owner market discourages large-scale homebuilders and, in any case, existing types of purchaser often prefer individualised 'self-build' homes. Altogether, the benefits of mass housing markets common in countries with high homeownership shares are absent in Germany.

The nature of German housing and mortgage markets creates difficulties for many households wishing to make the transition from renting an apartment to single-family housing and owner occupation. As the relative cost of single-family housing is high, the comparatively low maximum loan-to-value ratios and concomitant high deposits make the cost of entry to homeownership insuperable for many households, particularly younger ones. Long savings periods and help from families are necessary.

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 as did post-reunification programmes.

Tax-wise, there is no mortgage interest tax relief but newly built, single-family owner occupied dwellings did benefit from a specific tax break known as "Eigenheimzulage", estimated to cost €7.5 billion in 2004.[4] From 2004, existing dwellings were brought into the scheme, which raised the subsidy cost. But, then, this tax break was fully withdrawn in 2006.

Quite what the structure of future tenure relationships will be remains to be seen over the next few years. As the long-run fall in house prices may finally be ending, the relative benefits of renting and owning will alter. If 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. 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 still also 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 it 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 has encouraged 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. Apartment prices have been much stronger in recent years than those for existing homes, which may indicate purchaser interest has been stimulated as well as investor interest.

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. 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.*

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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, means 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 life-cycle 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.

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 limited. 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, because of the general policy preferences of regional planning authorities on 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 it may encourage over-investment in particular housing types once new land-use plans are put in place. 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. They fear the impact of the full infrastructure costs associated with such suburban expansion that they have to bear; 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. 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.

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 judiciary are also more 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); 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 ran by small landlords.

The scale of small-landlordism is not 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 encouraged by the tax laws). 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. 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 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 2,500 properties, showed a return of 5.3% in 2009. This was made up of a 4.2% income return and 1% capital growth.

Social renting

Social housing means something different from elsewhere in Europe; 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.[6] These companies are organised within the Gesamtverband der Wohnungswirtschaft (GdW).[7] 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.

In the East, the large rental stock was in a rundown state at reunification. The programme of housing privatisation in the East has been far slower than was originally anticipated. Social housing programmes have had to deal with large numbers of poor quality and empty properties in the East, where in 2002 there were 1.3 million vacant properties. Programmes of extensive demolition and neighbourhood regeneration are in place and will continue for some time to come. Old industrial areas in the West are facing similar problems, though on a smaller scale.[8]

[2]This is argued, for example, in Structural Factors in the EU Housing Markets, ECB, 2003.
[3]In Berlin, for example, there are about ten public housing companies.
[4]The organization of the private housing companies is the Bundesverband Freier Wohnungsunternehme e.V., (BFW). However many companies are members of both organisations.
[5]Wohnungswirtschaftliche Daten und Trends 2009/2010, GdW.

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Privatisations and sell-offs

There have been some substantial sales of rental homes in the past few years by non-profits organisations industrial firms with residential estates and the public sector. In general, funds aim to make returns in several ways: through renovations, sales to tenants, other disposals, managerial and financial efficiencies, and through 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 purchasers have already sold out as returns have been lower than expected and highly leveraged purchasers 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.

Housebuilding

Housing completions fell by 10% between 2008 and 2009 to only 140,000, repeating the decline of previous years (Figure 5.3). Germany is now amongst the lowest per capita housebuilders in Europe in marked contrast to the persistent high levels of output of the previous decade and before. However, permits data suggest that the worst may be over, with permits up by 7% year-on-year for the first nine months of 2010.[9]

There has been a long, substantial decline in housebuilding since the mid-1990s boom, when over 600,000 dwellings were built in the peak year of 1995. Output is now less than a quarter of that peak period. Recent years have seen notable fluctuations in output, some of them policy-induced (Figure 5.4). For example, 2007 was the year that owner purchase subsidies were abolished and VAT in general was increased by 3% to 19%, which is significant for housebuilding because the standard rate of VAT is charged on new homes. 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 to beat the tax and subsidy changes, after which building levels fell back again.

The building boom that occurred in the mid-1990s was stimulated by the post-reunification experience. Policy makers over-reacted to temporary accommodation shortages so new housing production subsidies and tax breaks were rushed through. In addition, the government provided low interest rate loans for housing investment and further incentives were offered in the East under the Promotional Area Act. It transpired that the scale of the building boom was out of all proportion to long-term housing demand, so that by the mid-to-late 1990s signs of severe over-building in many localities were apparent. This encouraged a long downswing in the housing market and a rising vacancy rate, as excess supply came on stream and was only slowly absorbed.

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 considerable 11%. The scale of the new supply created during that period was sufficient to accommodate extra demand in many localities and for a long time afterwards.

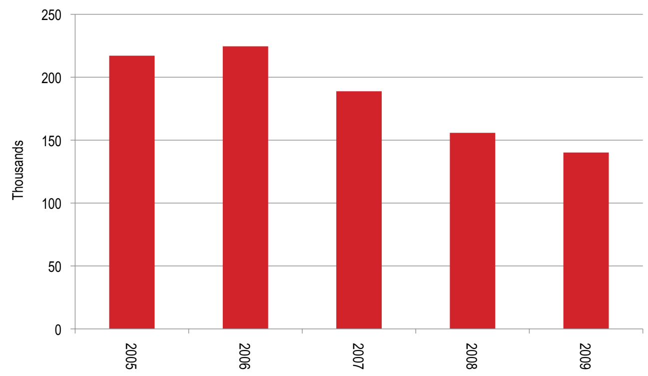

Figure 5.3: Housing completions, 2005–2009

Source: Federal Statistical Office

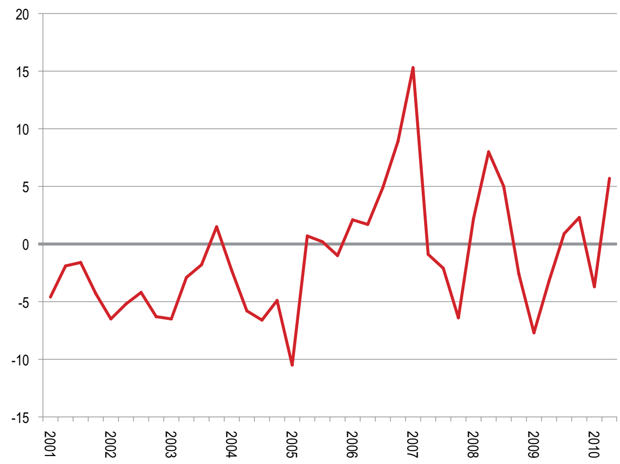

Figure 5.4: Real change in housing investment 2000q1–2010q2

Source: Federal Statistical Office

[9] *Federal Statistical Office.*

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Macroeconomic influences

Activity in 2008 slowed rapidly because of weak private consumption and a poor export performance due to the global recession. The situation worsened in the first quarter of 2009. But the economy responded to government stimulus measures by the second quarter and continued to improve through the year, although a fall in GDP of almost 5% was recorded for 2009 as a whole. Growth revived strongly in 2010 with a 3.6% outturn expected by the central bank at year end. That is the strongest annual rate of growth for over 20 years. The rate of recovery was strongest in the first half of 2010 and although 2011 is unlikely to match that, growth is still forecast to remain strong.

Inflation was running at over 2.5% in 2008. However, falling commodity prices and the recession curtailed inflationary pressures sharply in 2009 and by September prices were 0.3% down on the year.[10]

Unemployment was 10% on an internationally comparable basis in 2006 but has gradually fallen since then to 7% in 2010. It 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.

Significant reductions in public expenditure are planned from 2011 to meet structural deficit targets set out in a new fiscal rule. They will slow growth somewhat. The precise impact on the housing market is unclear but the measures imply less intervention in the East and older industrial areas.

Mortgage market influences

The mortgage market relies on finance provided by one or other of the three branches of the financial system: the commercial banks, the public savings banks and the co-operative sector. Via each route, a prospective purchaser may raise housing 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 that the rate is fixed. Around 80% of the housing loans held by banks of all types are 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. It should also be remembered that many loans are advanced to housing investors as well as homeowners in a country with a large private rental sector.

The country has a unique financial system and a large number of banks, with two-thirds of all the credit institutions in the euro area as a whole. Mortgage banks traditionally had the sole right to issue mortgage bonds (Pfandbriefe) in the capital market, though no longer. Their bonds are covered by the real estate mortgages (and other assets) they hold on their balance sheets 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 the existence of strong capital bases and/or state guarantees of the issuing banks.

As elsewhere, institutions lending mortgages screen customers for their ability to repay a mortgage and loans can be advanced up to 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 Pfandbrief 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 its stipulated 60% ratio. This is not the case because other loans are often added into loan packages. For instance, in 2010 q3, 17% of new housing loans (€191bn) were unsecured ones and a similar ratio has prevailed in the past few years.[11] Nevertheless, credit availability is more strictly rationed in Germany compared with the pre-financial crisis experience in many other countries. For example, there is conservative loan appraisal, no sub-prime segment and thorough vetting of loan applicant details.

The Pfandbrief 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. 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 of first, second, etc. mortgages are sold to owner occupiers and landlords structured around the first bond-funded mortgage loan. Members of the German mortgage bankers association had a market share of 27% of all housing loans in 2009, so the range of sources for loans is wide. For example, deposit-based lending rather than the bond market is typical for second mortgages.

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 over-ambitious lending and investment strategies and are currently looking for new owners, most notably WestLB. Yet, there are few pressures for major organisational restructuring, so a widely fragmented ownership structure remains. This limits the opportunities for scale-economies and innovations in the mortgage industry. 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.

[10] Bundesbank.
[11] Bundesbank.

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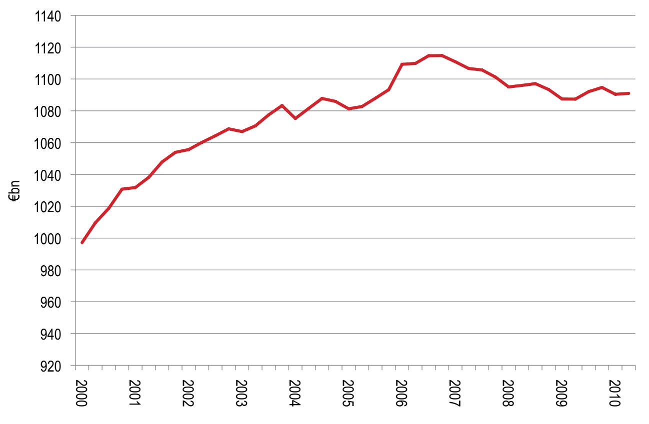

Figure 5.5: Housing loans, 2000q1–2010q2

Source: Bundesbank

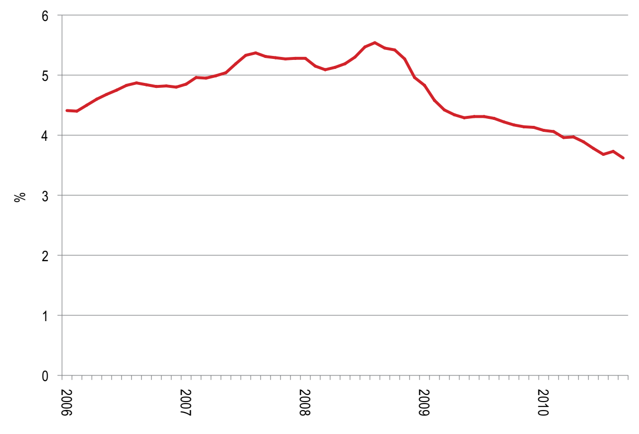

Figure 5.6: Average interest charges on new housing loans, Jan 2006–Sep 2010

Source: Bundesbank

The mortgage banks' monopoly access to covered bonds was abolished in 2005. This followed 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 Pfandbrief market. At the same time, regulatory and capital adequacy criteria have been strengthened.

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. There were €86bn of loans at September 2010, similar to those in 2009 and €127bn deposits under savings and loans contracts, slightly up on the year.[12] This is a relatively small but still significant part of housing finance activity. As with mortgage banks, most of the remaining 24 Bausparkassen are now parts of universal banks and their activities contribute to the mix of housing finance packages on offer.

Mortgage finance volumes grew during the expansionary 1990s but in the 2000s the increases were modest, rising by around 11% between 2000 and 2006 but levelling and declining slightly after that (Figure 5.5). There was some reduction in the volume of outstanding mortgages since the start of the financial crisis and a modest revival in 2009 and 2010. But the decline has not been as great as in some other crisis hit European countries, despite a temporary seizing up of the Pfandbief market in 2008-2009.[13] Pfandbief spreads over government bonds had been less than 20 basis points for a number of years, but shot up to 160bp in the aftermath of the Lehman collapse when the German authorities had to rescue one mortgage bond issuer. The ECB also announced its covered bond purchase programme, which helped to sustain liquidity in the bond market. Spreads then declined sharply again but were again up in the Eurozone crisis of spring 2010, showing that the problems of the Eurozone can impact directly onto German mortgage finance.

Home loan interest rates peaked at the end of 2008 and were down by 180 basis points by autumn 2010 (Figure 5.6). This fall helped to increase housing demand and induce the more optimistic state of the housing in 2010.

A significant part of mortgage borrowing is used to finance rental housing. This has been an important factor in determining quiescent mortgage market behaviour, because many rental investors have experienced some softening of 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; these factors have probably led to more mortgage debt being paid off in those sectors rather than taken out. Owner occupied housing's share of the mortgage market is also greater than implied by its tenure share, because it tends to be associated with more expensive dwellings and larger per unit borrowings.

[12] *Bundesbank.*
[13] *Bundesbank.*

Demographic influences

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, more than a 10% decline.[14] 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 5.2). 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 is forecast to rise to 55 and by 2030 to a substantial 71.

An ageing society will have implications for pensions, health care, 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 increasingly 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.

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.

% of population aged:	2001	2050
Less than 20	68	16
60 and over, of which:	14	37
80 and over	6	12

Table 3.1: Tenure patterns

Source: Federal Statistical Office

[14] *Federal Statistical Office forecasts.*

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Overview

The downswing in the housing market showed few signs of abating in 2010. Prices had started to slide in real terms in 2007 with the onset of the world financial crisis. The price decline accelerated in 2009 and then prices continued to fall in 2010 at an annual rate of around 3%, with the declines concentrated in the first half of the year (Figure 6.1).

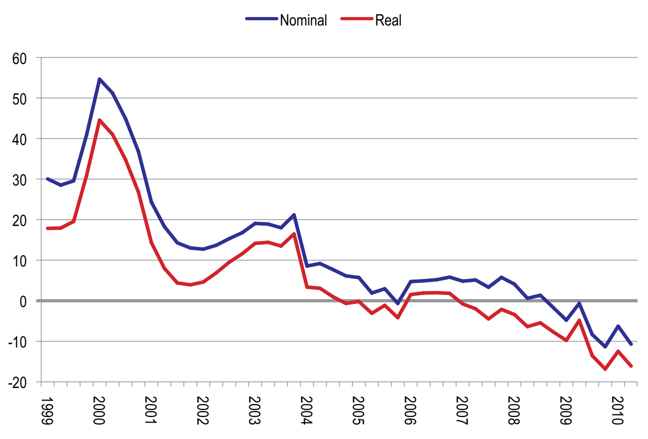

Figure 6.1: House price change, 1999q1–2010q2

Source: FHB House Price Index

Overall, prices were down by about a quarter in real terms since their peak early in 2007. (The country has been suffering from relatively high inflation, so it is helpful to look at real price changes.)

Housebuilding has also been tumbling and housing transactions low. Vacancies have risen as well. As well as reflecting the continued problems of the housing market, some of the downswing was a rebound as a consequence of earlier policies that had encouraged purchases to be brought forward into 2009.

After the sharp recession in 2009, when GDP fell by 7%, the economy showed signs of recovery in 2010 with moderate 1% growth. That this turnaround was not itself reflected in the housing market owed much to continued depressed consumer expenditure and the problems of mortgage finance, especially the overhang from the previous high use of foreign currency denominated mortgages.

Hungary's period of booming house prices was earlier and less sustained than those of most other central and eastern European countries. Prices did increase sharply between 1998 and 2001, particularly in Budapest, with the greatest price growth concentrated in the new build market. But then it gradually petered out as vote winning subsidies were withdrawn and fiscal austerity caused a severe reduction in economic growth. So, from 2004 to 2007, the housing market was in the doldrums and, then, it contracted with the impact of the world economic crisis on the economy.

The use of mortgages expanded rapidly up to 2009 from a very low base, though the total loan book is still only around 15% of GDP. However, because most mortgages are relatively recent in age, average LTVs are quite high at 70% (and 80% on foreign currency loans).[1] So, those purchasers that have used mortgage borrowing in recent years are highly sensitive to mortgage market developments.

Borrowing in foreign currencies eclipsed borrowing in Hungarian forints (HUF) in the years from 2005 to 2008. More attractive interest rates were on offer and the easy terms under which they could be borrowed took little account of the foreign exchange risk inherent in them. Outstanding loans denominated in foreign currencies (FX) rose to over 66% of all mortgage loans by the middle of 2010. New FX lending remained high until 2009.

Much FX borrowing was in Swiss francs, according to the central bank, which has moved particularly adversely against the forint. So, the domestic value of outstanding mortgage debt has continued to rise when measured in HUF terms, even as FX loans declined. A consequence has been that the FX mortgage burden has risen substantially. Swiss franc dominated monthly mortgage costs for a loan taken out in 2005 had risen by 36% by autumn 2010 and some borrowers were now paying 50% more than they did originally, due to the higher HUF value of the principal, according to central bank estimates. Foreign exchange markets continued to be volatile throughout 2010 and the risks of borrowing costs rising further were high at year end.

Overall, combining all types of borrowing, households' average monthly debt serving burden has risen sharply. It was up by 30% in July 2010 on September 2008 and is now the highest in Central and Eastern Europe, according to the Central Bank.

The risk of growing mortgage defaults and the extent of foreign currency mortgages have led to drastic policy action. From August 2010, it became illegal to register a mortgage under a foreign currency loan. So, the era of large-scale housing borrowing in foreign currency seemed to draw to an end, apart from limited refinancing.

[1] *Central Bank.*

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However, the large outstanding stock of household mortgages and consumer loans in foreign currencies remains a continuing and substantial financial risk and burden on households. The Swiss franc exchange rate against that of the Hungarian forint (HUF) is now much higher than many expected when they took out loans and the risk of further appreciation remains.

General defaults on household loans have risen substantially. The 90+ day delinquency ratio by 2010 q3 had risen to 6% on foreign currency dominated and 4% on HUF denominated mortgages. Overall, non-performing household loans to the total outstanding amount reached 10.5% in September 2010.[2] As one of its measures, the government has imposed a maximum loan to value ratio on new mortgage issuance of 75%, which applies to HUF loans (as well as the now-defunct FX ones). This cap is arguably relevant for avoiding another loan crisis at some distant time in the future but, if rigorously enforced now, will act as dampener on increasing housing demand immediately and may help to delay a sustained recovery.

A number of other responses have been made to the growing default crisis. The government announced an extension of the moratorium on eviction until mid-April 2011. The legal details are complicated but the measures were, first, a 6-month ban on foreclosures until the end of 2010 and the further enforcement of a ban on 'winter' evictions that has been around since 2003.[3] These measures may temporally benefit some households who are unable to keep up repayments, but they have imposed substantial costs on banks, as they lose their collateral and face higher administrative costs. The policy once it is expected to be recurrent also creates a situation where households are less inclined to pay off their mortgage debt, which increases the likelihood of further non-performing loans. There is a high risk that banks will price the extra risk of more of such interventions into mortgage rates, adding to their already high spreads and choking off mortgage demand further. Banks may also limit allocations of funds to Hungarian mortgages if they become increasingly unprofitable. A new support scheme to help mortgage borrowers in distress is being introduced which should make it easier to lift the ban, which is necessary to restore a functioning mortgage market and enable the development of a covered bond market to which the central bank has given its backing.

The new Hungarian government elected in 2010 argues that growth will revive and deficits disappear through a radical lowering of taxes while filling the fiscal gap with 'temporary measures': tax swoops on banks and utilities and a compulsory transfer of private pension funds into the public scheme. The tax reductions came into force in 2011 and represent a radical break from the previous programmes of austerity and reform. This policy shift is controversial and Moody's downgraded Hungarian debt in December 2010 on the grounds that the programme was unsustainable.

In pure housing market terms, the boost to spending power may stimulate demand but the extra taxed banks may be more reluctant to lend or will charge higher interest rates, which may more than offset that positive effect. Another housing demand downside could arise if those who have lost private pension rights start to save more. Worries about the future of the economy will also make buyers cautious about house purchase.

With questions over economic policy and European financial markets once again in turmoil at the end of 2010, prospects for 2011 in the Hungarian housing market do not look that bright.

The housing system

Housing standards are low by Western European standards in a country where the average standard of living is just under two-thirds of the EU average. There are substantial quality, repair problems in the existing stock and significant overcrowding. Eurostat on its composite measure of these factors estimates that a fifth of the Hungarian population suffers from severe housing deprivation and 48% from overcrowding alone.

At 90% of the housing stock, Hungary has one of the highest home ownership rates in both the EU and the world as a whole. There is a long tradition of owner occupation. In the 1980s, it was around 65% with virtually all of the remainder rented from the state. Nowadays, 71% own outright, 18% own with a mortgage, 3% rent privately and 8% pay a reduced rent or nothing, according to Eurostat.

Rural housing has traditionally been owner occupied and so has much middle-class urban housing. All major cities have several 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, which have been tackled to only a limited degree over the past 20 years.

Most building is for private owners. A development industry has grown strongly in recent years and now matches in output individual self-build. In cities like Budapest, there is a lively second-hand market, especially for better-quality homes of which there are quite a number.

[2]Central Bank.
[3]Central Bank.

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The existence of substantial transactions in the existing homes market and the relatively good supply of existing dwellings relative to demand helped contribute to the lower level of price increases in the Hungarian housing market compared with those in several other central and eastern European (CEE) countries during the pre-2007 years. Two-thirds of mortgage loans (and subsidies) were used to buy an existing home in 2008. As the housing market is broadly based, the new build market does not dominate recorded transactions and price indices as it does in a number of other CEE countries.

During the era of shifting to a market-based economy in the 1990s, there was a substantial programme of selling off state housing. This greatly increased the amount of private ownership and left only 4% of the stock in state hands. How much of the ostensible private 'owner occupied' stock is actually rented out in full or part is unknown, so the 90% home ownership 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 very high.

Sales of 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. Low income people who have remained tenants cannot afford the higher rents of improved properties. Some new owners are also reluctant to contribute to repairs and improvements. However, earlier uncertainty over the enforcement of repair obligations was resolved by a law making contributions to collective building repairs compulsory.

The total housing stock in 2007 consisted of 4.2 million dwellings. The average dwelling size is 75 square metres (63 in Budapest) and there are 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.[4]

There are quality problems in the housing stock, although improvements are being made with demolitions of some of the worst – running at an average of 4,000 units annually – and renovations of others. A significant proportion lacks facilities, with around a quarter 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.[5]

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 on a large scale – consisting of 5-10 storey buildings, built in suburban locations.
- new housing built in the past 20 years, consisting of single family homes and apartments.

Most urban housebuilding during the 1970s and 1980s took place with industrialised large panel and other concrete systems, constructing standardised flats on large housing estates with around 55 square metres of living space per dwelling. A fifth of the population, 2 million people, now live in such homes.[6] Many of these 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.

The Hungarian housing market has been distinctive over the past decade for the wide range of subsidies that have been introduced and withdrawn at various times. They have been directed at the owner occupier market or parts of it, with the aim of winning votes. 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 waivers. Complex stipulations and caps were imposed but, overall, the subsidies were generous. Ensuing public expenditure crises then subsequently led to curtailments and then new voter enticements came along.

Much of the house price history of the past decade can only be explained through a tracking of changes in varying subsidy rules. The justification for most of them on economic or social terms was scant. The 2009 announcements of subsidy and tax changes several months in advance of them happening was consequently part of a long history of political intervention into the housing market. The incoming government also has ambitious plans for improving the housing situation, making house building and improvement a main element of the 'New Széchenyi Plan' of economic reforms it launched in August 2010.

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 emerging over time, as with the new FHB house price index used in this report.

[4] *Central Statistics Office.*
[5] *Central Statistics Office.*
[6] *Ministry of Interior.*

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Housebuilding

Housebuilding has been on a gradual downward trend since the general slowing of the economy in 2004. There are two main types of developer: individuals and professional development firms, and their relative fortunes now determine housing output levels.

One sector that builds only a small amount of housing nowadays is the social sector, mainly comprising local government. Up to the 1990s, the major part of the 80-100,000 houses built annually was in the social sector. Then it virtually ceased after 1990, although there was a slight revival following the introduction of investment subsidies in the early 2000s; ones which were subsequently abolished, so that social output fell to a negligible level again (see the 'Local govt' category in Figure 6.2).

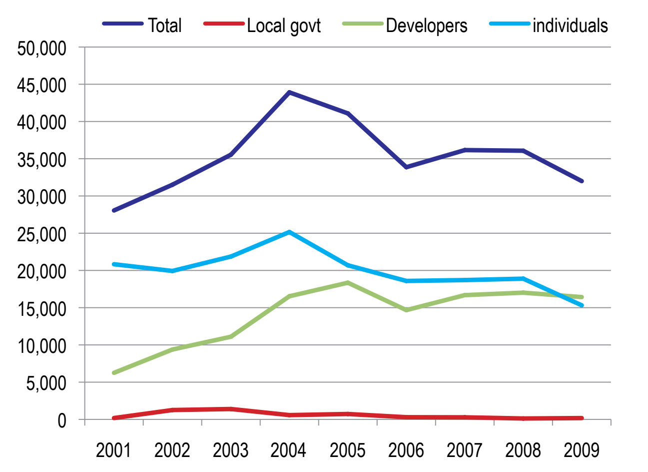

Figure 6.2: Housebuilding by type of developer, 2001–2009

Source: Central Statistics Office

Developers of new housing for sale are a fairly recent phenomenon. Only a few existed in the 1990s and they focused on the upper-end of the market. They only really took off when the state mortgage interest subsidy regime was introduced in the early 2000s. Developers' output peaked at over 18,000 units in 2005 and now represents almost a half of all building (Figure 6.2). Hungary's housebuilding rates continue to be low by average EU standards, at 3.6 dwellings per 1000 population in 2008.

Dwelling permits fell by 34% in 2009 as the recession intensified. There was some improvement over the previous year in 2010q1 but the next quarter saw a huge -30% drop on the same period in the previous year. Completions had fallen by 35% in 2009 and another major fall was expected for 2010 as well. The biggest decline was in the individual sector, with developers holding up better. Over half of all housebuilding is in the Budapest region.

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Macroeconomic influences

The state of economy has been dragging housing demand down, as it has been for several years. Growth had been flat for some time and then the economy fell dramatically into recession in 2008 and into 2009. It contracted by almost -7% in 2009, and the modest 1% recovery in 2010 was driven by exports rather than domestic demand. That surge in exports was encouraged by the devaluation that took place in 2008-9, which improved competitiveness somewhat. By contrast, real private consumption fell by 4% in 2010, illustrating the austerity squeeze on the private sector and the deleveraging it is undergoing.

The economy had been facing problems for some years, associated amongst other things with a loss of competiveness and a large government deficit. That deficit peaked at over 9% of GDP in 2006 and, despite tax hikes and expenditure cuts, was still 4% in 2010. That may have been modest by the standards of many other European countries but the country had just recently experienced joint intervention by the IMF, World Bank and ECB with a $25bn rescue package.

There are chronic problems with tax collection and the sharp recession inevitably put pressure on the fiscal deficit. However, that deficit has been long running and shows signs of short-term political influence in that political parties have often supported unsustainable populist fiscal measures over the past decade. Once in place, such measures then became politically difficult to undo, until a crisis provokes action. But governments that then oversee fiscal retrenchment have rarely been re-elected.

The government newly elected in 2010 has a strategy to increase tax compliance and economic competiveness through large cuts in income and corporate taxes starting in 2011. This is risky as it depends on a substantial and quick response by the economy. The deteriorating financial and economic situation in Europe at the end of 2010 may bring into question those aspirations.

The scale of the county's debt and the continuing above target inflation rate have led the central bank to argue that there has been little scope for monetary policy to deal with excess capacity in the economy. Hungary has consequently seen little of the interest rate stimulus to its housing markets experienced elsewhere in Europe over the past three years. As interest rates are so important for both housing demand and supply, the downswing in the housing market has been intensified by monetary policy rather than counteracted by it, as has been the case elsewhere.

The severe balance of payments deficit prior to 2009 was virtually eradicated due to the sharp squeeze on private consumption in the recession. Yet the private FX denominated debt issue remains crucial to future economic prospects.

Previous government austerity packages were reinforced by the near bankruptcy of the country late in 2008 at the depth of the world financial crisis, which led to the $25bn international rescue noted earlier. These austerity measures helped to push unemployment up to 11% in 2010 and unemployment is likely to remain high for some time to come. Moreover, only 61% of the potential workforce participates in the labour market at all. This represents further underemployment and a significant loss of productive potential.

Inflation has been high for some years. A sharp spike of 8% was reached in 2007, partly due to the government's austerity measures and also because of imported inflation. It has moderated since then but, at an annualised HICP rate of 4.3% in October 2010, inflation was still well above that in many other European countries.[7] Continued excess capacity is expected to bring the rate down in 2011and beyond.

[7] *Eurostat.*

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Mortgage market influences

Up to the mid-2000s, high nominal mortgage interest rates then deterred new private borrowers. As recently as 2000, nominal interest rates stood at over 22% on HUF-denominated loans and they were still over 12% in 2004. In fact, it was not until 2006 that HUF-denominated interest rates fell to 10% but then they started nudging up again later in 2006 and then rose sharply during 2008 as the world financial crisis began to bite, before falling in autumn 2009 and levelling out in summer 2010 at around 8% (Figure 6.3).

Inflation has been relatively high in Hungary for many years, especially in 2007 and 2008, but mortgage rates in real as well as nominal terms have often been substantial and some of the highest in Europe. For most of the 2000s seemingly better short-term rates could be found via the euro and Swiss franc (CHF) loans widely on offer, although these carried an exchange rate risk. However, during 2009 interest rates on FX loans were moving closer to those on HUF denominated ones, so that their attractiveness was waning prior to the ban on FX lending.

Policy for some years has been to peg the forint broadly to the euro, which gave the impression of exchange rate stability and low risk to foreign currency borrowing. The loss of international competiveness implicit in the country's high inflation rate meant that this strategy was increasingly under threat and, at the height of the world financial crisis in autumn 2008, the exchange rate deteriorated sharply (Figure 6.4). It recovered somewhat in 2009-10 after international intervention but the exchange rate remains volatile and under threat from continuing above target inflation.

After low levels in the previous decade, the use of mortgages picked up from 2002, encouraged by the introduction of generous mortgage subsidy schemes by the then government. The growth in mortgages was then fast up until 2009, but the market overall is still small-scale by western European standards and represents only around 15% of GDP.[8]

From hardly existing previously, FX mortgages had crowded HUF-denominated ones out of the new loans market by 2006. FX borrowing continued to grow up to the late 2008 financial crisis; the most common currency used being the Swiss franc. In the midst of severe recession, the volume of outstanding mortgages levelled off in HUF terms after 2008 and a period of significant private sector mortgage deleveraging began (Figure 6.5). However, as the exchange rate had deteriorated, the share of FX loans continued to grow when measured in HUF terms. By mid-2010, FX borrowing represented over 60% of outstanding housing loans.

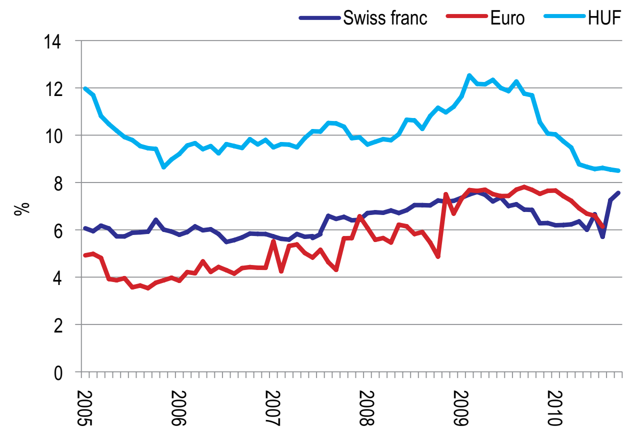

Figure 6.3: HUF and FX housing loan interest rates, Jan 2005–Sept 2010

Source: Central Bank

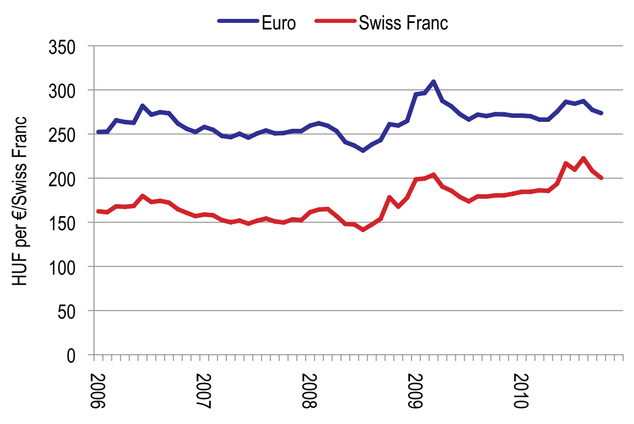

Figure 6.4: Exchange rates Jan 2006–Oct 2010

Source: Central Bank

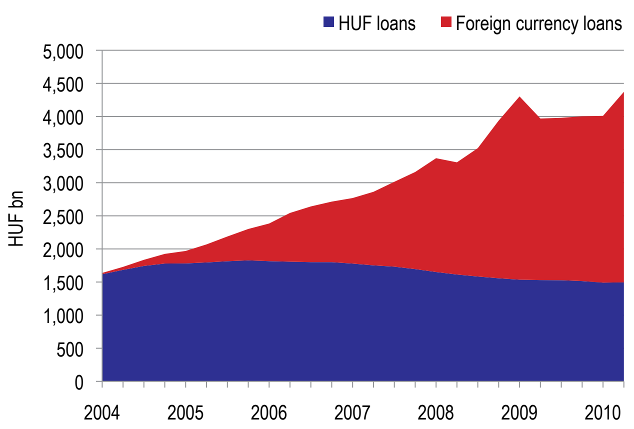

Figure 6.5: Outstanding housing loans 2004q1–2010q2

Source: Central Bank

[8] *European Mortgage Federation.*

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The mortgage market is dominated by two major Hungarian firms: OTP and the Land Credit and Mortgage Bank, FHB. Foreign banks have entered, increasing competition, but the central bank continues to be critical of the market power of the banks in the mortgage markets which it suggests has led to large loan rate spreads and onerous loan terms. In 2010, it proposed regulations that would limit mortgage lending to two products. The first is a variable rate one with interest rates linked to a benchmark interest rate and a fixed spread over the reference rate and the second is a fixed-interest product, where the interest rate can only be altered at pre-determined times by pre-determined means.

The central bank was active in purchasing covered bonds in 2010 in order to support the market. It is keen for the covered bond market to grow in order to promote competition and to reduce reliance on banks funding mortgage loans from potentially volatile short-term foreign sources.

Demographic influences

The population is gradually shrinking as the fertility rate is significantly below replacement levels. The actual scale of the future change in population depends on assumptions made about lifestyle choices in terms of the number of children people have. On the scenario that they remain as at present, the population dips by around 0.5 million (out of a current 10 million) by 2020 and then stays at around that level. Alternatively, if the birth rate continues to decline, the fall is likely to be much greater and could be a huge 3 million drop by 2050 on some assumptions. This latter prediction is likely to be unrealistic as it assumes no inward migration, which is unlikely in what should by then be a more affluent country.[9]

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.

In contrast to a falling population, there is strong growth in the number of households, especially in the metropolitan regions. Moreover, a large ‘youth’ cohort is currently moving through into the early years of household formation and so they are now entering the housing market as first-time buyers or as tenants.

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 there and around the other major cities.

[9] *Central Statistics Office estimates.*

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Overview

The decline in house prices moderated in 2010, with around a 2% fall in nominal terms, according to Scenari Immobiliari, and a similar 1.6% drop in Nomisma's 13 city average index. The overall price decline since the 2008 peak has been about 10% in real terms. This is relatively moderate compared to some other European countries, despite the country experiencing one of the sharpest recessions of the major economies.

Signs of the housing market stabilising were beginning to appear in 2010. This was suggested in a key market survey, the quarterly survey of estate agents by the Bank of Italy and Technoborsa. The balance of agents expecting price rises or falls turned positive in autumn 2010 for the first time since January 2009, although respondents did express a sense of uncertainty about future market prospects.

Italy was directly affected by the Eurozone financial crisis at the end of 2010 and this heightened uncertainty and damaged already weak lender and consumer confidence. The government debt ratio at 120% of GDP is virtually the highest in Europe and nearly on a par with that of Greece, according to the European Commission. So intense market uncertainty exists about the future short-run direction of prices, though forecasters, including Scenari Immobiliari and Nomisma, are expecting level or even modest house price growth in 2011. More positively, home owners are relatively debt unencumbered, credit remains available, interest rates on housing loans are historically cheap and there is no housing supply overhang to worry about. The problems besetting some other European housing markets are therefore not apparent in Italy.

The lack of a major crash in the housing market during the economic downturn is due to several factors. For one thing, the previous boom was relatively modest and concentrated some time ago in the five year period after the introduction of the euro, when mortgages became readily available at reasonable interest rates for the first time. In contrast, price rises have been limited since 2005 (Figure 7.1). Weak economic growth, poor consumer confidence and a responsive supply side all contributed to that out-turn.

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 institutional setting helps to keep housing supply relatively plentiful. What is more, informal building is undertaken to order, which limits the threat of over supply. Physical shortages, which drive up prices, are greatest in the major cities of the centre and north.

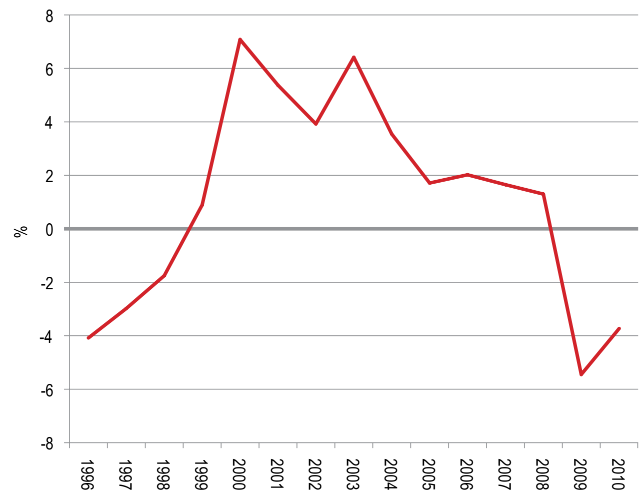

Figure 7.1: House price changes, 1996–2010

Real terms
** Forecast*
Source: Scenari Immobiliari

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The economy was weak prior to the financial crisis and this contributed to holding back the housing market. Poor growth constrained consumers' living standards and dampened buyer confidence. The economy was then one of the first to be badly hit by the world economic crisis but experienced a slight recovery in 2010. House sales plunged as the economy fell into recession in 2008. The decline continued into 2009 but turned up by around 10% in 2010. Yet, transactions are still a fifth less than before the downturn (Figure 7.2).

The conservative banking system was not badly affected by the financial crisis, particularly following ECB support. In any case, mortgages are far less important elements of the housing market than they are in many other countries, but they have generally remained available, if wanted, for those that can fulfil somewhat tightened lending criteria. Overall, household debt is 97% of disposable income, which is much less than the euro-area average, and it has not been growing in scale much.[1]

Rising interest rates prior to 2009 had, for some years, helped to suppress mortgage demand. However, rates dropped sharply in 2009 and stayed low in 2010. This has helped to encourage the signs of a modest recovery.

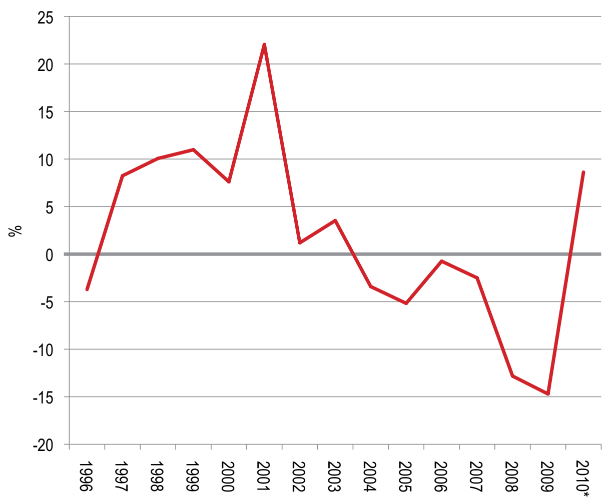

Figure 7.2: House sales, 1996–2010

Source: Ministry of Internal Affairs, Scenari Immobiliari

[1]*Central Bank.*

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The housing system

Homeownership is high, with almost three-quarters of residents owning their home.[2] Many own them outright – about 60%[3] - while the use of mortgages is one of the lowest in Europe. 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 little social housing; renting is highest amongst 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 home is decreasing, in parallel with the decline in the rental market.

Part of the housing stock is in quite poor condition, with many buildings in need of significant modernisation. Around 8% of the population live in conditions of severe housing deprivation – where the dwelling is overcrowded, lacks basic amenities or is in a poor state of repair – which is far higher than in countries such as the Netherlands and Spain where the housing deprivation rate is less than 1%.[4]

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.[5]

Family structures vary considerably between the north and south, with a large portion of 1 or 2 person households in the northern regions and major cities and a preponderance of larger families in the south. The difference is accounted for by variations in birth rates, incomes, employment and the continued existence of more traditional family structures in the south. An indicator of the potentially difficult housing circumstances for larger households is that almost a quarter of the population live in overcrowded conditions.[6]

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 zone 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 to work, so that two or more income households are now commonplace, making house 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 and repairs and renovations pay a higher, but still reduced 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 that extensive rent controls have made it unprofitable for landlords to repair.

5. Rent laws changed in the late 1970s and the policy inadvertently enabled landlords to sell out. The Fair Rent Act of 1978 established a common four-year lease and continued rent controls. This made the dwellings far more valuable in the owner occupied sector than those in the rental market and enabled landlords to sell out when leases came up for their four 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.

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 and unrecoverable cost increases over the course of contracts. This rental front-loading 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 and fixed by local social housing bodies. The incentives to landlords of such terms are associated with local property tax exemptions 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.

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[2] *Housing Statistics in the EU, 2005/6.*
[3] *Eurostat.*
[4] *Eurostat.*
[5] *Housing Statistics in the EU 2005/6.*
[6] *Eurostat.*

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Housing supply

Recorded housing investment – that is expenditure on new building and improvement - expanded steadily, but moderately, from the late 1990s through to 2006, but then began to slide as the economy slowed with a maximum decline of 9% in 2009. During 2010, new housing supply continued to fall, but at a more moderate rate (Figure 7.3). ISTAT data suggests a much greater decline in new building, with a 19% fall in 2009 followed by a 12% decline in 2010. The fall-off in building since 2007 corresponds to the general weakening of both the economy and housing market activity.

The data is unlikely to account fully for the large amount of ‘illegal’ building that takes place and that may have been particularly badly hit during the recession due to a substantial loss of self-employed and other under-recorded income. This makes it hard to assess the supply situation. Illegal building has been widespread for many years and there is no way of accurately measuring whether it is rising or falling in scale. Most of this unrecorded output is scattered development in the suburbs and urban peripheries.

Certainly, there is still a limited supply of housing available for sale on the market in places where demand is strongest. In particular, there remain shortages of high-quality, well-located accommodation. New housebuilding is estimated to represent around 15% of housing sales nationally, but only 5% in the major cities, where demand pressures are greatest; the difference will be even higher once informal building is taken into account.[7] Nonetheless, local planning constraints can be substantial when the rules are enforced.

New recorded building investment is falling relative to maintenance and renovation, and the latter has hardly been affected by the downturn. Given Italy’s availability of extensive, old and desirable stock, it is unsurprising that investment in residential renovation and improvement is one of the most important construction markets. Renovations showed strong growth prior to the downturn, helped by tax incentives. Renovation has also been encouraged by the trend amongst some affluent and younger households to live closer to city centres in attractive and historic neighbourhoods.

Limited long-term increases in house prices overall suggest that the supply situation is quite elastic over the long-run. The often informal nature of building means that much of the new housing and renovation fails to make it onto building permit, tax and data registers. Periodic amnesties eventually bring some of them into the fold.

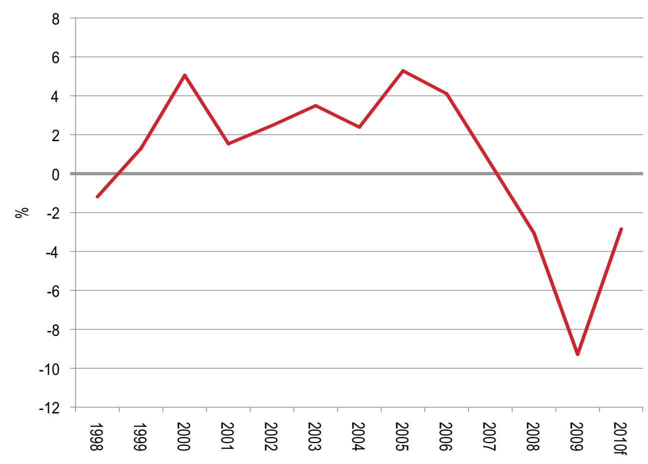

Figure 7.3: Annual % change in real residential investment, 1998–2010

Source: OECD

[7] *Scenari Immobiliari.*

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Macroeconomic influences

The Italian economy started to recover in 2010 after one of the worst downturns in the OECD area. 2008 saw the onset of recession, with output falling by 1%, driven by declines in domestic private sector activity and a sharp fall in exports. The recession intensified during 2009, with the economy falling by almost 5% according to Eurostat. Growth was modest in 2010, at a little over 1%, and the sluggishness of the economy is likely to remain over the next few years.

The country has some deep-seated economic problems. Competitiveness has been eroded by low productivity growth, high costs and an industrial structure vulnerable to competition from Asian economies. However, the export sector has been leading the economic revival, along with a pickup in investment in machinery and investment. Household consumption is stagnant and this state of affairs is likely to continue for some time. Unemployment will have to improve and the large recent losses of self-employed earnings overcome before aggregate consumption expands strongly again.

Such an economic backdrop remains an unattractive setting for the housing market. There can consequently be little expectation of major housing demand increases for some time. However, modest price growth may well be in prospect, as long as Euro debt market problems do not derail them.

Governments have not been able to introduce major economic reforms in recent years. This has limited economic recovery and policy leverage. The government deficit and national debt were seen as too high to introduce much of a stimulus package to offset the slide in the economy in 2008 and 2009. So, although the government deficit rose to 5% in 2009 and 2010, it did not reach levels seen in Spain, Ireland and Greece and is expected to fall gradually. But, as the scale of outstanding government debt is very large, the economy is vulnerable to financial market pressures. According to government estimates, the overall level of public debt should start to decline from 2012, particularly after cuts in public expenditure enacted in 2010. They were concentrated on capital spending, rather than on deeper but politically unpopular reform.

Consumer price inflation peaked at 3.5% in 2008. Falling commodity prices and the sharp recession then reduced it to below 1% in 2009. It rose again by half a percentage point in 2010 but it is unlikely to increase much above that over the next couple of years due to the extensive excess capacity in the economy.

Unemployment rose during the recession and approached 9% in 2010; it is likely to stay around 8% in the expected weak recovery. There are, however, wide regional variations, with the unemployment rate over 20% in the south. Overall involvement in the labour market remains relatively low – at only 63% of the working age population, it is one of the lowest in Europe. This represents both a loss of productive capacity and potential purchasing power in the housing market.

Mortgage market influences

A well-established mortgage market is fairly recent. Outstanding mortgages were only 20% of GDP in 2008, up from 6% in 1990.[8] Many dwelling purchasers still do not 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. Euro zone membership was a precursor of the expansion of the mortgage market. A tightening tax net has also helped.

Because of the level of mortgage debt, Italy has an exceptionally low rate of personal borrowing for an affluent society. The overall ratio of long-term household debt to household disposable income was only 48% in 2008. Nonetheless, recent growth in long-term borrowing has been notable, with the ratio nearly doubling in the decade after 1998.[9]

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. Spreads on mortgages are similar to elsewhere in the EU, so if there is a higher structural default risk, lending in Italy is going to be less profitable than elsewhere. It may also encourage lenders to impose tighter screening criteria on borrowers than exists in some other countries. Lenders certainly tightened loan criteria in the crisis; though central bank surveys did not suggest further tightening in 2010, but rather a slight easing.

New laws were introduced in 2006 and 2007 aimed at liberalising retail banking. The onset of the financial crisis has subsequently held back change but, 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 eventually have significant knock-on effects as it allows borrowers to remortgage more easily.

Mortgage advances were consistently expanding until 2008, but since then they have dipped and were even negative for a while. Then, more loans were being repaid than lent, because of the slowing housing market and the problems associated with the credit crunch. Mortgage demand expanded again in 2009 and was even higher in the first nine months of 2010 (Figure 7.4).

Interest rates rose from 2006, particularly for variable rate loans, and peaked at the end of 2008. Greater financial stability and Eurozone monetary policy then led to marked falls. Mortgage rates bottomed out at 2.2% in March, 2010. They stayed low through most of the rest of the year, rising by only 20 basis points over the next six months. One to five year fixed mortgage rates were also attractive up to September 2010 and were being offered at below 3% in summer 2010 (Figure 7.5).

Variations in interest rates between fixed and variable rate mortgages have led to considerable fluctuations over time in their market shares. In the first half of the 2000s, variable rate mortgages had a commanding share of around 90%, but this fell to only a third in 2008 as variable rates rose above fixed ones; only to rise again as short-term interest have subsequently moderated.

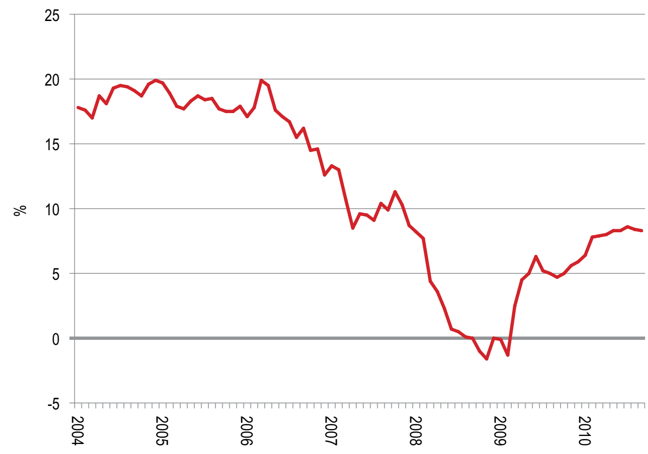

Figure 7.4: Housing loans Jan 2004–Sep 2010

Source: ECB

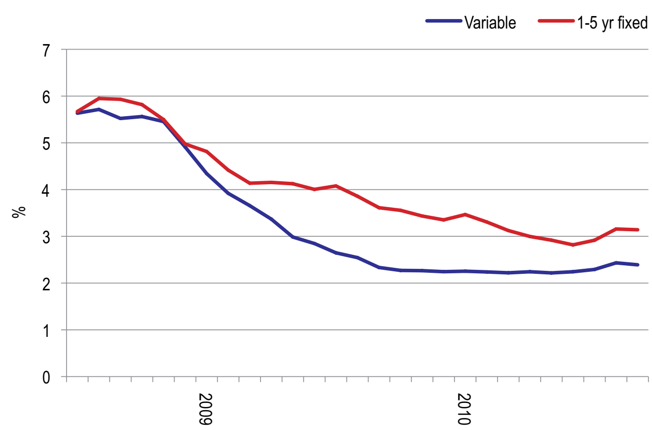

Figure 7.5: Housing loan interest rates, Jul 2008–Sep 2010

Source: Central Bank

[8]*European Mortgage Federation.*
[9]*OECD.*

CHAPTER 7: ITALY

Demographic influences

The total population rose by 5% between 2002 and 2010, and now stands at 60.3 million, with natural declines being offset by immigration. Current household numbers of 20.5 million are also rising moderately.

Population growth is expected to slow over the next 20 years. The overall increase is only forecast to be 3%.[10] At the same time, the population will be ageing and life expectancy high and rising. The result is that the country will experience one of the greatest demographic shocks of all advanced nations. The dependency ratio (share of those age 65 and over as a percentage of those of working age) is currently 31% but is expected to almost double over the next 40 years.[11] Such a transformation is likely to have profound effects on the housing market.

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. However, in reality, it is close to the European average in the north 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.

Net inward migration has been rising rapidly over the past decade and there are now 4.2 million foreign residents.[12] 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.

[10] *ISTAT.*
[11] *ISTAT.*
[12] *Eurostat.*

CHAPTER 8: NETHERLANDS

Overview

The housing market remains subdued. House prices are down, but the change is moderate. In October 2010 prices were down by 1.1% on the previous year. However, rather than highlighting a price decline, it may be more reasonable to say that the market was flat in price terms for most of the past year. There was some weakening in the final months of the year, which may be due to seasonal factors (Figure 8.1). Overall, prices have not fallen by much since their peak in 2008: down by 7%, with most of the fall occurring between autumn 2008 and autumn 2009.

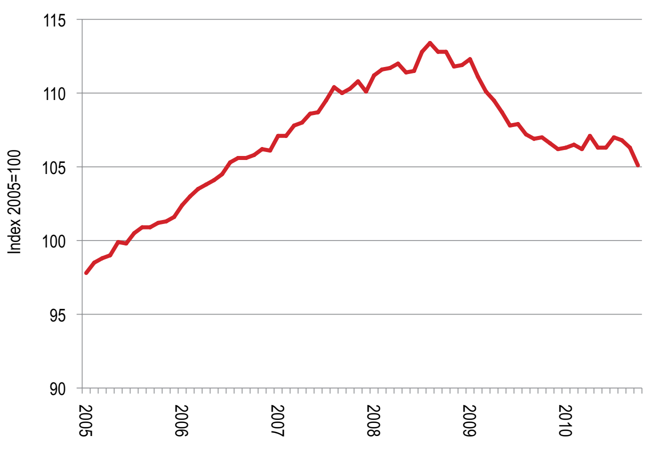

Figure 8.1: Monthly house index, Jan 2005–Oct 2010

Source: Netherlands Statistics

In contrast to relatively stable prices, transactions have dropped quite sharply. They were 10% down in the third quarter of 2010, compared to the previous year, and by then had fallen by around 40% from their 2006 peak. The principal cause of the reduction in transactions remains subdued consumer confidence and weak demand. Mortgage lenders also remain cautious about market prospects and have continued to tighten lending criteria.

Housebuilding continues to be affected by the slowdown. Completions fell by around a fifth compared to the previous year in the first half of 2010. Much of that fall was concentrated in the owner occupied sector, but building permits information suggests that the sustained amounts of social building by housing corporations in recent years is likely to tail off markedly in the near future. So, with temporary housebuilding subsidies being withdrawn, the housebuilding decline has probably yet to bottom out.

The Netherlands' financial system was badly affected by world financial turmoil. ABN Amro and Fortis Bank Nederland were taken over by the state in the aftermath of the collapse late in 2008 of Fortis, their parent company, with a €25 billion bail-out by the end of 2009, and the state also injected funds into other banks. The aftermath of these events still affects national mortgage markets.

The country experienced a sharp economic downturn in 2009 but saw marked growth from the second quarter of 2010, and there are prospects of further growth into 2011. However, housing market demand is being dampened by declining labour incomes and by the withdrawal of temporary stimulus measures. So, the overall state of housing demand remains weak and is likely to be like that for some time to come.

During the last boom, the time of the most rapid house price increases was far earlier in the Netherlands than in much of the rest of Europe, as it occurred during the years around the turn of the century. From 2003 onwards, nominal price growth moderated to around 4% a year. So, from then on they were virtually stable in real terms, meaning that the country's sharp house price surge moderated a long time before the financial crisis began. Even so, prices remain high; being roughly double now in real terms what they were in the mid-1990s.

The housing market was sustained by record levels of borrowing throughout the 2000s, at high average loan to value ratios, and mortgage borrowing continues to be high. As a result, the level of mortgage indebtedness of many owner occupiers is exceptional by international standards. An inducement to high levels of borrowing is mortgage interest tax relief (MITR) in a country with high marginal rates of taxation, so that consumers have a strong incentive to load personal debt onto housing.

Prices in Amsterdam rose faster than national ones for most of the years of rapid increases, but prices there have also been more volatile; over the past year they have risen by around 5% according to NVM data. This higher than average performance, to an extent, reflects a bounce back from sharper price falls in Amsterdam during the previous year, although transactions in the capital actually fell faster than the national average. Other major cities have experienced somewhat slower than average price rises and falls, partly because much of the demand for owner occupied housing has mainly been associated with household moves to more suburban areas and to medium and small towns.

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The onset of the economic crisis led to a package of economic stimulus measures being introduced in March 2009, which included a €395 million inner city housebuilding and urban improvement package. The construction subsidy was set at up to €10,000 per home built for either renting or ownership and meant that a large proportion of dwellings built throughout 2009 and 2010 received subsidy. The National Mortgage Guarantee Scheme (NHG) was also temporarily increased to a maximum level of €350,000 so that more people became eligible for an NHG-guaranteed mortgage. The increase was both aimed at encouraging more purchasers and inducing lenders to offer more loans. In consequence, it was expected that a further 15,000 purchasers would use the scheme in 2010. Around 80,000 households utilised mortgage guarantees for house purchase in 2009 and defaults were very low.[1] Whether the market will have recovered sufficiently in 2011 to withstand this loss of support from this source remains uncertain.

Housing policy has been high on the political agenda for a long time in contrast to the experience in most other European countries. The general election in summer 2010 produced an inconclusive result, with the new government only sworn-in in October, 2010. But, as with past governments, the new coalition agenda includes policy changes towards housing. At the time of writing details were fairly limited, especially given a recent merging of the housing ministry with other functions, as part of the new government's policy of cutting back on the number of separate ministries. However, the published coalition agreement indicates that policy emphasis will move away from central government direction of housing outcomes towards greater regional and local responsibility. More emphasis will also be placed on market mechanisms in accord with a desire to reduce public expenditure and to lower state control over private actions.

Over a third of households live in social housing but a recent ruling by the European Union has forced the social housing institutions to adopt a more focused remit on lower income groups. As a result; rents for many will rise, a sales programme has been sped up and many who might have expected to be housed in the sector will no longer be able to do so. All this represents a sea of change in the housing scene and the full consequences are unlikely to be seen for some time. But a stimulus to the private sector is underway, particularly with regard to owner occupation.

The housing system

A quarter of the Netherlands housing stock is in the form of apartments and the rest is single family dwellings. Of those single family dwellings, two-thirds are terraced houses and there are relatively few detached dwellings.[2] Although the housing stock is ageing, it remains relatively young by European standards; only 20% date back to before 1945.[3]

In view of the country's apparent land constraint, it is perhaps surprising to realise that the average Dutch dwelling is one of the more 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. Newly built homes also tend to be more spacious than existing ones.

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 living 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 and 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, partly because of the high cost of doing so in a country at threat from water inundation. Such a scale of public sector initiation of land development is unique in Europe and, historically, it has conferred considerable power over housebuilding on highly interventionist public land-use planning. Of course, there is no physical necessity for such a degree of public agency intervention but, rather, it has reflected past political choices and social models. However, once such institutional frameworks are in place they are difficult to change.

[1] *NHG Annual Report 2009.*
[2] *The Netherlands on the European scale, Netherlands Statistics.*
[3] *Ministry of Housing, Spatial Planning and Environment.*

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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, at around 53% of the occupied stock in 2007 - up from 42% in 1980.[4] This homeownership share is still low by international standards but, even so, growth in owner occupation has helped to stimulate the upward shift in house prices because supply has not adjusted sufficiently in either composition or scale to accommodate it. How the share will increase further strongly depends on public policy, because three-quarters of rental housing is in the social sector. For almost a decade until 2010 it proved politically expedient to expand social housebuilding and hold down rents but this era is now coming to an end. The consequence may be a significant switch from social renting to owner occupation over the next few years.

Owner occupation rates are far lower than the national average in some cities and some of the lowest in the world. Amsterdam had only 30% homeownership and Rotterdam 59% in 2007. This may help to explain the exceptionally high prices of houses in some cities and has encouraged trends towards suburbanisation.

Transaction costs are relatively high. Tax-wise, 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.

Tax breaks are also substantial in a country with high marginal tax rates. In 2008, 3.5 million households had a mortgage - roughly half the total number of households. They paid €28bn in mortgage costs, over €10bn of which was then refunded in tax deductions. Nearly half this relief was paid to those in the top fifth of the income distribution. The incentive for better-off households to take out large mortgages can be seen by the fact that the 1% of households with mortgage costs of more than €2,700 a month received 44% of those costs back in tax relief.[5] The OECD, amongst others, has been vocal in arguing that this distortionary subsidy should be withdrawn, although there seems little likelihood in a country where elections are closely fought and political parties pledge to keep it. In addition, the capital gains from rising house prices are not taxed. With the prospect of upward pressures on rents, such fiscal benefits will continue to stimulate the demand for homeownership.

Property taxes were traditionally levied by municipalities separately on property ‘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 and boost to house prices. 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). Assessed values 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.[6] Each year a cap is put on the budget for this programme. A 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.

Shifting housing policy

The state has long had a highly interventionist role in housing and housing remains high on the political agenda. For many years it has been a politically controversial issue for a large number of reasons, including acute housing shortages for movers and new households, social tensions (particularly in relation to ethnic minority communities), growing problems of affordability (especially entry barriers to owner occupation), tax breaks and fiscal constraints, planning policy, the role of housing institutions (such as the countries’ social housing corporations) which own over a third of the total housing stock.

Housing policy has been subject to much inter-party negotiation during the formation of the various coalition governments of the past decade and, as a result, policy emphasis has fluctuated quite considerably over time. However, as successive governments have been in power for relatively short periods of time, the traditional underlying characteristics of the housing system have not been altered that much. However, major changes are likely to take place over the next few years, because of the knock-on implications of the new rules for the county’s housing corporations required by the EU. A wide range of the population has traditionally had access to social housing. However, the new government proposes that the system will gradually move towards having a greater welfare role, with new allocations limited to those on low incomes only, in line with EU directives.

The principal areas of political difference have related to support for market processes, planning policy and rent control. The previous government’s stance had marked a significant move away from earlier attempts at a more market-oriented policy. It had downplayed an earlier commitment to increase owner occupation; tightened up on planning constraints; and abandoned proposed long-term real increases in social housing rents. The new 2010 government’s policies seem to lie between these two stances, with an overlying emphasis on extra local control and less public expenditure.

[4]Netherlands Statistics.
[5]Netherlands Statistics.
[6]Previous Ministry of Housing, Spatial Planning and Environment.

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Social housing

Social housing as a share of all dwellings reached a substantial peak of 38% in 1998. 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 with 24% in 1980.[7] Most new rental properties are now built in the social sector. However, recent developments in government and EU policy may see significant reduction in the size of the social renting sector and could lead to a concomitant expansion of owner occupation.

Social housing providers are called "woningscorporatie", housing corporations in English (equivalent to British housing associations). They are independent, private, non-profit institutions. Many are large entities, particularly after recent mergers, and they form a key pillar of the Dutch 'Polder model', based on co-operation and negotiation between state and non-state entities. There are 455 of them owning 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.[8] So, they currently provide homes for a wide range of households, many of whom could afford to live in private housing as owners or tenants. Given the implicit and explicit subsidies, rent levels are low, so that many residents have little incentive to move.

The characteristics of the stock encourage tenants to stay put as well. Most dwellings are comparatively well-designed in attractive, accessible locations. However, there are problem estates on the urban fringes or in less desirable, more central neighbourhoods.

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. They receive grants and loan guarantees from government, which have grown again in recent years after an earlier 'final' financial disengagement by government in the mid-1990s.The returns on their capital are relatively low, which is perhaps unsurprising given their non-profit nature. The Aedex/IPD Dutch social housing index showed gross returns (i.e. net of property management costs but before overheads and other organisational expenses) averaging -1.0% in 2009. The income return was positive at 2.6% and has been stable over time, but the total return was depressed by falling capital valuations of -3.5%, reflecting the performance of the wider housing market.

Housing corporations have been 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 and that they are able to allocate households to tenancies. Recent governments relied on housing corporations to build homes to overcome shortages and to sustain housebuilding during the recession, thereby lowering the need for direct government funding of building programmes. For example, the corporations built 25,000 new dwellings in 2007 (and demolished 16,000). This construction effort was further leveraged by the temporary housebuilding subsidies announced for 2009 and 2010, as noted earlier. However, recent building permits data suggest that this era is now coming to an end with a fall of one third in the number issued to housing corporations in the first half of 2010, which will lead to much lower building rates over the next few years.[9]

Housing corporations have not solely built rental properties, but also ones for sale. The housing corporations have become significant providers of new owner occupied housing and until recently almost 60% of their construction was outside of the affordable sector. New building for the market is going to experience the greatest decline in housing corporation activity in 2011, because of a change in their rules of operation.

Their role is being gradually redrawn to that of being a provider of accommodation for lower income groups, under legislation that came into force at the beginning of 2011. So, over the next few years substantial changes may be in prospect for the Netherlands' unique housing system. The reasons for this primarily relate to EU state aid rulings. The Association of Institutional Property Investors (IVBN) had submitted a complaint to the EU Competition Commissioner some years ago about the increasing role of state-aided social housing institutions in their markets and the unfair competition it represented. IVBN members own 130,000 homes in the Netherlands and form a major part of the private rented sector.

After a protracted process, the then government finally came to an agreement with the European Commission on the issue at the end of 2009, following on from which limits are now being placed on what the housing corporations can do.[10] The reformulation of their roles requires them to become more directly and transparently social housing providers for those unable to operate in the private housing market. This does not mean wholesale evictions of the better-off but rather that new tenancies are going to have to be 90% rented to a pre-defined target group of socially less advantaged persons with the other 10% linked to some form of social prioritisation, such as local social mix.

[7]Previous Ministry of Housing, Spatial Planning and Environment.
[8]Previous Ministry of Housing, Spatial Planning and Environment.

[9]Netherlands Statistics.
[10]European Commission IP/09/1928.

Nonetheless, other actions are likely to lead to an exodus of many of the better-off from social housing over time because their rents are going to rise and the inducements of a right-to-buy may well encourage them to purchase their current dwelling or move into owner occupation elsewhere. The chance of them moving into the private rented sector is less because of the tax benefits of ownership and the limited supply options currently available. However, housing corporations may decide to spin off estates in new private rental companies or sell them onto investors, as has occurred in Germany. However, the mix of income categories that currently exists in any locality may make such exercises problematic.

In recent years, urban regeneration moved up the political agenda because of housing shortages and reluctance to build extensively in the urban fringes. But its expansion has also been stimulated by social tensions, rundown social housing neighbourhoods and increasing spatial segregation of ethnic minority groups. The EU directive on housing corporations reaffirmed its acceptance of this programme under state-aid rules. So, a programme will still go ahead of targeted public investments and subsidies in deprived communities, with a budget of €750 million in the course of next 10 years. However, current public expenditure constraints may curtail this activity in 2011 and beyond, unless local government picks up the financial burden. The new government aims to focus spatial planning policy more towards those regions that are losing population, leaving regeneration in the major cities more in the hands of cash-strapped local government.

Housing allocation policies, renovation and building programmes and the gradual long-run movement of middle-income groups out of social housing into owner occupation have all led to high levels of spatial segregation of ethnic minority groups. Parts of the social stock are also now ageing badly, with a significant proportion 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 social polarisation are substantial problems.

Annual sales from the existing social housing stock have been running at around 15,000 properties a year, according to VROM data. Though significant, this was being counterbalanced by new rental building. So, it has not led to much alteration in the scale of the social sector in overall housing provision. However, the new coalition agreement states that social housing tenants will be given a right-to-buy their homes at reasonable prices. Such a programme, if it takes off, may lead to a much greater shift towards homeownership in a way that occurred in the UK in the 1980s.

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 were also able to request ‘reasonable’ improvements to their dwellings which landlords are obliged to carry out. Despite the long boom in house prices, real rent increases have been limited and over the past decade have actually fallen somewhat in real terms (Figure 8.3).

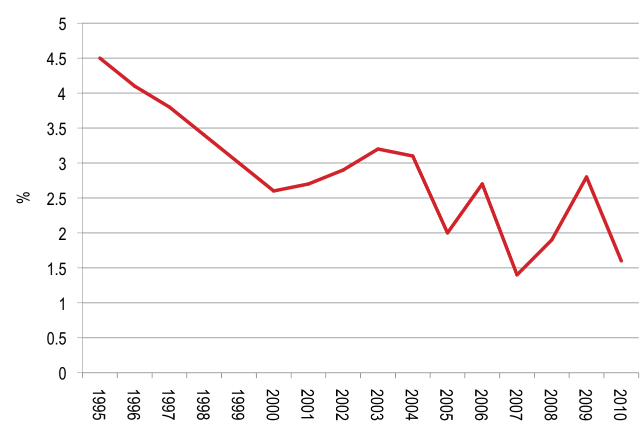

Figure 8.2: Nominal average rent increases

Source: Netherlands Statistics

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While the freezing of real rent levels over the past decade has undoubtedly been 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. Those that can afford to become home owners are discouraged from purchasing. Housing providers have less income for investment and less free stock to allocate to younger households and those in greatest need. 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 lead to general welfare losses rather than gains.

In partial recognition of some of the distortions created by rent controls, the new government is relaxing controls for those tenants with annual household incomes in excess of €43,000. Landlords will be able to raise rents by up to 5% above the annual rate of inflation; whereas for those on incomes below the threshold rents will remain fixed in real terms. This measure hardly heralds the introduction of a free market, but it may encourage some of the better-off to think about purchase, especially in light of the new right-to-buy proposals, mentioned earlier. How well the system will work in practice remains to be seen, especially as households may be reluctant to reveal incomes to landlords and will have clear incentives to under-declare incomes. Landlords will also have an incentive to discriminate against lower income groups under the new rent rules.

Around €1.5bn 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.[11] As an economy measure, the level of subsidy has been reduced somewhat on a stepped basis.[12]

Privately rented housing

Around 10% of the stock is rented privately, amounting to 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 the same rent controls as the social sector.

There are two types of institutional 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, holding portfolios collectively amounting to 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. Much institutionally-owned rental housing has been built over the past thirty years, predominantly in good city locations. The units are generally spacious, well-equipped and maintained to a high 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 total return of -2.2% for 2009, of which 3.7% was income return countered by -5.8% 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.

[11] *VROM.*
[12] *VROM.*

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Housebuilding

The decline in housebuilding has continued to accelerate over the past year. The building rate peaked prior to the financial crisis in 2006, when measured in terms of starts. From then on, private starts have dropped but starts remained above 2005 levels overall until 2010, due to continued high levels of social housebuilding (Figure 8.2). Overall, the Netherlands did not experience the sharp fall in housebuilding that occurred in many other European countries in the years of recession; an outcome influenced by the extra building subsidies on offer and the response of the social housing institutions.

However, with subsidies and housing corporations now reigned back, revived economic growth was insufficient to offset further housebuilding declines during 2010, particularly as mortgage funding remained tight. Starts were also depressed by the large number of homes begun but still remaining unfinished, which stood at 178,000 in July, 2010; around two years of the average pre-crisis output. This highlights that sales in the new build market remain weak across all sectors.

40% less homes were completed for buyers in the first half of 2010 compared to the same period a year earlier; although the decline in rental properties was, somewhat less, so that total completions fell by a third. Permits, a leading indicator of further housebuilding, were also sharply down in the same period, falling by a fifth overall and indicating that housebuilding was set to decline throughout the rest of 2010 and into 2011. Housing Corporations had 34% less permits issued, highlighting the short-run impact on housebuilding of their changed role.[13]

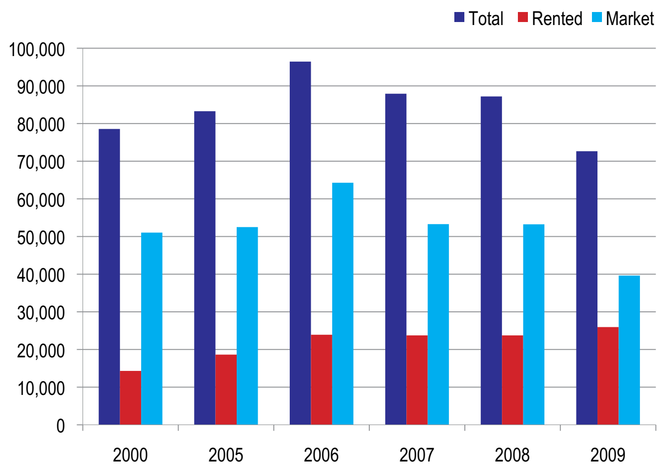

Figure 8.3: Housing starts by tenure, 2000, 2005–09

Source: Netherlands Statistics

The long run decline in housebuilding has been substantial. The annual level of private housebuilding fell by 25% between 1998 and 2004, even though house prices were much higher at the end of that period. Total output had declined steadily from the late 1980s, when around 110,000 dwellings were built annually, to a low of less than 60,000 in 2003. Building then grew again to 2006, as noted above, but with the recession was down again.

The paradox of declining housebuilding in the face of marked shortages and rising prices provoked considerable debate and continues to do so. The planning system and associated local authority provision of development land has been blamed for many of the problems but, given the tightness of election outcomes, voter resistance to extra building has influenced the response of successive governments.

Land release in the Netherlands is influenced by a rigorous planning regime and by costly site infrastructure provision in a country where much of the land is below sea level or otherwise expensive to convert. Institutional practices are such that the land development process is principally organised by local authorities. What is more, most housing is required in the Randstad core of the country but there is a long tradition of protecting its 'Green Heart' from building. Added to this, general concerns about the environment have been increasingly interpreted in the anti-development way familiar in other countries.

Planning strategies, such as 'VINEX' initiated in the 1990s, have tried to direct most new 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 restricted 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.

[13] *All housebuilding data are from Netherlands Statistics.*

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Over the past decade, governments have tried to solve the problem of getting more new housing without taking up politically sensitive land. The previous-to-last government began 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 last government, this relaxation of planning controls was reversed. Instead, central government entered into agreements with local authorities in areas where development was less controversial, especially on brownfield schemes, and public-private partnerships were encouraged. For example, it was announced in November 2009 that the 'new town' of Almere was to expand by 60,000 dwellings up to 2030 and gradually be linked into the Amsterdam conurbation. Countrywide, 40% of new building was expected to be on brownfield land but sites are relatively limited in supply.

The current government in its initial statements has said it will leave more spatial planning and the supervision of housing issues to the provinces and municipalities, while symbolically indicating the lowering of central intervention by merging the previously powerful VROM planning and housing ministry into one with a much larger remit. At the same time, it has said it expects to see reform in the building industry, more individual building initiatives, and more building in the 'Green Heart', though how it will pursue these aims remains to be seen.

The localism agenda is unlikely to lead to an upward shift in housing land supply. No additional incentives to build are being offered to the provinces and municipalities, which will also find it harder to fund land development and regeneration. As a result, restrictions on housebuilding may easily grow. Planning dilemmas are going to remain high on the political agenda, because as many as 440,000 extra homes are forecast to be needed in the Randstad area by 2030. The country's long-term housing supply problem does not look as if it is going to improve at any time in the near future.

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.[14] However, the general world economic slowdown in 2008 brought expansion to a halt, especially as the Netherlands has such an open economy, and the economy contracted by 4% in 2009. Exports and investment were particularly badly hit and competiveness was lowered by the increase in the value of the euro. Financial services in particular are in retrenchment, as the financial crisis badly hit the country's leading banks and marked deleveraging is taking place.

A moderate recovery is underway in line with developments elsewhere in the euro zone. Growth was expected to be 1.75% in 2010 and forecast to be 1.5% in 2011, according to the Central Planning Bureau. Consumption is subdued as households have increased their savings rates and real labour incomes were expected to decline through 2011. So, a situation of overall weak consumer demand is likely to be reflected in a frail housing market for some time yet.

Inflation is now moderate and expected to remain at around 1.5%. Continued excess capacity in the economy means that price rises will remain contained. Unemployment has risen somewhat to around 5.5% but this remains less than in past major recessions.

Emergency measures to bail out banks and stimulate the economy plus the normal fiscal dynamics of recession all plunged the government fiscal balance into deficit, which is expected to be 5.8% of GDP in 2010. To shrink the deficit, spending cuts have already taken place and more are expected in 2011. The cuts will inevitably put pressure on public expenditure as the recovery continues.

[14]OECD and CPB, Netherlands Bureau of Economic Policy Analysis.

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Mortgage market influences

Dutch households are encouraged by mortgage interest tax reliefs, mortgage guarantees, and high house prices to borrow heavily. Average household mortgage indebtedness is approximately 250% of average annual disposable incomes, which is two-and-a-half times the euro-zone average.[15] Loans grew substantially up to the financial crisis and are greatest amongst higher income groups because they gain the most out of current tax reliefs. This degree of indebtedness makes mortgage borrowers highly vulnerable to housing downswings and financial shocks. However, prolonged low interest rates, limited falls in house prices and the relatively short-duration of the recession have meant that to date negative equity and default remain rare.

There are a variety of mortgage lenders. The most important ones are general banks. Two of the largest are now merged and nationalised, ABN Amro and Fortis. Another, ING (including Postbank), has received significant injections of state capital. So, the mortgage market is now effectively state-run. There are some specialist mortgage banks and building funds ('bouwfondsen'), and insurance companies and pension funds also directly provide mortgage finance. But all of them amount to only 5% of the mortgage market compared to the overwhelming role of the banks. In the past, competition between the leading bank lenders was intense but the impact of recent mergers, bailouts and the credit crunch has lowered competitive pressures significantly, enabling lenders to increase spreads. Prior to the credit crunch, almost a fifth of mortgage lending was actually outside of the country but the crisis has led to a 're-domestication' of Dutch financial institutions.

A large part of the financial system is now state owned, heavily subsidised, able to issue state-guaranteed paper, and raises much of its liquidity needs from the ECB, posting securities as collateral. This ECB facility has become an important route through which mortgage finance has been sustained since the advent of the financial crisis.

Securitisation has been an important feature of the mortgage market in recent years. Under this arrangement, banks sell their mortgages onto special purpose vehicles (SPVs), which then issue new residential mortgage backed securities (RMBS). By 2007, the Netherlands had become the third largest European issuer of securitised mortgage debt after the UK and Spain, in spite of its much smaller size. Securitisation accounted for 31% of all outstanding mortgage debt in 2010 Q1, whereas it was only 5% in 2003 and 26% in 2008 Q3 (Figure 8.4). As private capital markets remain virtually closed to RMBS, the role of the ECB has been central to the sustenance and continued expansion of this market. However, expansion in it has ceased since the early part of 2009 and banks are now resorting to alternative sources to fund mortgage growth.

Overall mortgage lending had been growing strongly for over a decade, with lending rising over threefold between 1998 and 2009 in nominal terms.[16] Annual growth rates in outstanding mortgage debt remained strong, up to 2010 Q1 (Figure 8.5), though lending slowed over the next two quarters due to subdued demand and continued tightening in loan criteria. Even so, the Netherlands housing market has not had the sharp reduction in mortgage availability experienced in countries like Ireland and the UK, despite the generally very high levels of indebtedness.

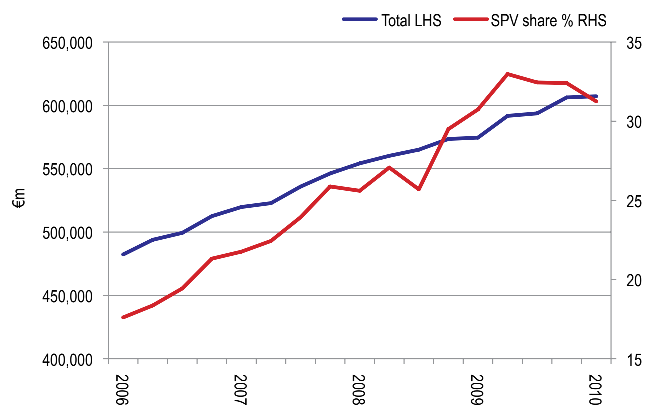

Figure 8.4: Outstanding mortgages 2006Q1–2010Q1

Source: Central Bank

Consumers may 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. Most mortgage lending is now on terms fixed for five years or more on which interest rates have been steady for some time at around 4.75% (to September, 2010). Reasonable mortgage availability and relatively low nominal interest rates together help to explain why the housing market has weathered the crisis relatively unscathed to date, despite the sharp general economic contraction.

A National Mortgage Guarantee ('Nationale Hypotheek Garantie', NHG) was set up by the government in 1993 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). A one-off tax deductible fee equal to 0.45% is paid at commencement but borrowers can attract marginally lower interest rates from lenders which more than offset these costs. 100,000 loans were financed in this way in 2009, 78% for purchase and the rest for loans raised for home improvements. In the same year, the fund had to pay out on only 753 foreclosures that incurred a loss out of an outstanding inventory of over 800,000 guarantees on mortgage loans thereby highlighting the current low levels of mortgage default nationally.[17]

[15] OECD and CPB, Netherlands Bureau of Economic Policy Analysis.
[16] Netherlands Central Bank.
[17] NHG annual report.

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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. The most recent overall population forecasts give widely ranging outcomes for population size by 2050, ranging from a slight fall to 15 million or a 25% rise to over 20 million.[18]

Over the same time period, the number of one-person households rose by 380,000 to 2.5 million and this trend towards higher numbers of singles is expected to continue and be the main source of rising household numbers in the future, with an additional 1 million by 2050. 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 are 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. It then fell sharply as entry criteria were tightened but has been rising again in recent years.

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.

[18] *Netherlands Statistics.*

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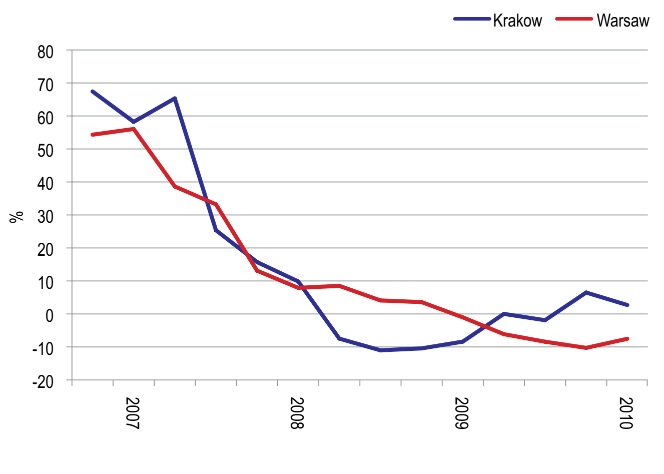

Figure 9.1: House prices, 2006 q4–2010 q1

Asking prices new dwellings
Source: Central Bank

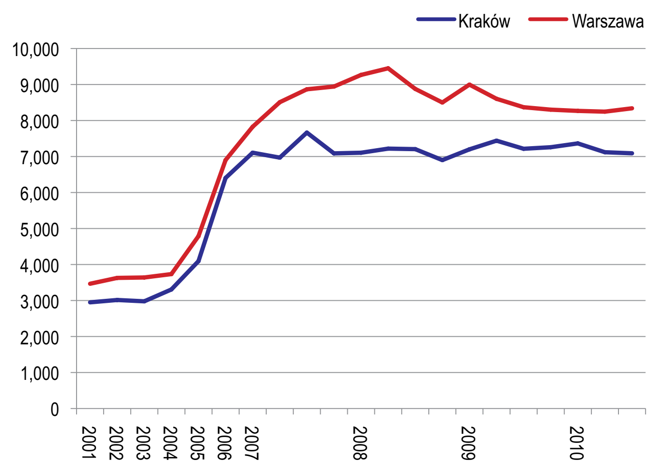

Figure 9.2: New dwelling prices, 2001–2010 q3

Source: Central Bank

Overview

The decline in the new housing market abated in 2010, after prices had fallen by 8% in 2009. There was a slight price decline by around 3% according to REAS, but sales and housebuilding were both up on the previous year. In fact, developer starts were 50% higher. A stronger economy underpinned this, though much uncertainty remains.

There is neither an official house price index nor a quality-adjusted one, so reliance has to be made on non-quality adjusted asking price measures for new housing in the country's major cities. Both sources suggest that new housing prices were down by around 3%, with most of the decline concentrated in the first half of the year (Figures 9.1 and 9.2).

The scale of the earlier price boom was dramatic. Prices doubled in the short period from 2004 to 2007 and foreign investors and speculators crowded in but are nowhere to be seen now. So, the decline from the peak so far is only a small one in comparison to the early upsurge. Whether the pre- or the post-boom prices are a better indicator of consumers' long-term willingness-to-pay remains to be seen.

A complication needs to be added to the question of measuring house prices and interpreting indices of them. In the new market, the development model has primarily been one of purchasers buying properties off plan or from semi-completed developments. Moreover, once developers have introduced their schemes to the market they are very reluctant to lower prices, because those that have already ordered will have paid more. This means that the prices of products on offer from existing developments are often higher than those on more recently introduced for sale in a declining market. The developer of apartments being sold in already started schemes may offer sweeteners to new buyers to account for at least some of the difference but those do not appear in headline price data.

So, neither sale completion nor offer price data necessarily give a clear picture of current market prices but, rather, a mix influenced by transactions that have been taking place over time; some of which may have actually been fixed some time before. Existing house prices are likely to be more volatile than new house prices because sellers there have to respond more directly to changing demand and do not have the same drivers or pricing strategies as developers.

Turnover in new residential markets across the six largest cities in 2010 was still lower than two years before but had recovered by around a fifth from the worst period in early 2009, according to REAS. However, extensive stocks of unsold dwellings continue to exist, which puts a dampener on any potential price increases in 2011. Credit restrictions continue to constrain the luxury flat market. In existing homes markets, the greatest falls after the boom occurred amongst flats in poor locations and those built during the era of concrete panel technologies. Though even here, there are signs that prices are flattening out.

Mortgage markets continued to expand in 2010 though at a reduced rate. The move away from foreign currency borrowing that started in 2009 continued in 2010, due to demand, regulatory and subsidy factors. PLN denominated loans now account for 80% of new loans, with euro denominated ones accounting for most of the rest.

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The move away from foreign currency loans followed currency devaluation that raised their cost and regulatory constraints on new issuance. However, mortgage interest rates in the domestic currency are much higher so the switch from lower interest foreign loans has had a negative effect on housing demand, because many purchasers seem to look only at current monthly outgoings when buying.

One of the government supports for housing demand is a "family in its own home" programme, which provides significant mortgage interest subsidies for first time buyers. Amendments introduced during the crisis now make it much more attractive and feasible as a borrowing option for many more purchasers and it covers a large share of their mortgage interest costs. The scheme is only available for domestic currency loans and, so, has encouraged the move away from the use of foreign currency ones. The central bank reckoned that almost a fifth of all mortgages were issued under its framework in the first half of 2010. However, this subsidy is costly and unlikely to last for that much longer, especially as there are considerable pressures to reduce the fiscal deficit.

The housing system

The vast majority of Poles cannot afford new housing. Surveys indicate that incomes of mortgage borrowers are twice as high as those without them. There is consequently a sharp divide between those active in the modern market-oriented housing system and others. The most active purchasers are the more economically successful groups aged between 25 and 40. The relatively small private rental market is costly relative to average incomes.

The housing stock is much larger than those of the other Central and Eastern European (CEE) countries in the EU but most of it lies outside the scope of market processes. Altogether private housebuilding has added about 1.2 million dwellings since the mid-1990s, which represents about 9% of the current stock.

Despite recent expansion, the country still has one of the lowest shares of GDP devoted to housebuilding in Europe. There is a shortage of building land for which poor infrastructure and a lackadaisical land-use planning framework must bear much blame. This constrains building and helps to keep up house prices. Construction costs have risen sharply over the past decade and developer margins are also high.

As national income per head is only 61% of the EU average, it is to be expected that housing conditions are significantly lower than in Western Europe. Even so, housing shortages are particularly acute. Over half the population lives in overcrowded accommodation and almost a fifth suffer from severe housing deprivation, according to Eurostat. So, there is high pent up demand for improved accommodation.

The housing stock relative to population is one of the smallest in Europe and there are correspondingly high numbers of people per dwelling, averaging 2.9 in 2008.[1] Poland also has the highest share of apartment blocks in its housing stock in the EU, comprising almost two-thirds of the dwelling stock and many of them are high-rise structures, which account for almost 40% of the overall dwelling stock.

Shortages are concentrated in the major cities. In addition, the population has a relatively young age profile and household numbers are going to continue to rise over the next few years, adding further to demand pressures in those cities. Counteracting this situation since Poland joined the EU has been out-migration and temporary working abroad, which has greatly reduced pressure on scarce housing resources. Despite national housing shortages, some regions have an excess of low quality dwellings and high vacancy rates.

The housing stock is relatively young, with over half of it erected since 1970. Despite this, much of it has repair and quality problems. Quality was sacrificed for quantity during the housing output drives of the 1970s and 1980s. This has had knock-on effects in terms of current high maintenance costs and renovation needs. Basic repairs are often neglected, making conditions worse. Furthermore, many buildings lack adequate insulation, with resultant high heating costs and energy wastage. Infrastructure facilities and local amenities are also sparse in many neighbourhoods. While basic dwelling amenity standards are generally good in urban areas, in rural localities the situation is different. Around a quarter of rural homes lack a bathroom and/or inside toilet and 10% have no running water.

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. By 2008, 62% of dwellings were fully-owned by private individuals as outright owner occupiers with no mortgage and a further 4% were owners with mortgages; 2% were private renters and 32% tenants in low or no rent properties.[2]

This tenure breakdown seems to suggest that a fairly limited change has occurred since the early 1990s, especially when it is realised that 48% of homes were already owner occupied in 1988. However, this to an extent is an artefact of the nature of the privatisation process, because there have been sales of individual apartments in building structures still owned by municipalities, employers and co-operatives. Most sales to tenants in co-operatives have been of tradable rights-of-occupancy, similar to those in Scandinavia, as well as 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 over 75%. This is not dissimilar to the experience in the other Central and Eastern European countries.

[1]Data on housing conditions from Central Statistical Office.
[2]Eurostat.

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Recently, the law has 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 values as assets 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. Political pressures have generally meant that co-operative and municipal rents remain low. Attempts to move towards more realistic rent levels have generally not had much impact.

Overall, there is a huge backlog of work required on existing dwellings and amenity improvements in local neighbourhoods. Over 60% of the stock was in need of significant repair and over 10% required major renovation, according to the most recent 2002 census. Though the repairs situation has improved in recent years, there is still an expensive backlog of work which will take many years to overcome and as soon as housing shortages moderate wide scale demolitions may be the most feasible option, as in East Germany.

Private renting is probably higher than the official statistics suggest. There is a small amount amongst the new flats built in recent years but a much greater quantity in the existing stock of which little is known. A 2002 survey by a World Bank research team, relying on household interview information, suggests that over a fifth of all households in the larger cities live in private rental accommodation and that around a quarter of younger households are private tenants.

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 urban rental market. With the slowdown in housing markets over the past couple of years, some of those who could not sell have rented out their properties instead. This has expanded rental supply and lowered rents in most of the major cities, though only by relatively modest amounts.

The situation of rental investors has been improved since the January 2010 introduction of the "Law on Occasional Rental". Under its stipulations, occasional rental contracts can be issued and registered. For them, income taxes on rents will be lowered to a flat rated 8.5% and the position of landlords in relation to tenants will be strengthened, particularly in respect of eviction for non-payment of rent. This reverses some of the effects of the earlier Tenant Protection Act but by no means creates a free rental market, especially as it applies only to private homeowners not to corporates or developers.

Large-scale central government subsidies still exist for the relatively small-proportion of the population able to afford purchase. They include guarantees on housing savings schemes, payments of interest costs (as in the First Family Home scheme) and interest cost tax reliefs on a limited and capped basis. There is some support for social housing and municipalities determine their own levels of housing allowance support for low income households, funded from local taxpayers. This framework leads to considerable cross-local authority variation in them.

However, the relevance of tax reliefs is currently less than in many other European countries because of relatively low income tax rates. Most people now pay 18% of their gross incomes in tax. The income tax system was reformed in 2009, with only two brackets remaining: both at comparatively low rates of 18% and 32%. This leaves the country with one of the lowest top marginal tax rates in Europe. There are no local property taxes but stamp duties exist on transactions.

A reduced VAT rate of 8% applies to most housing-related construction activity (new build, renovation, etc). It was raised by 1% from 7% in 2010 as part of a general increase in taxation.

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Housebuilding

Housebuilding levels doubled in the 2000s and completions reached 165,000 dwellings in 2008 and were only slightly down in that figure in 2009 (Figure 9.3). The development market is concentrated in the five metropolitan areas: Warsaw, Cracow, the Tri-city region, Wrocław and Poznan.

Growth in housebuilding was strongest in the final years of the boom. This was due to both supply and demand factors. The returns to development were growing fast with rapidly rising prices and most sales off plan but, in addition, institutional arrangements were more firmly in place than they had been a decade before. A development industry had grown up, mortgage finance was more widespread and more land was coming through the planning system, although this part of the development pipeline remains a bottleneck.

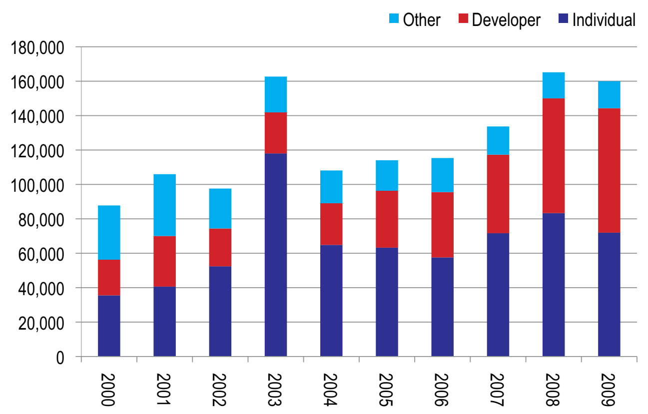

Figure 9.3: Housing output, 2000–2009

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: Central Statistical Office

Along with expansion has come greater product sophistication. The average floor area of the dwellings built has also grown by around 10% since the early 2000s. A practice grew up, encouraged by booming demand conditions, of selling flats as shells for purchasers themselves to arrange the internal layout and finishing off. Greater competition, intensified by a supply overhang in the downswing, has now led to a larger share of fully fitted-out apartment sales.

Most new housebuilding is for the private sector. Social and other non-market housebuilding has dwindled to only 10% of completions, as seen in the 'other' category in Figure 9.3. Moreover, much of the building by housing co-operatives that still exists is now of apartments for sale.

The output of professional development firms has grown rapidly from a small scale activity in the late 1990s to producing 45% of all output in 2009, mainly through the building of apartments. The typical development model is for many sales to be off-plan. Building only commences after the developer raises sufficient purchaser deposits; a point which also triggers an offer of development finance from the banks. Such a model is good for developer margins, as purchasers pre-fund construction but is poor for competition, because without alternative sources of development finance builders have less possibility of supplying homes ahead of market demand but rather lag significantly behind it as they wait for order books to fill up before starting construction. Usually developments are completed within 24-30 months, outside of slump periods when there is temporary discontinuation of some schemes. This long lag encourages major upsurges in house prices in face of positive demand shocks of the sort seen in the mid-2000s and represents a long term weakness in the country's housing system by exacerbating price volatility.

Mortgage lenders have tightened up on their lending criteria since 2008 and have become more cautious about advancing loans for flats under construction. So, developers have had to be more reliant on sales at or near completion, although that may change again when the market fully recovers.

Processing completed transactions through the Land and Mortgage Register also takes time, so that mortgages are often in place prior to full completion of title. The consequence was that only around two-thirds of mortgages were secured against the property in boom years but that proportion then rose to 80% by early 2010, reflecting lender caution and the slowdown in the sales market.[3]

The other main type of private sector housebuilding is small-scale, or one-off, building for private individuals, which still represents around half of all output (Figure 9.3). This type of activity mainly consists of private individuals having single-family dwellings erected on individual plots they have bought or already own. Such plots may be piecemeal or the result of developer land conversions and onward sales of serviced plots. These homes are generally for own-use though they may be sold. The development process is a long one: about 6 years on average pass from starting the construction until its registered completion, so today's completions may have been started a decade or more ago. Build numbers are high currently but the full effect of the downturn may not be apparent in completions data for some time to come yet.

This type of procurement is much easier in suburban and rural areas and smaller towns and the build quality is variable. A typical house of this type has 145 sq. m of useable net floor space.[4] There are now a number of substantial suburbs of such dwellings around the country's major cities.

[3]Central Bank.
[4]Central Statistical Office.

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Within the social sector, 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 but Co-operatives have legal problems with raising finance for development. They now produce only 5% of new dwellings, down from a third at the turn of the century. Municipal and enterprise housebuilding increased in 2009 but still represents less than 3% of output. Another three thousand or so social homes are provided under other social housing arrangements and their output has been declining in recent years as political support for them has waned.

There was a move towards greater emphasis on building near urban cores in the 2000s as more land became available. In Warsaw, several high rise developments have been built in the city centre. But with growing oversupply in the middle to upper sub-markets, a move downmarket to more mass, typically suburban, housing sectors is likely to occur in the upswing, if planning and infrastructure constraints can be overcome.

A new planning regime was introduced in major cities in the 2000s. It has made the old existing plans redundant as they no longer had any legal status but many new local plans still have to be set up and agreed. All development is technically frozen until those new local plans are ratified; unless special micro-local plans are made in relationship to specific developments as they arise. This special procedure is time-consuming, expensive, and leads to sub-optimal land-use change.

The cooling of the market did not initially lead to a fall in completions, as sites continued to be built out. However, starts were 20% lower in 2009 and permits almost a quarter lower than in 2008. The biggest falls were for developers, as they retrenched in the face of unsold completed dwellings. The decline in completions continued in 2010 and they were down 19% on the previous year in the first 10 months,[5] so that year-end figures were expected to be around 120,000 to 130,000 units overall. Starts data are the strongest indicator that the market is turning up in 2010, with a 50% rise for developers over the previous year. However, there were indications of a slowdown in the recovery in starts in the last quarter of 2010. By contrast, permits data which had been flat for much of 2010 showed a substantial pick up in the last quarter. Such discrepancies may be explained by the fact that developers could quickly bring back in to production sites that had been halted in downturn but it takes time to bring new projects on stream and get them processed through the permit system. Consequently, the late 2010 surge in permits may be the best indicator of a growing confidence amongst developers that sales were improving.

Macroeconomic influences

The economy expanded rapidly between 2004 and 2008, driven by booming domestic demand. The economic crisis then slowed growth but the country did not fall into recession, uniquely in the EU. In 2009, growth remained positive at 1.7% and accelerated to 3.5% in 2010.[6] Prospects for 2011 are of continuing economic strength.

The public sector deficit has been increasing as a result of the downturn and associated stimulus measures and it reached 8% of GDP in 2010. Actions to raise taxes and reduce public expenditure were announced in 2010. Tight public sector finances and further modest tax rises are likely to continue for several years while the country remains in the EU's Excessive Deficit Procedure and the deficit is gradually reduced. However, these fiscal policies are unlikely to overly constrain the growth of private consumption, which has continued to expand throughout the past few years – although not at the heady heights reached prior to the crisis.

Inflation rose significantly in 2008 to 4% and only moderated slightly in 2009. It fell somewhat in 2010 but continues to be quite high. Inflationary concerns have encouraged the central bank to raise interest rates over the past few years and that stance is unlikely to change, which may raise mortgage costs.

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 with a booming economy it then fell to 7% in 2008. It rose back to 10% in 2010 but is expected to slowly decline as the economy continues to expand over the next few years. The country has a relatively low share of people of working age in employment with only 63% in work. This represents a substantial loss of productive potential and in housing terms restricts the number of people capable of contributing to housing costs from earned income.

[5] *To end October, 2010, Central Statistical Office.*
[6] *OECD.*

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Mortgage market influences

The mortgage market has been growing rapidly. It rose 35-fold between 2000 and 2009 in nominal zloty terms.[7] The credit crunch led to a severe cutback in mortgage lending, although the situation was easing during most of 2010.

The slowdown was due to supply-side constraints as well as lower demand. Banks tightened up mortgage lending criteria throughout 2008 and into 2009; raised spreads; and most stopped lending in foreign currencies, a move encouraged by the regulatory authorities.

Tight mortgage conditions continue. Half of the banks were reporting that in 2010 q4 they were tightening loan housing standards in the central bank's senior loan officer opinion survey. The tightening was mainly as a result of the implementation of Recommendation T, introduced by the financial regulatory authority, which stipulates that FX denominated loans from now on have to have a maximum LTV of 80% and that banks should judge applicants' ability to pay to include ability to cope with exchange rate risks. Another recommendation effective from the beginning of 2011 stipulates that banks' FX denominated mortgage holdings have to be 50% or less of their total outstanding mortgages.

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. Outstanding mortgage debt to GDP ratio was 16% in 2009, representing about a fifth of the banking system's assets. 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.

Mortgages are generally offered by commercial banks, issuing variable loans on interest rates linked to various benchmark interest rates plus a spread. 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. Budget surveys by the central statistical office highlight that most borrowing is undertaken by relatively young households. They spend around 40% of their budgets on housing, split 50/50 into debt financing and energy and repair costs. So, although borrowing ratios are low in aggregate, they are still high for key groups of recent borrowers, many of whom would have defaulted if they had lost their jobs. So, prospects for the housing market might well have been very different if Poland's economy had actually gone into recession, rather than surviving the economic crisis in relatively robust shape.

Foreign currency lending accounts for a high proportion of outstanding loans and it had been the fastest growing part of the mortgage market until the financial crisis brought new FX lending to a virtual halt, while existing loans were being paid off (Figure 9.4). This does not show up in the outstanding mortgage debt data, because the devaluation of the Polish zloty (PLN), particularly against the Swiss franc, raises the value of FX denominated mortgages when measured in domestic currency terms. Overall, when measured in PLN terms 60% of outstanding housing loans were denominated in foreign currencies in October 2010, down from 65% of total mortgage debt a year earlier.

Fortunately, falling interest rates on Swiss franc loans from late 2008 offset adverse exchange rates effect, so that household repayment burdens did not actually rise substantially (Figure 9.5). Such a fortuitous combination of events may not occur again in the future, especially as Poland's inflation rate is relatively high.

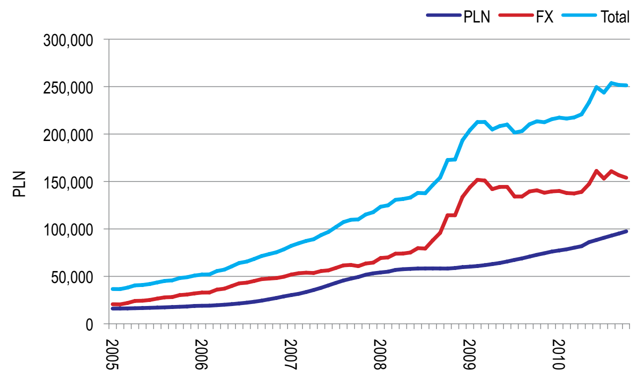

Figure 9.4: Outstanding mortgage loans, Jan 2005–Oct 2010

Loan amounts measured in zloty
Source: Central Bank

[7] *EMF.*

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Borrowers tend to be myopic when deciding which type of loan to take, looking simply at current exchange rate differentials, even though they have no hedge against adverse currency shifts. Much borrowing in the final years of the boom was in Swiss francs because of the attractiveness of the interest rates on offer (Figure 9.5). By 2008 almost 40% of new loans were in Swiss francs. Then, in 2008, as the cost of PLN- denominated loans increased even further because of tightening central bank monetary policy, the share of Swiss franc denominated loans in new business shot up to peak at around 70% of all new loans, despite the obvious exchange rate risks. Swiss franc loans subsequently fell away to a very low share by autumn 2010 as loan criteria were tightened (Figure 9.6). There was a brief surge in $ borrowing at the end of 2008 and also in euro borrowing during 2010 as the exchange rate against the euro temporarily improved, only to become worse again in November.

As household earnings are denominated in Polish currency, borrowers of foreign currency denominated mortgages continue to face significant exchange rate risks, especially as the exchange rate began to decline from 2008 onwards, with periods of devaluation punctuated by partial recovery. When the currency depreciates, the costs of 60% of outstanding mortgages rise, unless there is an offsetting interest rate effect. Therefore, the large amount of foreign mortgage debt remains a risk for the housing market. However, central bank surveys suggest that FX borrowers tend to have higher incomes than those borrowing in domestic currency and, so, are more able to withstand shocks. Moreover, the default rate so far has been significantly lower amongst FX borrowers than domestic currency ones.

The recent tightening by banks and the regulators of FX borrowing means that the performance of the housing market is now far more influenced by domestic monetary policy than it was in the recent past. PLN-denominated interest rates were over twice as high in the second half of 2010 as Swiss Franc ones. So, in terms of many new purchasers' immediate outgoings, debt funding costs have risen sharply over the past two years. They are likely to continue to rise if the central bank increases interest rates further to rein in inflation. Tighter loan criteria and higher mortgage interest rates are likely to dampen enthusiasm for house purchase in 2011 and probably beyond.

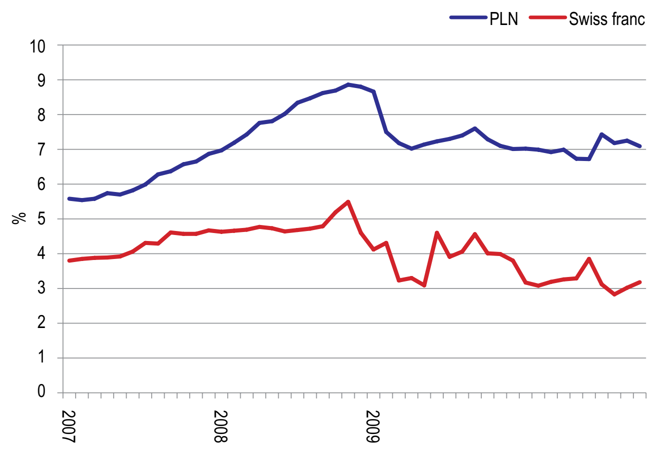

Figure 9.5: Mortgage interest rates, Jan 2007–Oct 2010

Monthly
Source: Central Bank

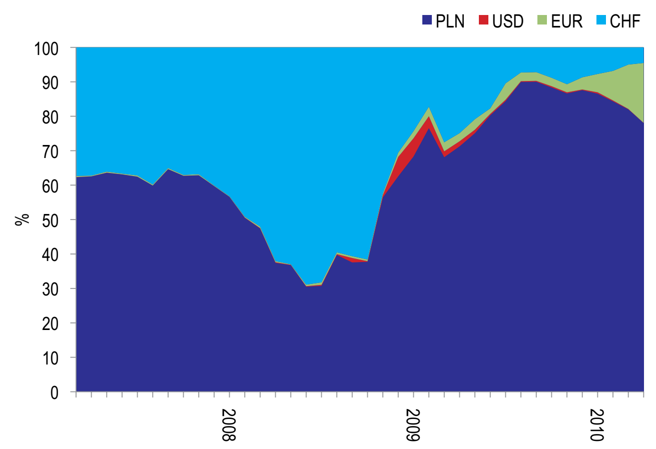

Figure 9.6: Share of FX loans in new housing loans Mar 2007–Apr 2010

Source: Central Bank

Demographic influences

Population pressures, which are currently strong, are forecast to abate. The population is expected to be broadly stable until 2015 and then fall by over 2 million in the subsequent decades up to 2050 because of the low birth rate and emigration.[8] The population will also age, so that 30% of people will be 65 or older by 2050, up from 17%.

Yet, even so, demographic pressures are currently pushing up housing demand strongly because there continues to be a large number of younger people entering the initial years of household formation. However, the low birth rates since the 1990s are beginning to influence the size of the younger adult population so that there will be a marked reduction in the number of people aged between 20 and 25 over the next decade. Also, offsetting the surge in young adults is the fact that many young Poles have moved elsewhere in Europe. Internal migration to the economically strong major cities away from rural and declining areas is putting pressure on housing provision in such localities.

[8] *Central Statistical Office.*

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Overview

The housing market downturn continued during 2010, though there was some evidence that the decline was slowing, with the INE index in particular showing only modest price weakness and some moderate quarter to quarter strengthening. However, other indices were producing more pessimistic results with around a 4% decline on the year during October (Figure 10.1). As the wider economy and financial markets still face substantial problems, it is by no means certain that the end of Spain's housing market downturn has actually yet been reached.

Housing demand in 2010 was held up by improvements in the availability and cost of finance: with mortgage interest rates at record lows of around 2.5%. Moreover, there was a pre-announced 1% increase in VAT on new housing to 8% from July, 2010 which may have helped to encourage a surge in transactions in the second quarter, especially as it filters through to the transactions tax on existing properties as well (Figure 10.2).

Other announced tax measures would have also brought forward property purchases to 2010, including the announced partial withdrawal of personal income tax deductions for the principal residence to take effect from January 2011. Though obviously a stimulant to 2010's housing demand, such tax changes and the way they are pre-announced then depresses housing demand in 2011. This occurs both through the impact of there now being higher taxes and, indirectly, because of the loss of the demand brought forward to 2010 to circumvent them.

Uncertainty and debate about the extent of Spain's house price falls continues unabated. As a result, it is worth spending a little more time than usual in the other country chapters to go through some of the various indices. There are two official ones from the Housing Ministry and the National Statistical Office, INE, respectively and two important ones from private agencies.

The most long-lasting house price index is that of the Housing Ministry. It is based on the property registry and, so, significantly lags market transactions. It recorded a 4% year-on-year fall in 2010 q3 (Figure 10.1) and an overall 13% decline since the 2008 q1 house price peak. It suggests that there has been much the same decline for dwellings that are more than two years old and more recently built (mainly new) ones.

There is also a fresh index from INE, based on data from notaries, which records the time at which purchases are closed. The broad pattern of change is not so different from that of the Housing Ministry's data (Figure 10.1) yet, unlike it, the INE indices for new and existing house prices indicate divergent outcomes. Whereas the existing homes index shows a 16% fall from the peak, its new housing index shows only limited change in prices since the end of the boom, with a 6% fall by 2010 q2, far less than suggested by the Housing Ministry data.

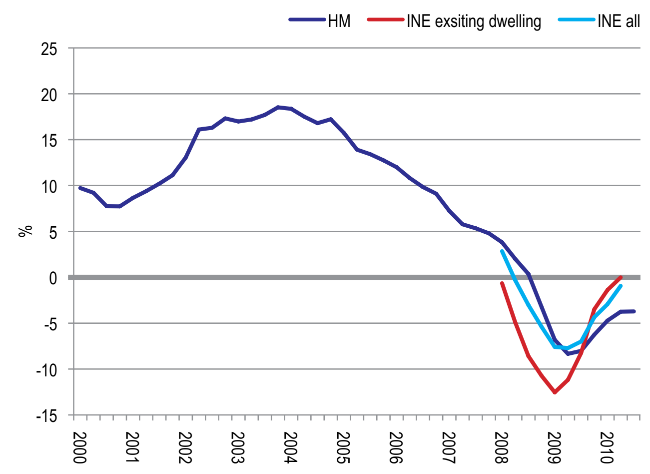

Figure 10.1: House price change, 2000q1–2010q3

Year on year
Note: HM = House price data from Housing Ministry; INE = House price data from National Statistics Institute. Source: Housing Ministry, INE

Other price indices also highlight significant price falls. Fotocasa's existing house price index recorded a 3.5% price fall in the year to November 2010. It suggested a larger 22% decline from the peak compared to both the Housing Ministry and INE's information. Fotocasa argues that its index is the most up-to-date as it is based on current asking prices. By contrast, Tinsa's index, based on its own property valuations, showed a slightly greater decline at 4.6% year-on-year to October 2010 but a more modest decline from the peak of around 14%.

An overall position on Spanish house prices from this varied information may be to say that there has been a approximately 15% price fall from the peak of the boom for existing housing and probably somewhat less for new. Taking account of general price inflation, this suggests a roughly 22% real decline in values for existing homes, which is one of the largest in Europe to date. (There are obviously locational and dwelling type variations around this average national number.)

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The scale of the downturn reflects the impact of earlier price rises. The country had one of the biggest housing market booms in Europe. House prices increased by 2.2 times in real terms between 1996 and 2006; housebuilding rose to record heights; and mortgage debt increased dramatically. The consequences for the economy as a whole were substantial; fuelling a general economic boom. Housing investment alone was 8% of GDP in 2006 and construction as a whole about 13% of GDP, much of it related to real estate. Average household debt reached 130% of personal disposable income in 2007 – three-quarters of it related to mortgages, although some deleveraging and falling interest rates had lowered the scale of outgoings since then.[1]

The extent of the market slowdown can be seen clearly in transactions data. The number of registered sales had peaked in 2006, some time before the onset of the financial crisis. But, by 2009 q3, recorded sales were 61% less than that peak (Figure 10.2). Sales have recovered somewhat since then, but some of the rise may be accounted for by the bringing forward of planned purchases for tax reasons, as was noted earlier.

It is hard to measure the vacancy overhang but it is substantial. Some unsold new properties are holiday homes but many are potential primary residences. The Bank of Spain estimates the number as being a substantial 3 to 4% of the housing stock as a whole – 0.75 million to 1 million dwellings. It may take many years to run that excess down and some of those dwellings may never be lived in, especially those of poorer quality or at unattractive locations. This supply overhang is also being rundown slowly because the real values of such properties are unclear. So, banks when they foreclose on developers have incentives to hold unsold dwellings on their books rather than to discount them heavily through sales, because that forces them to write the losses into their books.

The holding off from the market of completed but unsold homes may help to account for the relatively slow decline in new house prices and that 'on-hold' situation continues to moderate house price falls. However, as time passes the impact on prices is likely to switch and the existence of such a large potential supply can be expected to have an increasingly destabilising rather than a moderating effect on price change. Moreover, it lowers current demand as well, because some potential purchasers may be encouraged to wait until bargains are gradually released on to the market. It is difficult to perceive of a floor to the current house price decline while the scale, timing and value of further market offerings from the accumulated mass of unsold dwellings remains unclear. In any case, little can be read about real house prices changes from the discounts offered by banks when they put such empty dwellings on the market, because they are often marketing devices rather than based on current market values.

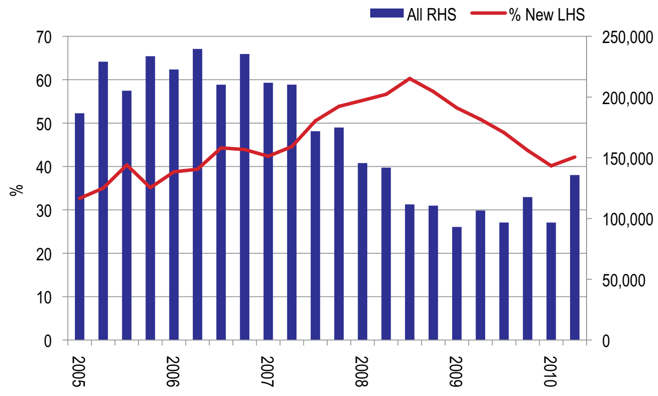

Figure 10.2: Housing transactions, 2005q1–2010q2

Source: Housing Ministry

Housebuilding tells a similar story of decline. It peaked at extraordinarily high levels in the final years of the boom. Almost 600,000 dwellings were completed in 2006, which works out to be around 13 dwellings for every 1,000 Spanish people. This rate was surpassed by Ireland in its boom but is many times higher than the volumes most other European countries were building in their housing market boom years.

Since then, output has fallen sharply and starts were expected to be below 80,000 by year end 2010 and this may not yet be the bottom. In contrast to starts, completions did not fall and surprisingly still remain very high by international standards. This may be due to statistical issues related to when a completion is recorded. It also shows the time it takes to build out developments and the incentive for developers to keep on building if they can raise sufficient short-term loan finance and sales revenue, or win forbearance from banks, to put off the threatened day of failure.

The data suggest that over 360,000 dwellings per annum were being completed over two years after the turnaround in the housing market. It may be the case that many developers, or their financiers in cases of insolvency, are being slow to declare completions. Whatever the true cause of the discrepancy, this is further evidence that the supply-side does not yet seem to have fully adjusted to changed market conditions.

[1]Bank of Spain.

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Some basic long-term drivers of housing demand are still strong. Housing shortages continue, despite all the building, because of previous low housing standards, demographic pressures and long-term rises in living standards. 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 in themselves count for little in an economic downturn.

Housing markets are invariably heterogeneous locationally and by dwelling type and Spain's diverse geography highlights such differences strongly. Consequently, the scale of the price changes that have occurred and the risks of further downward adjustments vary across the country and by market segment. Nationally, some commentators argue that prices still have a long way to fall. For example, the leading bank BBVA forecasts that the downswing will eventually lead to a 30% fall in prices.

Overall, the prognosis is that the problems of the Eurozone, high private sector debt, continuing excess housing supply, and the sluggish rate of economic recovery suggest unpromising housing market prospects for 2011.

The housing system

Despite having the highest overall number of dwellings per 1,000 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. This cramped lifestyle reflects cultural factors as well as housing shortages, as several generations of families may live together in dense urban accommodation. 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.

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. This helps to make crowded urban conditions more tolerable for those that can afford it. There is also a high level of second home ownership by foreign nationals and many Europeans retire to Spain as well.

Owner occupation and taxation

Most housing is owner occupied. Spain has one of the highest levels of homeownership in the EU, at 82% in the last census.[4] Tax breaks for homeownership have been significant, including mortgage interest and capital repayment income tax relief and tax breaks on housing savings schemes though these were mainly abolished from the beginning of 2011 as part of austerity measures. 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 an initial exemption amount. Landlords are also offered tax breaks.[5] Such tax breaks have encouraged investing in housing in general and favour owner occupation more than renting. So, reductions in them may be welcome from an efficiency point of view, but they will further depress housing demand during 2011.

New housing pays VAT at a recently raised 8% 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.

[2] *Housing Statistics in the EU 2006.*
[3] *Housing Statistics in the EU 2006.*

[4] *Census 2001.*
[5] *OECD Country Report Spain, 2007.*

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Subsidised housebuilding

Some newly-built owner occupied housing is given subsidies in the form of reduced interest on loans via means-tested schemes. According to the Housing Ministry, housing subsidies in recent years helped to finance about 60,000 or more new units a year and another 40,000 renovations. Programmes include energy efficiency and neighbourhood improvements. The 2009-2012 Housing and Renovation Plan allocated €15bn for use in 2010 alone. Adding to the stock of housing when so many are already built and empty carries the obvious risk of intensifying the surplus.

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.

Supply-issues also relate to changes that have been taking place in land policy and taxation. A recent land law goes much further in these respects than did the previous arrangements. It specifies that 30% of all new housing land has to be reserved for the building of subsidised homes, which raises the costs of free market dwellings at a time when developers' profitability is already being severely eroded by the market downturn. 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 and, so, this ability has been argued to have been a major fiscal incentive to rezone land for housebuilding. However, the incentive has now been severely weakened under the new land law. For, under its terms, municipally-acquired land has to be sold for subsidised housing and, so, it will command lower than free market prices and, therefore, local authorities will earn smaller incomes when they rezone land. Such issues may seem of little importance in the depths of a housebuilding slump but they will become important as the housing market recovers.

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.

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, and court procedures have been streamlined.

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. This is remarkable for a country of Spain's size. In 2006, the number of housing completions per 1,000 population was almost 15, which is 4 to 5 times the figure common in most advanced European economies.

In 2009, starts had dropped to 80,000 dwellings, 88% lower than three years before (Figure 10.3). Yet, completions were still much higher at over 350,000, a huge difference. A similar pattern occurred in the first half of 2010: with starts totalling 36,000 but completions are much high at 130,000.[6] Though completions are finally falling sharply, they continue to be far above the number of new dwellings sold and therefore are still adding to the stock of unsold dwellings. This will continue to have a softening effect on house prices. Unsurprisingly in such circumstances, starts continue to fall. June 2010's figure was 18% down on that month a year before.

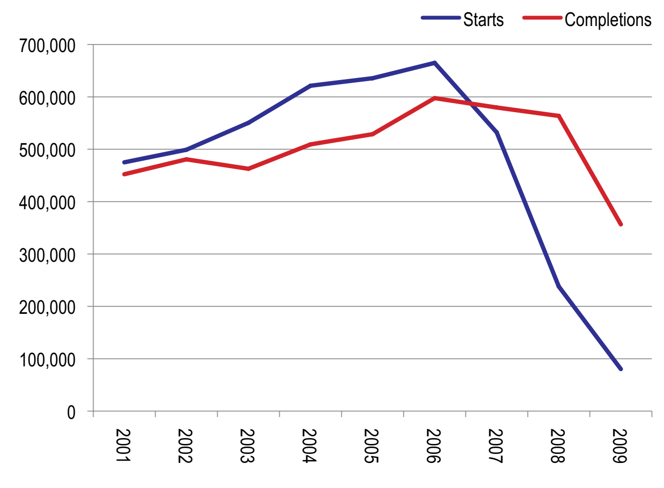

Figure 10.3: Housing starts and completions, 1991–2008

Free sector
Source: Housing Ministry

Output peaked in 2006, partly because of the introduction of a new building code which encouraged developers to bring forward projects. The subsequent fall as the market slowed was muted for over a year until the second half of 2008 as projects were built out. Given the fact that blocks of apartments have to be built out once started, it takes some time to cut back output. Once the finance is in place and contracts are signed, developers may prefer to hope for the best, gambling 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. Banks may also be reluctant to call in loans, as discussed earlier, so projects proceeded even though they eventually turned out to be heavily loss making and a drag on the market. Such projects also helped to push some large and many small developers into liquidation.

The housebuilding downturn probably still has some way to go. Yet, trend per capita building rates are likely to stay 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, which appeal to a Europe-wide clientele.

[6]*Housing Ministry.*

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Macroeconomic influences

The economy entered recession in 2008 and the downswing intensified in 2009. During 2010, the economy roughly levelled off; although the renewed decline experienced in the third quarter was a surprise. Some growth is expected in 2011 but sustained revival is unlikely to 2012. Financial turmoil at the end of 2010 was bringing into question growth prospects, with further expected public expenditure cuts likely to dampen aggregate demand. However, the economy is slowly adjusting away from its previous high reliance on construction and property.

There had been an economic transformation in Spain in the years prior to 2008. Up to 2007, economic growth was stronger than the EU average for well over a decade; with growth rates averaging 3-4%. Although population increases helped this expansion, living standards rose, unpinning higher housing demand.

During the boom years, job creation was also strong and the labour participation rate rose to almost 75%. However, unemployment shot up in the recession and is currently over 20% and is only expected to fall back below 17% in 2012, according to OECD forecasts. Labour market restrictions, including job protection legislation, are said to contribute to the high unemployment rate.

The decline in housebuilding was an important contributory factor in the onset of the recession and continues to be a drag on the economy. Stimulus measures and the loss of tax revenue pushed the government into a deficit and this was 9% of GDP in 2010. Higher tax and lower spending measures were introduced on several occasions in 2010 and the squeeze is likely to continue for some time in order to reduce the deficit. Pressure from financial markets may force an even more rapid reduction, which would weaken economic growth further.

Spain's higher than EU average inflation rate in the years prior to the slump means that it has over time significantly lost international competitiveness. So, to an extent full recovery depends on whether domestic price changes can be lowered significantly below rates of inflation elsewhere and how much the general growth rate can be increased through productivity improvements. As part of that painful process, the scale of the recession means that inflation is now very low and likely to stay that way.

Mortgage markets

The impact of the economic slowdown and the reduction of activity in the housing market led to a sharp reduction in new mortgages issued, so that the growth in housing loans fell to about zero in autumn 2009 and has hardly risen since then (Figure 10.4). Mortgages are still being issued but are offset by existing borrowers' repayments which are now substantial after previous years of very high growth. Overall household debt remains high and mainly consists of mortgage payments. Household debt peaked at almost 130% of gross disposable income in 2008 and has fallen only slightly since then, although lower interest costs had reduced the repayment burden on gross disposable income from a peak of 18% to around 16% early in 2010.[7]

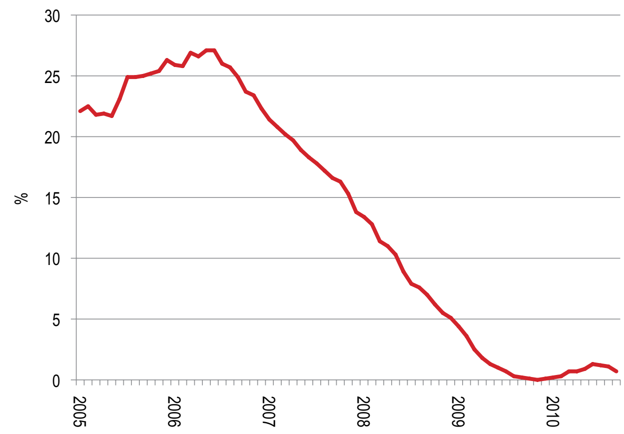

Figure 10.4: Housing loans growth

Monthly
Source: ECB

[7] *Bank of Spain.*

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Increases in mortgage interest rates between 2006 and 2008 helped to puncture the previous housing boom. They almost doubled between 2005 and 2008, when average mortgage interest rates peaked at over 6% (Figure 10.5). Most mortgages are variable rate ones, so that they are sensitive to the rates that the ECB sets. After its previous steep rise, the mortgage rate fell sharply in the last few months of 2008 and the falls persisted through 2009 and held steady throughout 2010, dipping slightly through the summer months. In September, 2010, they were on average 2.65%. Such low rates have helped to sustain housing demand and greatly improved the ability to pay of existing mortgage holders. The falls through 2009 were marked and borrowing rates were down to 3% by October.

During the boom years, Spanish financial institutions relied increasingly on securitised vehicles for finance. Lenders came to covered bonds, mortgage-backed securities and other vehicles. By 2008 q1, Spain at 24% had the largest share of total outstanding European capital market residential mortgage funding.[8] So, the closure of the international RMBS market affected Spain badly and covered bond spreads widened considerably. By 2009, €340bn of covered bonds were outstanding and €42bn were issued in that year.[9] However, according to central bank data, the maturity structure of outstanding bank debt is concentrated in the longer term, with over half due in 2013 or later. So, immediate refinancing risks are limited.

ECB invention through a €60bn Eurozone wide cover bond purchase scheme between July 2009 and June 2010 partly restored confidence in Spanish mortgage securities; though in practice actual purchases of Spanish bonds were a relatively small part of that exercise.[10] The ECB's other active market operations also helped to keep up mortgage lending in Spain and lower lender spreads. In summer, 2010 capital markets looked as though they were again opening up for Spain, with around €12.5bn of mortgage-related paper issued in July by several banks, although at much higher spreads than had been the case before.[11] However, later in 2010 contagion from the crisis in Ireland once again sharply raised bond spreads and increased market uncertainty.

Mortgages are mainly advanced by banks. Spain's major financial institutions have so far not been badly hit by the financial crisis. However, the smaller savings banks, the local and regional Cajas, have been more exposed to real estate losses and are also major domestic mortgage lenders. To resolve their problems, a Fund for the Orderly Restructuring of the Banking Sector (FROB) was set up in 2009 in order to encourage mergers and force through restructuring where necessary. Two savings banks were in sufficient trouble to warrant Bank of Spain intervention. A year later, 39 of the 45 savings banks had been involved in restructuring, with 7 of the mergers, involving 26 of the previously existing savings banks, aided by €11bn from FROB. In the closing months of 2010, there was strong pressure to speed up what was turning out to be a protracted restructuring of the Cajas. Further legislation is also pending to enable the remaining savings banks to strengthen their capital bases.[12]

The standard mortgage product is a variable rate one, with EURIBOR typically used as the reference rate. Lending conditions have been tightened over the past few years. The 80% LTV ratio forms a financing threshold, because banks are required to increase their capital adequacy provisions when lending above it.[13] The maturity dates of new mortgage loans are also falling, whereas they had been growing during the boom years as a means of keeping annual annuity costs down.

80% of first mortgages are for primary residences rather second homes or housing investments. The central bank argues that the loan exposure is not too worrying as 81% of first residence loans have loan-to-value ratios of 80% or less; while 15% of them are between 80% and 100%; and 4% above 100%. Looked at in the aggregate, the LTV of banks in retail mortgages was 62% in June, 2010 and was similar across institutions. Obviously, if house prices continue to fall negative equity amongst mortgage borrowers will rise. But the costs of default under Spanish law are high, so it is very much a last resort measure for most households.

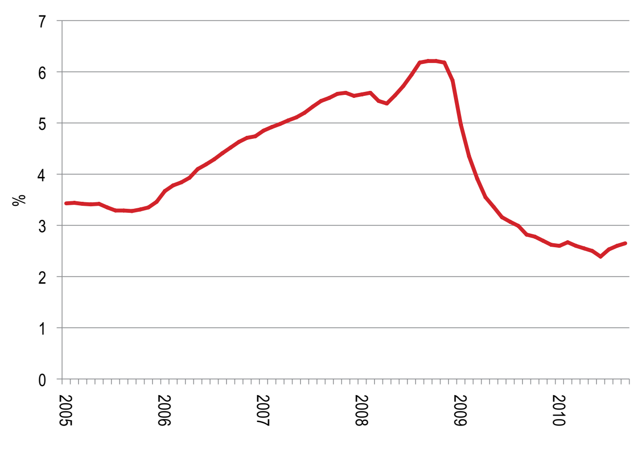

Figure 10.5: Average interest rate on housing loans

Source: ECB

[8]*Crosby, Mortgage finance interim analysis, HM Treasury, London, 2008.*
[9]*European Covered Bond Association.*
[10]*European Covered Bond Association, Fact Book 2010.*
[11]*Bank of Spain Financial Stability Report, October, 2010.*
[12]*Bank of Spain.*
[13]*Bank of Spain.*

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In the last housing market downturn from 1991 to 1993, banks faced high levels of mortgage default. However, this downswing has to date been different and default levels are currently low. Doubtful loans represented 2.2% of outstanding housing loans in June, 2010 and had fallen slightly since the previous year.[14] So far, high unemployment has not led to a wave of mortgage defaults, similar to those in the USA. This is partly because the young and immigrants have borne the brunt of it rather than homeowners. In addition, mortgage rescue schemes have been introduced to lower the potential impact of unemployment on defaults. 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.[15]

Where defaults are much higher is amongst construction firms and property developers: in other words, on the supply side of the new homes market. These debts are the ones that have caused most problems to date and have led to the banking sector as a whole becoming major holders of unsold new homes, which they are gradually disposing of or are setting up subsidiaries to rent them out. These problems, as was noted earlier, may help to explain the relatively slow adjustment of supply to the new realities.

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 in the early 1990s. Outstanding residential mortgage debt was only 14% of GDP in 1990. Now total household debt of gross personal disposable incomes is one of the highest in Europe, as noted earlier, and outstanding mortgage debt to GDP was 62% in 2008.[16] So, Spain has rapidly emerged from being an underdeveloped mortgage market into being one of the most important in Europe.

Demographic influences

According to INE estimates, the population grew fast between 2000 and 2010, rising by 15%, but expansion is expected to slow considerably over the next decade with a total population increase over the 10 year period of only 3%. The already low birth rate continues to fall and the population ages. So, on current projections, the number of births and deaths in the country will balance themselves out by 2019 and the population will continue to age.

Demographic factors will put further pressure on local housing markets in the future, because of the age profile of the population and the reduction in household size, which is gradually converging to that in many other advanced EU countries. Younger people are increasingly reluctant to stay at home with their parents until so late in life as in the past. The economic crisis and youth unemployment are forcing some back to the family home but there will be a rebound effect as the downturn wains.

There is 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 as a result experiencing substantial vacancy rates in their housing stocks.

Up to the recession, the rate of immigration into Spain was by far the highest in Europe. Net immigration was almost 40% of the whole of the EU's in 2007. As a result, the resident foreign population increased from 920,000 in 2000 to around 4.1 million in 2007, and the percentage of foreigners rose to 11% of the population. Between 2007 and 2010, however, immigration fell sharply as the labour market was weak and housing markets in retirement and holiday areas were experiencing capital losses.

There are a variety of different types of immigrant. Some are predominantly relatively wealthy older people from North West Europe, particularly the UK, who wish to settle in Spain but not to participate in the labour market. They are a mainstay of new housing demand in the coastal and other tourist areas. Other typically poorer ones come from Central and Eastern Europe, Africa and Latin America and migrate for economic reasons.

[14]Bank of Spain.
[15]Bank of Spain.
[16]European Mortgage Federation

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Overview

The boom in the Swedish housing market continued through 2010, with house prices up 6% on the year, according to the official data (Figure 11.1). There was some moderation of the high price growth seen in the spring and summer by the autumn. This suggests that the market was beginning to be affected by rising interest rates and a recently introduced cap on loan-to-value ratios. The cap had been recommended by the regulators and is set at 85% of the purchase price. Above that, loans can no longer be secured on the property and, hence, are more risky and expensive.

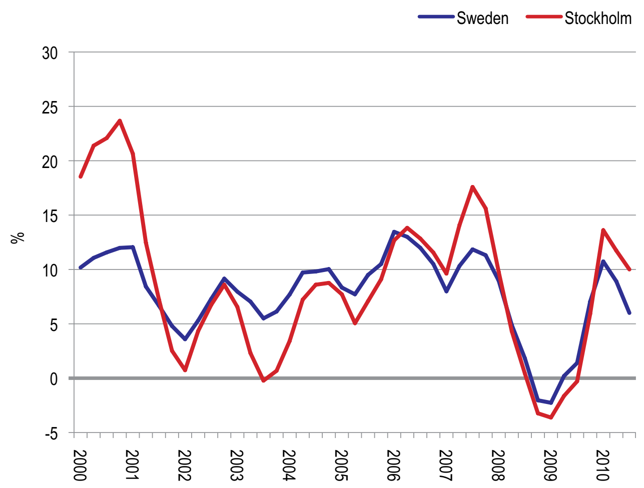

Figure 11.1: House price growth, 2000q1–2010q3

% year-on-year nominal change, quarterly
Source: Statistics Sweden

The slight slowdown in price growth was confirmed by other sources. Maklarstatistik's house price index is taken from an earlier stage of the house sales process than the land registry used in the Statistics Sweden data. It is derived from brokers' data on contracts signed, and typically indicates rates of house price increase broadly similar to those in the official data. However, the more timely figures signal a marked slowing as of the autumn of last year with a 3% fall for tenant-owned apartments and a flat picture in the housing index. Whether this proves a temporary variation or a seasonal effect rather than something deeper remains to be seen. A brokers' survey suggested that a third of estate agents experienced rising prices in their businesses in September, a result that was greater than expected.

As winter set in, further price rises were not projected, though whether the market will actually slow substantially in 2011 is uncertain. It is unlikely that interest rates will rise sharply, although they are drifting upwards, so borrowing will continue to remain attractive. Economic growth is also likely to stay high, which will continue to boost housing demand. Meanwhile, supply continues to be extremely tight. It remains to be seen whether declining affordability, consumer concerns about future rises in interest rates, and any further policy measures are enough to offset expansionary forces fully.

The boom in the housing market is being driven by a strong economic recovery, led by exports. In addition, mortgage interest rates are very low. The average variable rate on new mortgages was below 2% for most of 2010. Rises in the central bank's reference rate led to a slight increase in mortgage costs in the third quarter, but they still hovered around 2%.

The high demand for mortgages does not seem to have been constrained by a shortage of supply, as has been the case across much of Europe. A deleveraging of household finances is not apparent in Sweden. By the spring of 2010, the ratio of household debt to disposable income had risen to 167%. That ratio has grown by over a third since 2000, mainly due to extra mortgage debt, according to the central bank, although it does not see the current level as an immediate threat to financial stability.[1]

The central bank has been concerned that a bubble may be growing within the housing market. Early in 2010, a commission was set up by the central bank with a wide ranging remit to investigate the operation of the housing market. It was expected to report early in 2011. Of course, its recommendations may not lead to any action, as most potential options lie within the prerogative of government rather than with the monetary authorities. However, the very substantial structural imbalances and inefficiencies within the Swedish housing market are once again being subject to investigation and aired for political debate. In 2009, the OECD in one of its regular reports on the Swedish economy also criticised housing market distortions and their impact on the economy.

Sweden experienced one of the largest increases in house prices in Europe during the boom years prior to the financial crisis. Its boom lasted from 1997 to 2007 with annual house price rises averaging 8% (Figure 11.1). Although that rate of increase may not seem that large in relation to the booms in some other countries, those increases went on for a long time. The result was that real house prices rose overall by 2.3 times in the period from 1995, putting the country in the top league for price appreciation. One type of property that experienced notably sharp price rises, particularly in the years towards the end of that boom, was owner flats (which have a specific legal status in Sweden and are called 'tenant-owned', as described later). During 2006 and 2007, their prices were growing at a rate of 20% or more annually in the major cities and they were once again leading price rises in the 2009-10 upswing.[2]

[1]Central Bank, Financial Stability Report, June, 2010.
[2]

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The 2007-8 financial crisis did dent the housing market and there were falls in prices during 2008 and early 2009. However, by mid-2010 prices were again at 2007 levels or in some places even higher. As is typical, price growth has varied around the country and has differed over the short-run between the single house and the apartment markets. Growth has been strongest in the major cities – Stockholm, Gothenburg and Malmö – and in university towns, like Uppsala. These areas are the ones experiencing the greatest economic expansion and inward-migration from slower growing regions and abroad.

A negative shock did occur in 2001 in the aftermath of the dot.com crash, which particularly affected the IT-oriented Stockholm region and its housing market. However, Stockholm bounced back and is currently one of the strongest markets. It is the one with the highest prices and tightest supply and tends to be more volatile than elsewhere.

In housing terms, Sweden consists of two halves: the growing cities and their surrounding regions, where demand consistently outpaces supply, and the rest of the country where the reverse situation generally pertains, of weak overall demand and an excess supply of poorer-quality accommodation, much of it in the social sector. The Stockholm region alone generates around 40% of total Swedish GDP and is experiencing rapid population growth, while some other parts of the country are experiencing economic stagnation and declining populations.

In contrast to prices, other indicators highlight that the housing market remains at a lower scale of activity than prior to the recession. Sales of houses fell sharply in the crisis period, especially in the second half of 2008 and into 2009 (Figure 11.2). Even though they did increase again in early 2010, they then faltered and still trail behind their pre-2008 levels.

It has not only been the economic and monetary responses to the financial crisis that have revived housing demand so strongly. A stimulus programme to protect employment late in 2008 pumped billions of kronor into the construction sector during 2009 and continued to do so into 2010. Existing homeowners wishing to renovate newly purchased properties could take advantage of the lower tax breaks on building, renovations and maintenance introduced as part of the aforementioned stimulus package.

Even so, housebuilding has not picked up much, following earlier sharp falls, which began in 2007. Initially that downswing had been caused by policy change, as long existing subsidies were withdrawn at the end of 2006 causing a bunching of housing starts in that year, and then starts fell because of the financial crisis. Housing output now remains at low levels and with stimulus packages at an end, prospects for sustained expansion are poor. Deep-seated housing supply problems in the growing city regions, which had played such an important role in the earlier long house price boom, are destined to continue.

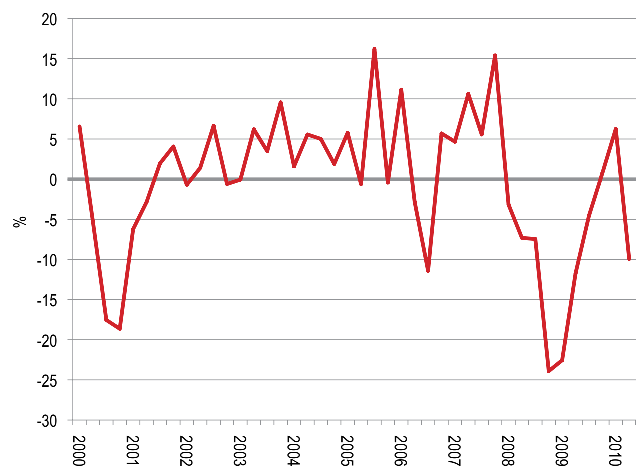

Figure 11.2: Growth in house sales, 2000q1–2010q2

Year-on-Year
Source: Statistics Sweden

With only a moderate, short-lived downturn and then renewed pressure on prices within a matter of months, the current housing market experience is vastly different from that in early 1990s. At that time, the housing market underwent a massive decline and real house prices fell by 30% from their previous peak. The spillover effects of that crash forced the government to rescue the financial system.

Severe distortions continue to persist. The relatively small owner occupation sector by international standards has a deeply troubled supply-side; it contains only an indirect and unique way of buying flats in the so-called tenant-owner framework; and it exists in a highly-regulated and heavily sitting-tenant biased overall housing system.

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Housing system

The country has long been famous for its interventionist housing policies, with a strong emphasis on social housing and market regulation. 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.

With the reduction in subsidies, housebuilding collapsed from around 65,000 units annually in the early 1990s and then languished during the rest of decade to reach a low point of 11,000 units in the late 1990s.[3] It rose in the 2000s, though still remained low by both international and historical standards, only to fall again with the onset of the financial crisis. At the same time, demand has been expanding rapidly, so that an inevitable outcome has been housing shortages and rising prices.

Despite the apparent withdrawal of the state, the housing market is surrounded and structured by a series of state-determined constraints, incentives and policy initiatives that have been subject to little change in recent years. 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, the distributional and efficiency consequences, and the degree of flexibility to cope with surges and declines in demand.

The distribution of housing opportunities favours incumbent households over newly- or recently-formed ones and others wishing 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 governments to cut property taxes and to put housing market reforms on the back burner.

Owner occupation has become the sole option for housing aspirations of many in a situation of constrained supply. This has encouraged a long trend of 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, has led to types of inequalities that the original interventions were supposed to smooth out.

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.[4] Therefore, slightly less than 60% of the housing stock is now owner occupied, well below the EU average of 70%. 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.

Statistics on tenure shares have to rely on limited surveys but it does seem as though owner occupation is growing. The biggest stimulus to homeownership is through tenant-ownership, both in terms of new build and conversion of private rental properties. Conversions have been so substantial in the major cities that little private renting remains in inner Stockholm, for example. Annual sales of existing tenant-owned properties now considerably outpace sales of single-family houses - 93,000 compared with 52,000 family houses in 2008, for example, according to Statistics Sweden, with around 80% of the turnover by value in the three major cities.

Tenant-owner may seem like a contradiction in terms to many but makes sense under the Swedish system of property law. 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. Each owner tenant has an equal share in the co-operative, although the open market values of individual apartments may vary substantially.

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 conversion and modernisation of a previous rental apartment block. In either case, the new association takes out a mortgage for most of the cost, with the remainder financed through contributions from co-operative members in exchange for a tradable right to occupy a specific dwelling. These contributions may be cash-financed or, more typically, funded by a down payment and personal mortgages, provided under similar conditions to mortgages on single family houses.

[4] *Regular National Report on Housing Development in Sweden 2005.*

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Housing co-operative members are charged monthly fees to cover the costs of the mortgage taken by the association, administration, taxes and insurance, 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 severe housing market downturn has not really been tested yet.

Tenant-owned co-operative dwellings are playing an important part in slowly increasing the role of owner occupation in Stockholm and other major cities, where traditionally renting has predominated and where the cost of single family housing is particularly high.

Most conversions are from previously privately rented properties. 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.

Taxes and subsidies

Overall, the tax system encourages house purchase over other investment options. 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 but that has been abolished. There is a capital gains tax of 30% on two-thirds of any price rises. However, this can be deferred as long as another owner occupied property is bought, and the rule applies to heirs as well. Tenant-owner apartments have a somewhat distinctive tax regime, though it roughly approximates in average incidence to that for owner occupation. Both enjoy the possibility of a tax rebate on 50% of the cost of repair, renovation and extension work undertaken on their homes.

A wealth tax was abolished in 2008 and a national real estate tax was ended in the same year, to be replaced by a typically lower municipal property fee. Overall, recent tax changes have helped to sustain the buoyancy of house prices.

Housing cost assistance of up to a third of outgoings is provided for lower income households, other families with children, and pensioners. Around a fifth of all households are in receipt of it, 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.

[5] *Housing and Housing Policy in the Nordic Countries, M. Lujanen (ed.) Nord, Copenhagen, 2004*

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Rental housing

Social housing is predominantly owned by municipal housing companies (MHC), which are 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.

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. Rents 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. 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.

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 are sufficient to attract investors. The SFI/IPD Sweden residential index had average returns in 2009 of 5.2% evenly split between income and capital growth.

The regulated rent setting process means that rents in attractive urban locations are often well below market clearing levels. 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.

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 benefit 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 in nominal terms to rise, because costs are increasing. However, there are variations across regions, with Stockholm having the greatest divergence of actual from potential market rents and the rents on social housing in some of the depressed regions of the country probably being higher than open market levels. As rents have not risen to reflect prevailing market shortages in an era when house prices are rising, investment in new rental housing is, outside of the luxury sector, generally unprofitable and so does not occur.

There has been no equivalent of the UK’s pre-2007 buy-to-let boom. 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 stock.

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 is high – though there is a serious problem with rundown social housing estates built in the 1970s and 80s and high vacancy levels. At the turn of the century, around 40,000 dwelling were being demolished each year, more than were being built, to reduce the number of poor quality vacant dwellings. The number torn down has diminished in recent years but still runs at 10,000 or more a year. In 2009, there were 34,000 vacant rental dwellings, mainly in smaller municipalities in declining regions.[6]

[6]*Housing and Building Statistics Yearbook, 2010.*

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Housebuilding

Housing completions were rising quite significantly in the 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 11.3). Within the owner sector in the last years of the boom, a surge in apartment building in tenant-owner co-operatives boosted output (Figure 11.4).

Housing starts peaked in a major spike in 2006q4, because that was the last period when state building subsidies were on offer and, so, projects were brought forward to qualify for them (Figure 11.3). Growth in housing completions then continued into 2008 as those starts were built out but fell away after that. Excluding that spike, total starts fell by around 50% to the trough in 2009 and have risen since then but still remain at a much lower level than before the crisis. However, it should be noted that subsequent revisions to these data may reduce considerably the apparent decline, because often there are substantial upward revisions to the published information. Housebuilding may continue to rise in 2011, although the most recent permits data did not indicate a surge in applications and an expected slowdown in the market may dampen the optimism of builders.

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, limited competition, low levels of construction imports, and heavy regulations – all of which constrain competition and innovation.[7]

Supply responsiveness is affected by land supply constraints. Land shortages occur for NIMBY reasons. Complex and lengthy processes of plan formulation and then appeals procedures generate considerable delay even where residential development is permitted. Furthermore, the structure of local authority finance discourages new development. Until the 2008 reforms, no local taxation was derived from property and municipalities still have large upfront costs, with little prospect of payback for many years to come, so the incentives still do not seem that positive.

Supply-side delays can spring up for ostensibly unexpected reasons. For example, the owner co-operative form of housebuilding may be the fastest growing tenure, but the process of setting up a co-operative is slow and cumbersome. So, the tenure is a tardy means of getting new housing on stream.

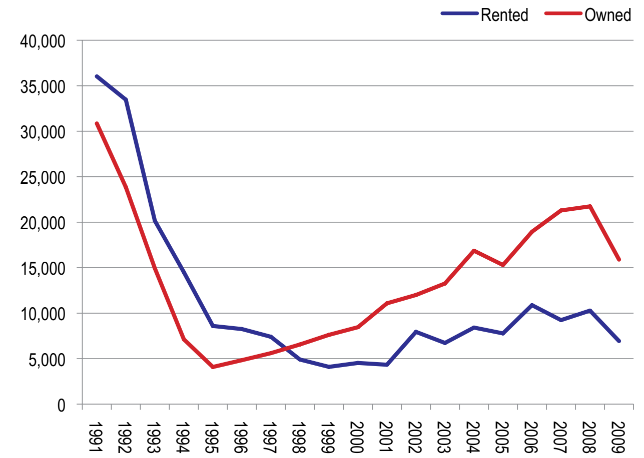

Figure 11.3: New housebuilding by tenure, 1991–2008

Completions
Note: Owned includes single family houses and tenant-owned apartments
Source: Statistics Sweden

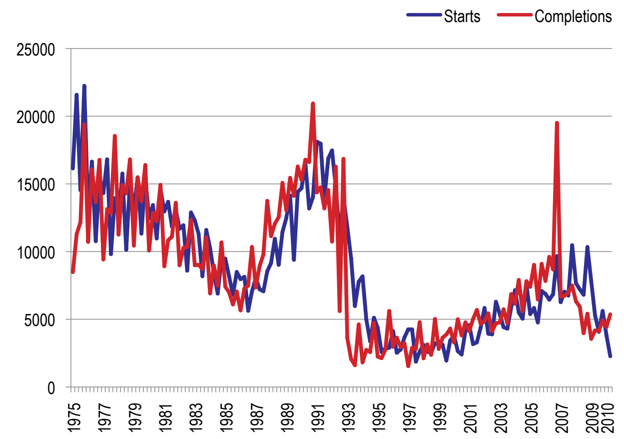

Figure 11.4: Housebuilding: a long view 1975–2010

Starts
NB: Recent quarters may be under-recorded by up to 30%
Source: Statistics Sweden

[7] 'The Swedish housing market – better allocation via less regulation' OECD Economics Department Working Paper no 559, 2007.

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Macroeconomic influences

The economy fell into recession in 2008 and that deepened during 2009. However, the bounce back in 2010 was strong at over 4% and is expected to continue for at least the next two years. Previously, the economy had been in a long expansion phase, surviving a minor blip in 2001 and 2002. This strong economic performance underpins housing demand.

The slowdown in the economy squeezed out inflation, which had been rising in the years prior to 2008, and it is expected to continue to be low. Unemployment at 8% is an indicator of continued excess capacity, which may be around for several years to come. Until 2008, job creation had been high in the booming regions and unemployment fell rapidly, and those regions are recovering fastest now. 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.

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 fiscal deficit is currently relatively low at 1% and it is expected to disappear soon.

Mortgage market influences

Mortgage growth has been strong over the past two years, encouraged by low interest rates and a strong economy (Figure 11.5). Earlier, the collapse of Lehman Brothers in autumn 2008 badly affected Swedish capital markets, as elsewhere. Difficulties were concentrated in mortgage-backed securities and the spread between 5 year mortgages and government bonds rose from 60 basis points in January 2008 to touch 200 basis points in September of that year. It then fell sharply from March 2009, heralding the current period of low loan costs. The average rate on 1-5 year fixed-term mortgage loans fell to 3.05% in December 2009 and did not rise by much in the months to follow (Figure 11.6).

Despite the problems generated by the credit crunch, mortgage lending has remained strong. Lending to households for housing purposes grew by around 9% in 2009 and by 10% for most of 2010.[8] So, a mortgage famine as experienced in some countries like the UK has not occurred in Sweden. Nonetheless, lending institutions have become more cautious and have tightened up their lending criteria, including the limiting of maximum LTVs, as noted earlier, and the withdrawal of interest-only loans for new borrowers.

Variable mortgage rates have fluctuated quite significantly for a number of years. 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 and by the end of 2008 had reached virtually the same level as 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 initially reflected in mortgage interest rates. But from the end of 2008, they fell substantially for variable rate products, where rates fell to only around 1.5% but since then have crept up as the repo has been lifted and by autumn they averaged just over 2% (Figure 11.6).

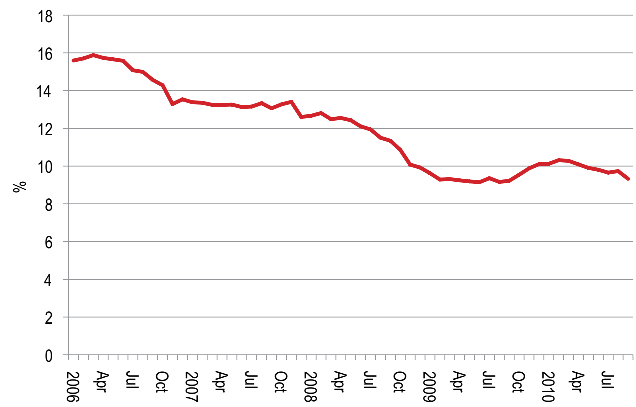

Figure 11.5: Growth in housing loans to individuals Jan 2006–Sep 2010

Source: Statistics Sweden

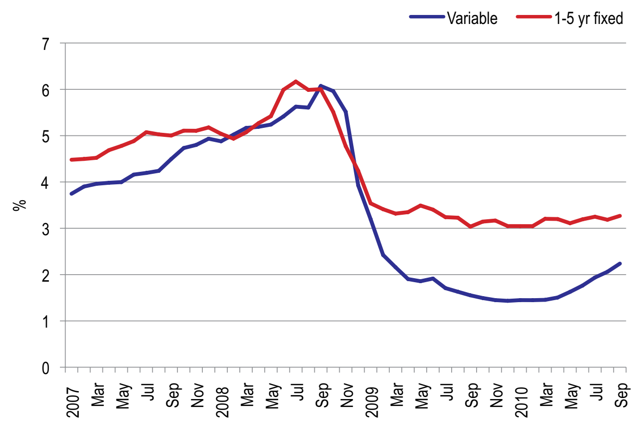

Figure 11.6: Housing Credit Institutions' lending rates on new business, Jan 2007–Sep 2010

Source: Statistics Sweden

[8]*Statistics Sweden.*

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The government took strong action to protect the financial system in 2008. As well as stepping up the provision of liquidity, the stability plan of 20 October 2008 included a guarantee programme of up to a maximum of SEK1,500bn to support the medium-term financing of the banks and mortgage institutions and to set up a long-term 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.[9] This has encouraged liquidity and kept the supply of mortgage credit growing.

Lending grew strongly during the course of the long housing market upswing, aided by loosening credit conditions and competition between mortgage providers. The sharpest increases were associated with tenant-owned properties; where borrowing is now over nine times the size it was in 1998.[10]

There has been limited mortgage churning caused by households refinancing their debt because of the use of flexible interest mortgages and the typically five year renegotiation clause in fixed interest contracts. There was some equity withdrawal during the boom years but over the past few years it has turned negative as many households attempt to lower their leverage.

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 were prepared to offer 100%+ loans. Interest-only loans also became more common, prior to the crunch. Lending terms may have been curtailed but still remain relatively relaxed compared to some other countries. However, the central bank remains unconcerned about the ability of most households to finance their debts, and expects further debt growth, because of the current attractiveness of borrowing. It also thinks that the risks of mortgage debt to the financial system remain slight.[11]

As interest rates are slowly rising, this should dampened mortgage demand. The cause is not solely monetary policy, but also non-domestic influences on credit markets such as the turmoil in the Eurozone countries and the rising cost of bank capital under new international arrangements.

Traditionally, single-family owner occupied housing was mainly 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 the most important as they have resulted in lower monthly outgoings and households have probably expected to be able to switch to fixed rates if interest rates rise, which in some other countries proved to be a risky strategy.

Variable rate mortgages peaked at over 80% of new loans in 2009 but declined somewhat in 2010 as interest rates rose and the spread between fixed and variable rates narrowed (Figure 11.7). Even the fixed interest rate market is now dominated by terms of five years or less.[12] With two-thirds of outstanding mortgage debt now linked to variable interest rates, the impact of short-term interest rate changes on the housing market is much stronger than in the past when for most borrowers they mattered little as their own rates were fixed for long-periods.

A significant innovation has been the recent development of the covered bond market, which has come to be a large source of funding for mortgage lending, even though the first were only issued in 2006. Outstanding mortgage bond values amounted to SEK133bn by 2009, of which 40% had been issued in that year alone.[13] Most outstanding amounts of other types of mortgage securities have been converted to covered bonds. Covered bonds are more creditworthy than residential-mortgage backed securities for a variety of reasons, including special rights in bankruptcy. To secure this important new source of finance and enhance the chances of retaining the highest credit ratings for the country's covered bonds, a new Act was passed in 2010 aimed at extending the mandate of the administrator in bankruptcy in the event of the default of an issuer.

Mortgages are provided by Housing Credit Institutions (HCIs), a type of mortgage bank which is often part of broader financial conglomerate, and also by commercial banks. HCI's have a market share in autumn 2010 of around three-quarters of the total mortgages lent to individuals. 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 the bonds issued in 2006 were denominated in foreign currencies indicating foreign interest prior to the financial crisis as well.

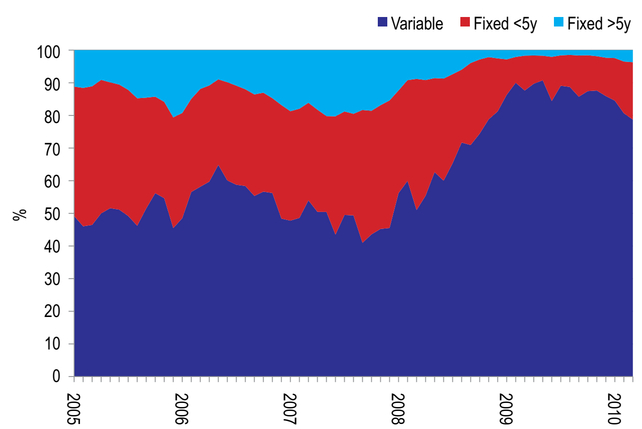

Figure 11.7: New mortgages by interest rate fixation 2005q1-2010q1

Source: Statistics Sweden

[9]Swedish Central Bank, Financial Stability Report 2/2008.
[10]Central Bank.
[11]Central Bank, Financial Stability Report, June 2010.
[12]Swedish Central Bank & Statistics Sweden.
[13]European Covered Bond Council.

CHAPTER 11: SWEDEN

There is some guaranteeing of mortgage loans by an apparently 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%.

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). The two largest HCIs, Stadshypotek and Swedbank Hypotek, have about 60% of total HCI business.[14]

Demographic influences

The population is growing and the birth rate has risen to just less than two per woman of child-bearing age. Immigration has also been rising. So, population forecasts have recently been scaled up. The most recent estimates suggest that the population will grow by 7% over the next decade.[15]

The share of the population over 65 is only expected to grow by 360,000 up to 2019, but there are expected to be almost 800,000 people aged over 80 in twenty years' time, so that the problems of an ageing society are going to affect Sweden but by less than in some other parts of Europe. However, as so many households already consist of one or two people, household numbers are not expected to rise much faster than the population itself. Amongst those of working age, 18% of them were born abroad and this number is expected to rise to almost a quarter of the 25-64 age band by 2030, partly reflecting immigration but also the low birth rates of recent decades.

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.

[14] *Swedish Central Bank.*
[15] *The future population of Sweden 2010–2060, Swedish Statistics, 2010.*

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