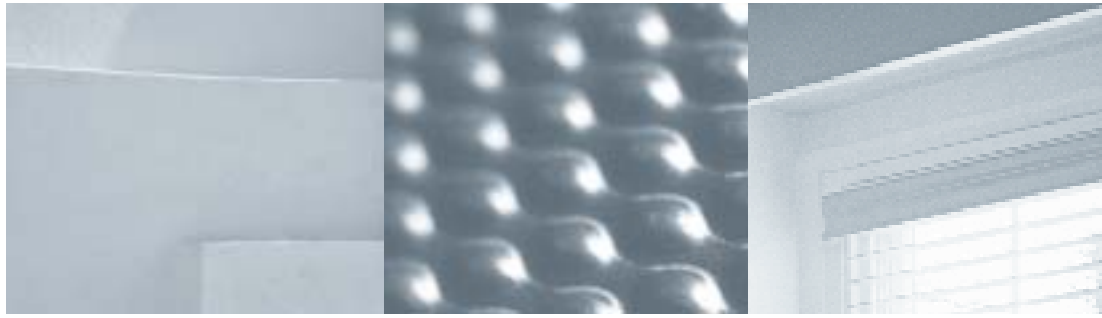


RICS European Housing Review 2005

Michael Ball

2005



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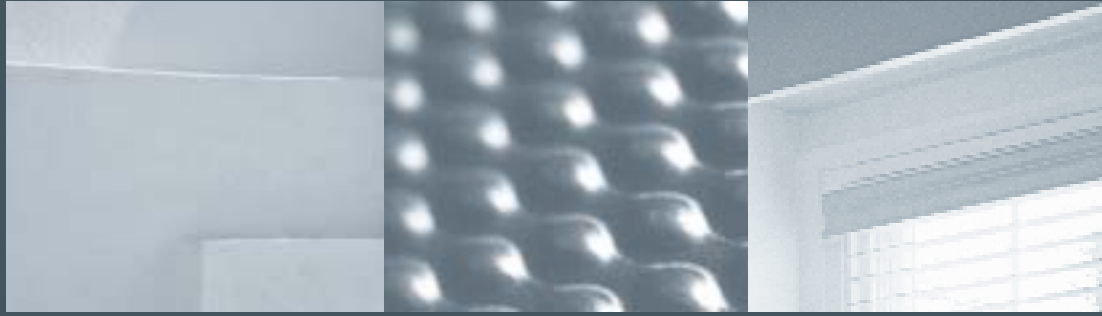
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Introduction

Interest in EU housing markets has expanded considerably in recent years. So, there is a growing need for information on housing in individual countries and for comparative housing market analysis across the expanding EU.

This Review aims to

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

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

Given the expansion of the EU in 2004 to 25 member states, it has not been possible to provide individual chapters on all the new accession countries. All of the old EU15 are now covered with the exception of Luxembourg – Portugal is a new addition this year. Of the new member states, country chapters have been researched and written for Hungary and Poland and an overview chapter on housing in the new accession countries is provided in Chapter 3. It is hoped to expand the range of countries in future editions. Switzerland has also been included because it has a particularly interesting housing system and good data.

Emphasis is put on residential markets at the national level where regional issues of particular significance are considered, but it is beyond the scope of this study to undertake detailed regional and city analyses. Primary use dwellings are concentrated upon, though in this year's Review, Chapter 2 presents an overview regarding second homes in Europe.

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

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.



chapter one

Housing markets in Europe

Overview

European housing markets continue to grow

Key messages

- Housing markets surged in most European countries in 2004. All the major market indicators, including house prices, transactions, housebuilding and mortgages, showed strong growth.
- There seems to be little chance of a crash in any of Europe's housing markets in 2005.
- The main drivers of this housing market strength were continued low interest rates and improved economic growth in national economies which helped to boost consumer confidence. The worst performing housing markets still tended to be those with the weakest economies.
- Three countries maintained double-digit rates of house price inflation throughout the year. These were France, Spain and Ireland.
- Many other European countries saw price rises of between 5-8%. These included Belgium, Sweden, Finland, Portugal, Italy and Denmark.
- The UK was the only country to see its housing market falter. After the summer slight price falls were reported and mortgage demand was down.
- The German housing market remained flat but showed some signs of revival late in the year.

Overview

2004 was another strong year for most EU housing markets, more so in fact than 2003. This becomes particularly clear when the mixture of relevant indicators is taken into account. These include prices, transactions, housebuilding and mortgages.

Only Germany of the larger countries had a stagnant housing market throughout the year, a situation that has existed for some time now. But even there, signs of increased mortgage demand by owner-occupiers in the second half of the year suggested that the long downswing in its housing market cycle may finally be over. Elsewhere in the EU, only Austria and Hungary of the 17 countries surveyed here had relatively poor housing market years.¹

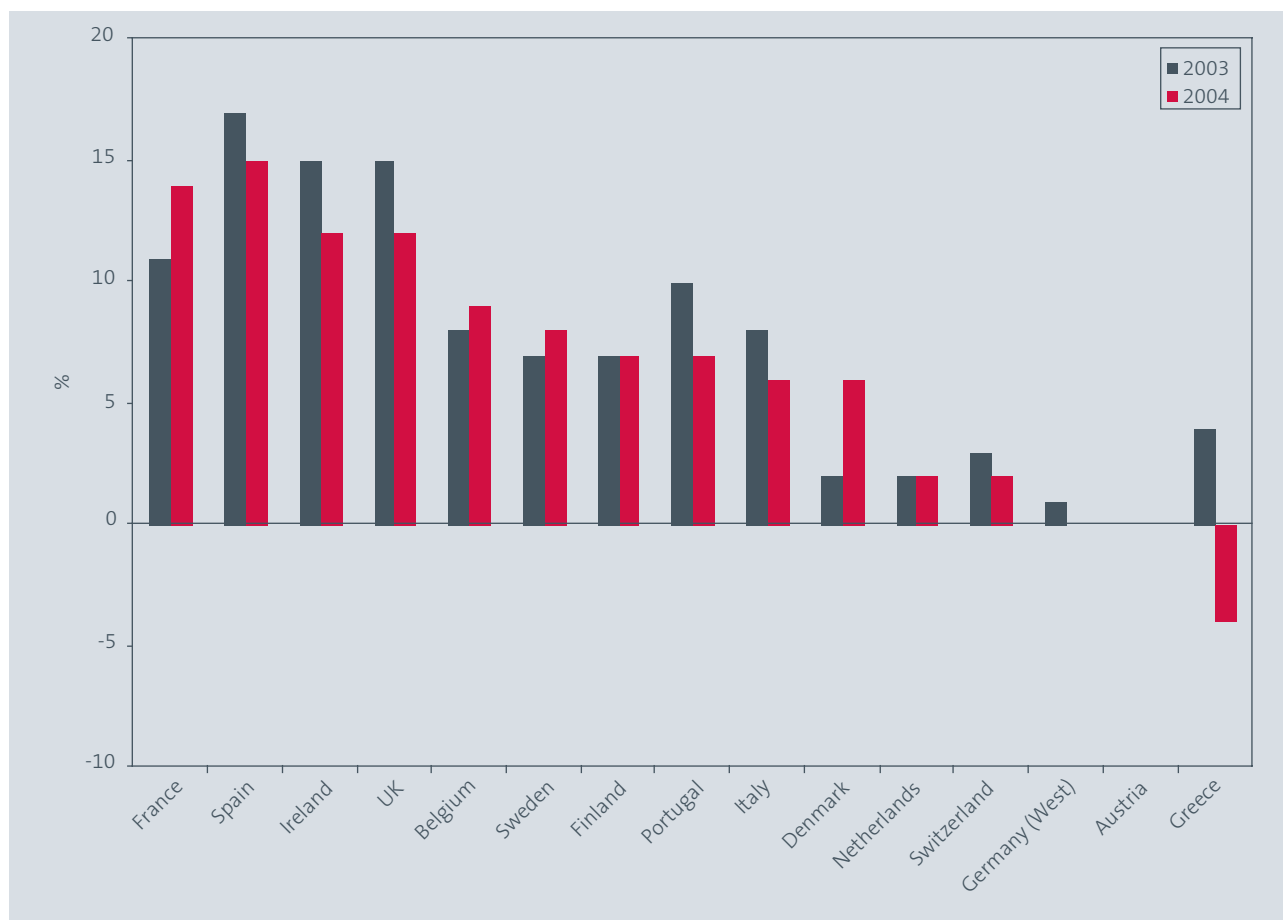
The main drivers of this housing market strength were financial and economic. Continued low interest rates in the Euro area – and cuts in some other countries, notably Sweden – kept down the cost of mortgage borrowing. Economic growth was also better than in 2003, even if in Germany and a few other countries it was still below par. This helped to boost consumer confidence. As in previous years, the worst performing housing markets tended to be those with the weakest economies.

By the second half of 2004, only one country – the UK – seemed to be heading in an altogether different direction. Its long boom ground to a halt in the summer of 2004 after a series of interest rate rises by the Bank of England. Because the UK has a predominantly variable rate mortgage system, central bank interest rate changes directly affect mortgage costs. Nevertheless, the full impact of the interest rate rises does not seem to have yet been felt by new borrowers, with lenders absorbing some of the impact in reduced spreads.

From rising at double digit levels in the first half of the year, UK house prices stopped growing and may have even fallen slightly in the second half of the year, unsold houses hung on the market, and mortgage demand fell noticeably. Even so, year-end prices were still significantly up on 2003, because of the strong increase in the earlier part of the year. Although most commentators have finally written off the UK boom, more realistically this will depend on interest rate movements and how house sales go in the traditional crucial spring season to come in 2005.

1. Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Netherlands, Poland, Portugal, Spain, Sweden, Switzerland and the UK.

Figure 1.1: House prices rises in 2003 and 2004(forecast)



Sources: Various, see country chapters, and UPE estimates.

House prices – The booming, the strong and the flat

Figure 1.1 shows forecast 2004 out-turn rates of house price inflation across Europe. The new accession countries in the survey are not included because they do not have particularly good house price data, though some comments are made in the text.

Several countries show slight declines in their rates of inflation but, frankly, such changes matter little as they are probably within the bounds of accuracy of the house price data. Many countries, in other words, saw similar house price rises in 2004 to those in 2003.

Two countries experienced marked increases in house price inflation. For Denmark, the increase was from a period of stagnation to renewed, but relatively moderate, real price growth. For France, in contrast, greater force was applied to the price accelerator. Price rises had already reached double figures in 2003, but in 2004 they raced ahead of the rest of Europe, with strong rises in the Paris area as well as in the Mediterranean regions – the areas with the most inflation a year before.

There are now three categories of country with respect to house price inflation in Europe:

Very high, double-digit inflation countries

This group includes **France, Spain, Ireland and the UK**. However, the UK may have now spun out of the inflationary race, as mentioned earlier. **Poland** may have joined it in 2004 if the informal price indices there are to be believed, partly on the rebound from a severe housing market recession in 2002 and 2003.

Each year for the past three or four years, pundits have predicted that the following year would herald a market slowdown in the booming residential markets of Europe. Yet, the UK apart, the slowdowns have failed to materialise. Low interest rates, instead, have continued to feed beliefs that capital gains can still be made out of housing and, to an extent, they have become self-reinforcing.

Strong inflation countries

These are **Belgium, Sweden, Finland, Portugal, Italy and Denmark**, all of which in 2004 had annual price rises hovering around the 5% mark in real terms. 5% may not seem so large compared to the very high inflation countries, but that rate of increase highlights that their housing markets are still in the upswing phase of the housing market cycle and most of them, with hiccups, have been in that phase for well over five years now. Moreover, such price rises are unsustainable in the long term. For example, they would imply that real house prices would rise by 55% every 10 years or double in real terms every 15 years, requiring the transfer of national wealth to house owners from non-owners on a substantial and unlikely scale.

Flat (low or zero rate) inflation countries

These are the **Netherlands, Switzerland, Germany, Austria and Greece**. The reasons why their markets are in such situations vary.

Austria, Germany and Switzerland all had chronic excess supply overhangs from the 1990s plus below trend rate economic growth. Switzerland recovered from its late 1990s housing market downturn a few years ago, but the experience has made housing market investors cautious in this predominantly rental country. Therefore, they – and owner-occupiers – are still reluctant to bid up prices, despite favourable interest rates. Also Austria and Germany, apart from the East, have now mainly recovered from early housing market downturns, and may experience stronger demand in the coming years. Much of this potential expansion is likely to come through a growth in owner-occupation, especially in Germany, where policy is now directed towards encouraging ownership after decades of renter biases.

The Netherlands and Greece have come out of a different phase of the housing market cycle to the previous three countries. In both of them, house prices boomed until either 2002 or 2003, then suddenly stopped growing. (The fall in Greece should be treated cautiously, as the data are not quality-adjusted and refer to Athens only – zero is probably a better guess than falling prices.) The Netherlands, in fact, had one of the highest increases in real house prices of all European countries between 1995 and 2001.

Neither country shows much other evidence of stagnation. Mortgage demand in Greece in 2004, for example, continued its large-scale expansion, growing at 25% a year in late 2004, and new housing investment also remained strong. In the Netherlands, transaction levels have stayed high in recent years, and have even increased in some of the major cities. Greece and the Netherlands may indicate that a soft landing is possible when interest rates and economic variables are relatively benign.

In **Hungary**, prices seem also to have flattened out in 2004. The explanation in this case relates both to the relatively undeveloped state of a market-based housing system and the impact of shifts in policy regimes. Generous interest rate subsidies stoked up demand from 2000 onwards, but were then cut early in 2004, precipitating the downswing in the market.

None of the countries with low house price rises show indications of an imminent crash. Instead, it may be the countries with the highest price rises that face the greatest risk of future market crashes.

Supply-side responses

New housing supply is one of the bugbears of Europe. Getting it in the right place, of the right type, and at the right quality has proved difficult over the past decade, no matter the prevailing level of house prices.

Several countries in 2004 showed marked upward shifts in housing supply, even if in many others the dismal story of little new output continued. Interestingly, the three very high inflation countries – France, Ireland and Spain – had some of the biggest increases in housing output. However, it is unclear whether the extra output was at locations that could help to satisfy primary housing demand. In all three countries, second homes absorbed significant amounts of new housing production, as did smaller cities where supply constraints are easier. In Spain and Ireland, the amount of supply in the capital cities continued to falter, falling sharply as shares of national output.

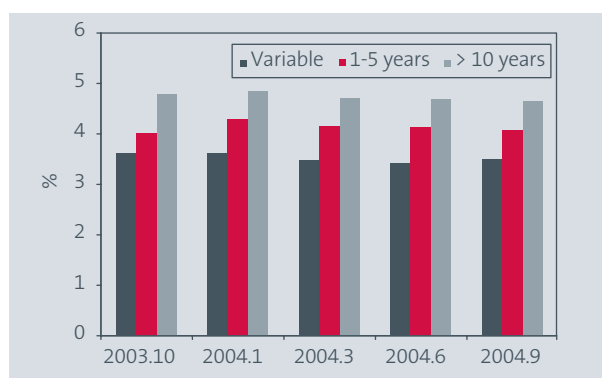
Low interest rates, high mortgage demand and tax breaks

Low interest rates continued in 2004 in most European countries, stimulating mortgage demand. They go a long way to explaining current strong house price growth in many European countries.

Housing demand has been boosted by loans growth in each of the three remaining countries with very high house price inflation. Elsewhere, outstanding mortgages expanded as consumers took advantage of the cheap costs of borrowing. The two major exceptions were Germany and, from the second half of the year, the UK.

Once again in 2004, real mortgage interest rates were substantially negative in Ireland and Spain, especially taking into account mortgage interest tax relief in those two countries. France does not have mortgage interest tax relief but, instead, offers subsidies on savings schemes and for many newly-built and renovated properties. Spain and Ireland rely predominantly on variable interest rates on mortgages, and European Central Bank (ECB) data estimated that they averaged only 3.49% in the Euro Zone in the autumn of 2004. Rates on long-term fixed rate mortgages had also improved over the year as bond yields fell (Figure 1.2).

Figure 1.2: Average mortgage interest rates in the Euro-zone by type of mortgage rate fixation 2003-2004



Source: ECB

The major exception to lower interest rates was the UK. Interest rate rises there had a dramatic effect on the housing market, suggesting that people were interpreting them as a signal of the end of positive capital gains expectations.

The positive housing demand impacts of lower interest rates are substantial, even though house purchase is a long-term investment. Temporarily low interest rates are favourable to house price growth, because they encourage optimism about the benefits of buying and raise expectations of short-run capital gains from rising house prices.

Low interest rates also encourage tenants to cease paying rents and buy houses instead, often on repayment terms that at the time may well be cheaper than the equivalent monthly rents. Cheaper borrowing, in addition, induces many new buyers to look for more expensive homes than they would otherwise have done. Many existing homeowners experiencing falling mortgage costs can now afford to move to a better home or to borrow and upgrade their existing dwellings. In turn, more private investors are willing to contemplate housing as a high-leveraged asset class, borrowing and buying in order to rent out to prospective tenants.

Lower interest rates, furthermore, encourage re-mortgaging in many countries, especially where the penalties for doing so are small. When house prices rise in the wake of lower interest rates, homeowners are also tempted to borrow more on the security of their homes and spend the cheap money on non-housing goods and services. Mortgage markets, fuelled by re-mortgaging and equity withdrawal, may as a result expand even faster than increased housing demand.

Overall in the Euro Zone mortgage long-term household debt was growing by 10% a year on an annualised basis throughout most of 2004. The debt to disposable income ratio has been gradually rising in the Euro Zone: from 65% in 1995, to around 85% in 2003. Yet, falling interest rates in the last few years have actually cut the interest rate to income repayment ratio. Moreover, the Euro Zone household debt to GDP ratio was still far lower than in other advanced economies, including the UK. So, the ECB is relaxed about the overall mortgage debt situation.

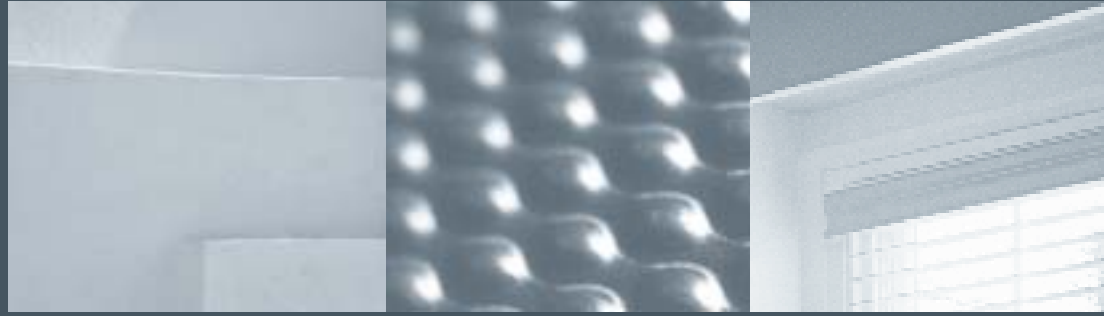
However, the average mortgage data for the Euro Zone mask sharp differences between countries. The tranquil housing markets of Germany have dampened average mortgage expansion, because of the importance of its mortgage market in the overall Euro Zone data. Meanwhile, in contrast, mortgages are growing rapidly in those countries with booming housing markets. Individual national central banks, therefore, are often more concerned about the debt positions of their own citizens, most notably in the countries with very high house price inflation.

Strong growth in mortgage and housing demand was experienced even in the countries where house price data indicated that markets are stagnant. Greece saw the value of outstanding mortgages grow by 23% in the first 9 months of the year, despite a forecast fall in house prices. Housing transactions were strong in the Netherlands, even though there have been several years of price stagnation after a pre-2001 boom.

Overall, there does not seem to be a strong likelihood of a crash in any of Europe's housing markets in 2005. Much, of course, depends on the future path of nominal interest rates. On the one hand, if they stay low, another strong year may be in prospect. On the other hand, if they rise in response to inflationary pressures, the squeeze will be on housing throughout Europe. Price expectations are also driving market developments in a number of countries and they can easily alter.

Housing markets are notoriously difficult to forecast. They are also subject to well-documented and studied housing market cycles. The timing of those cycles between EU countries varies substantially, and the current state of Europe's housing markets indicates this is likely to remain the case in the future.

One country whose housing market currently is clearly out of synchronisation with the rest of the EU is the UK, partly because interest rates are set independently. The current market upswing also started some years before that of most other EU countries. The UK has experienced one of the biggest housing price rise and mortgage debt booms of all countries in recent years. Whether it is heading for a housing market collapse or not is considered in depth in its own country chapter in this Review. Overall the prospect of a major crash seems remote.



chapter two

The second home boom

Overview

This Review is mainly concerned with primary residential markets, that is, people's first homes. Yet, many European households have more than one dwelling – a second home – which is not rented out in the privately rented sector. It may be in their own country, in another part of Europe or even elsewhere in the world, and it may be rented out occasionally, but is generally directly used by one family only. Occasionally, second homes are rented from someone else, but most are owned directly.

A part of the leisure industry

The motives for owning a second home may relate to employment when jobs are not near primary residences¹, but the majority are associated with leisure activities. Though leisure considerations predominate, the investment characteristics of properties are generally still important, because quite significant proportions of household asset holdings are often tied up in them. Some households may, in fact, rent their first home and own a second one as a way of investing in the housing market. This pattern is common in the northern European countries with relatively high shares of renting, including France, Germany, the Netherlands and Scandinavia.

Another motive for having a second home may relate to urban lifestyles. Countries with large amounts of city accommodation in dense blocks of flats encourage the use of second homes as a way of having some contact with a more spacious, 'fresh-air' type of environment by the sea, in the countryside or in the small town from where family members originate. Hungary, Sweden, Denmark and the Netherlands are such cases. In places where summers are very hot, the need for a place away from the city becomes more important. For example, many Greek, Italian, Spanish and Portuguese families own or aspire to own a second-home. Unsurprisingly, the UK, with its moderate climate, expensive housing and high proportion of urban dwellings with gardens, has traditionally ranked relatively low in the European second-home league.

The second home market consequently has long influenced acceptable built forms in the primary housing markets of many European countries. Leisure pursuits, in fact, can directly affect primary residential accommodation. For instance, in recognition of the growing demand for a link between housing and outdoor leisure pursuits, some up-market suburban developments for primary dwellings now focus on providing large, enclosed estates with resort-style facilities or developments around golf-courses. This style is a growing trend, especially around the major towns in Southern Europe where warmer climates mean that the facilities can be enjoyed all year round.

The linkages between the second home, retirement and investment housing markets

Another important linking factor is the congruence between second home markets and the locational demands of retired people. Unsurprisingly, retirees are attracted to the same places that people like to go to on weekend and holiday trips; especially the more active younger ones who have a low risk of shortly needing intensive personal care or regular medical attention. Those that do not stay in the place where they have lived all their lives tend to search for the sea and the sun. Family ties generally determine the order of importance between the two.

When a retired couple move their home to a new location they are clearly moving their primary residence, but they are also competing in a similar market place to younger households buying their holiday homes. The latter themselves might also be thinking of spending more time in their newly acquired second home as they age. The fortunes of second home and retirement housing markets, consequently, are closely entwined.

Holiday homes can also be lucrative investment opportunities, combining capital growth with good rental income, at least for part of the year. Tourists are prepared to pay high rents in season and, furthermore, short-holiday lets fall outside of the remit of the frequently stringent security of tenure and rent control laws in many countries. Investors can be attracted to the segment as a result, especially when they believe it offers the prospect of good capital gains. Much Spanish purchase of coastal property in recent years, for example, has been for such investment purposes.

¹ 17% of second homes are used in this way according to a recent English survey. Survey of English Housing 2002/3.

Where are second homes most important?

The shares of second homes in housing stocks across the EU vary considerably. Some of the highest are in Southern European countries, both because of high local demand and interest from throughout Europe in such classic holiday destinations. In such countries as Greece, Italy, France and Spain between 10 and 15% of all dwellings are second homes.

Second homes in several northern European countries are important as well, particularly in Scandinavia and other countries with long coastlines, such as Ireland. The Netherlands has 94,000 holiday homes, mostly near the coast, equivalent to almost 15% of its primary housing stock.² Of course, not all second homes are of the same standard as primary residences. For the functions they serve, they can be quite modest, yet others are significant properties.

Accessibility is an important facet of second homes; otherwise exhausting journeys negate their beneficial leisure impact. So, it comes as no surprise that attractive localities most accessible to major cities generally have the highest rates of second homes.

In Spain, for example, it is not the coastal areas that have the greatest shares of second homes but, rather, the provinces around Madrid. The highest, at 42%, is Avila, followed by 38% in Guadelajara, according to 2001 census data. The areas around the major coastal cities of Barcelona and Valencia also have high concentrations of second homes. In central Europe, the motorway between Budapest and Lake Balaton is crowded at the weekends with Budapest residents travelling to and from their second homes.

What determines the size of the second home market?

Differences in national and personal preferences, lifestyle fashions, climates and local physical geographies all play important parts in understanding the scale and location of second homes. However, economic and financial factors are important as well.

Household incomes in the EU are rising over time, so the demand for income-sensitive leisure goods, like second homes, is increasing. This helps to explain the high demand for weekend homes in Scandinavia – affluence there spread throughout the social strata many years ago. Moreover, with regard to costs, many expenses associated with leisure homes have been falling, as will be discussed below. So, income and price effects have both been moving in the right direction for some time and can be expected to for years to come.

Transport prices are falling for a number of reasons. The development of low-cost airlines is an oft-cited reason. The decisions of particular airlines about where they fix their routes can have an enormous impact on local property values. Some countries are poorly served, and their role in Europe's second and retirement home markets has been relatively declining as a

result. The Greek islands, Portugal and Turkey, currently outside of the EU, are clearly on the sidelines of the budget airline revolution. The prime reason seems to be protecting local, financially stretched airlines.

Long-distance surface travel is also improving, with better motorways and, on occasion, rail services. Perhaps most important is the real cost of car travel, which is much lower than it was two or even one decade ago, despite recent rises in the price of fuel. This means that people can now drive more easily and cheaply to their second homes than ever before.

Furthermore, a whole range of domestic technology has improved and fallen dramatically in price, so that having to provide two kitchens – one for the primary and one for the second home – is much cheaper than it would have been 10 years ago. The same goes for a whole range of consumer goods ranging from home security to wardrobes of spare clothes to avoid the drudge of packing every time a journey is made between the primary and second residence. What was only feasible for the very rich in the 1950s and 1960s is now commonplace as a result.

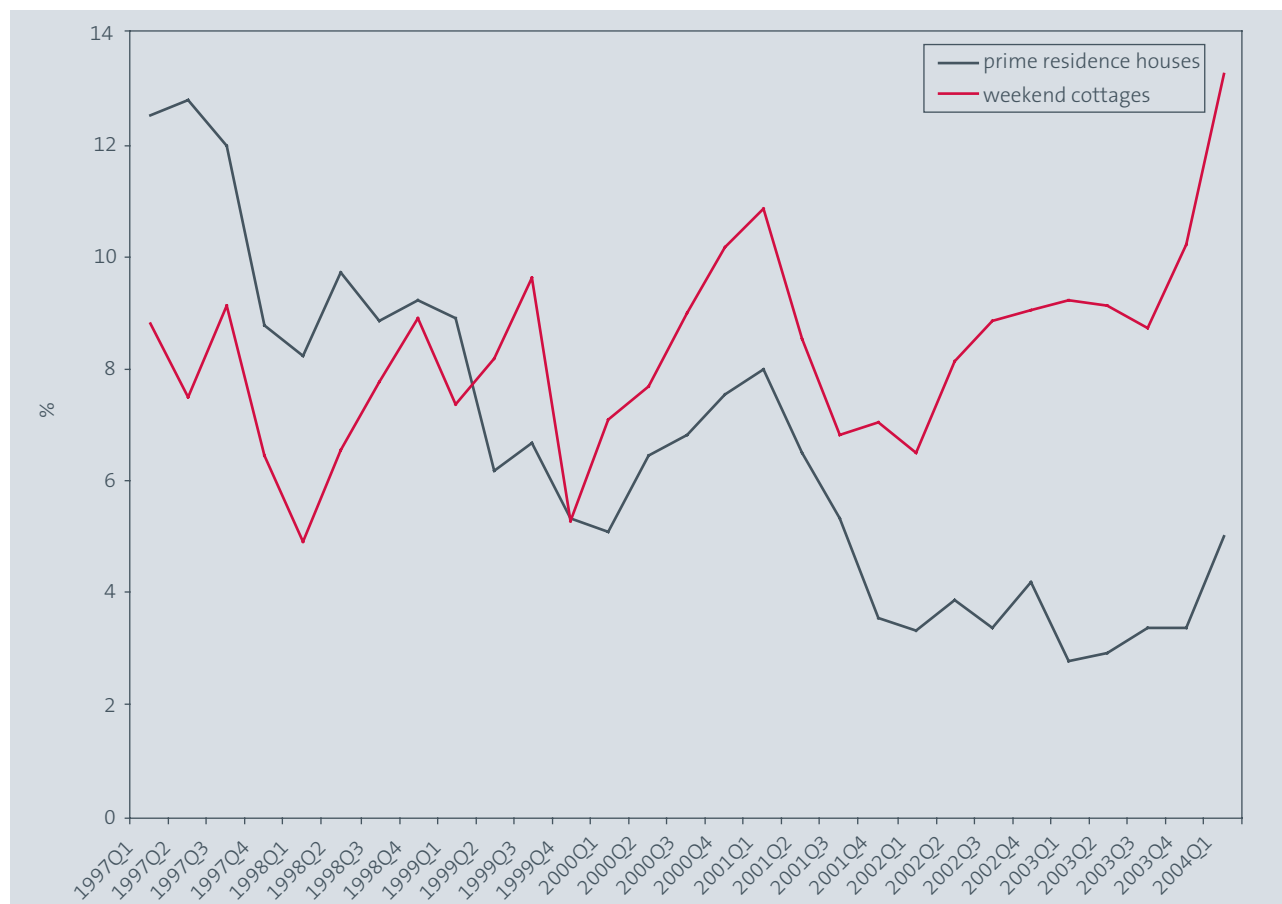
Another important factor has been the development of the EU itself. For example, structural funds are often used to improve facilities in the regions where second homes are located. Most significant for the growing cross-national trade by both holiday and retiree buyers in housing markets has been the ability of all EU citizens to buy property in other countries. Some new accession countries are concerned about this, while their living standards and property values are so low compared to the old EU, and have negotiated delays in this right. The Czech Republic, next door to affluent Germany, has managed to secure a 5 year freeze, for instance.

The right to live, reside and buy property in another EU country has had other knock-on effects. Access to local mortgage finance is possible and, given the lack of pan-European financial integration, may be cheaper than in the person's country of origin. People can also move their prime residence between countries and gain the benefit of mortgage interest tax relief not available in their former country. All of the Mediterranean states, with the exception of France (and, increasingly, Portugal) offer generous mortgage interest tax relief; whereas, for example, the Germany and the UK do not. Tax breaks are consequently higher when moving south.

Another key factor in increasing the demand for second and retirement homes has been the long-term growth in housing equity in the EU, due both to households paying off their mortgage debt and rising house prices. As a result, there is now much more housing wealth available to help finance a second home. First home mortgages can be taken out or extended or, alternatively, the household might be trading-down in its primary residence, say when the children leave home, and using the realised equity to buy a second home.

² Netherlands Statistics.

Figure 2.1 : Price of Danish primary residences and weekend cabins 1995-2004



Source: Statistics Denmark

The significance of housing market cycles

An important factor in the growth of the second home market in the EU has been the general housing market boom that has existed in many countries in recent years. The reasons for it are discussed in detail elsewhere in this Review, but focus on rising real incomes in upward phases of the business cycle; falling interest rates, which in some countries like Spain are negative, especially once tax-reliefs are taken into account; and, not least, growing capital gains and expectations of further price rises.

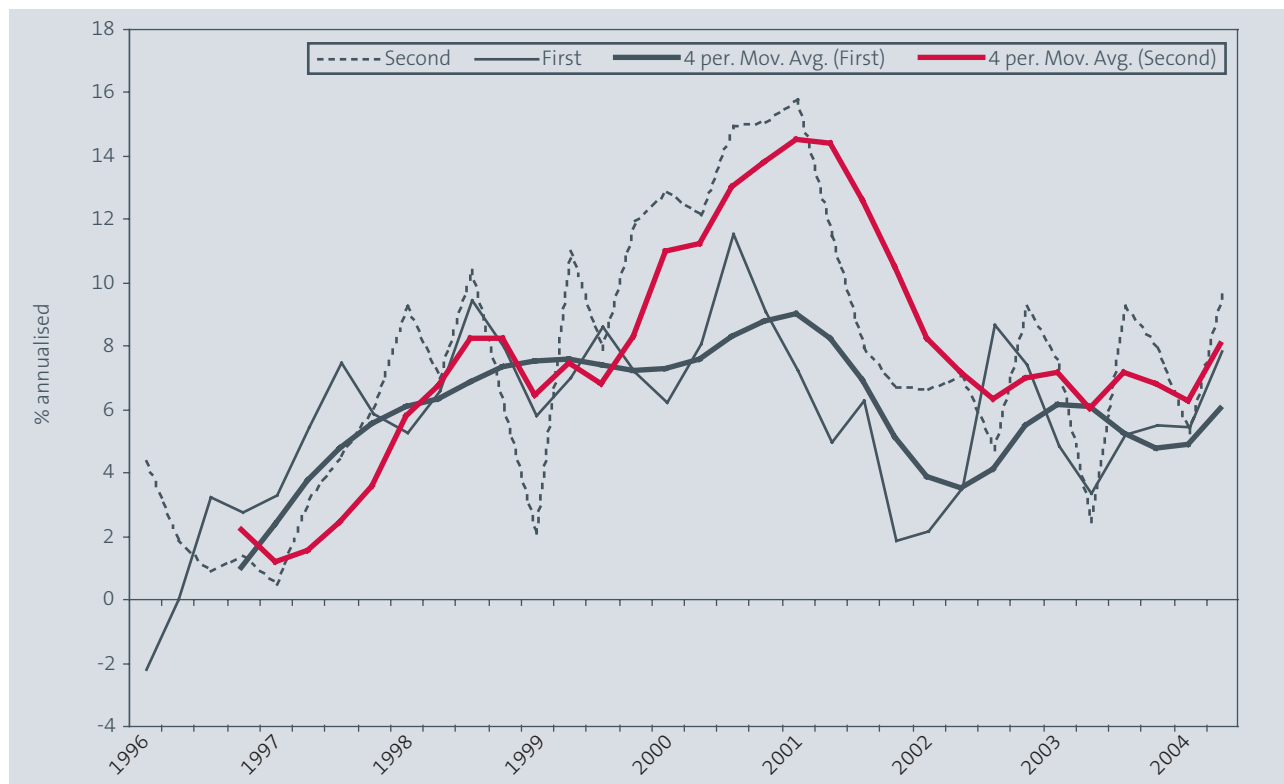
For most countries, it is difficult to distinguish price and quantity effects in second-home markets from those in the housing market in general. However, there is some evidence to suggest that second homes have done exceptionally well.

The clearest cases in price terms are for Denmark and Sweden, where second home prices are published separately from the primary market. They are shown in Figures 2.1. and 2.2, where it can be seen that prices have been rising at a significantly faster rate than those for primary residences since 2000. The trajectory

of change has varied between the two countries. The price of weekend cabins in Denmark has accelerated away from those of primary homes, so that in the winter period of 2003/4 they were rising at over 10%, compared to less than 5% for primary residences. In contrast, the peak of the divergence in Sweden seems to have passed two years ago. All the same, in terms of capital gains, it clearly has been better to invest in second homes than primary residences over the past five years in these two countries. Elsewhere, more anecdotal and regional price evidence around Europe suggests that leisure house prices have frequently risen noticeably more than have national average house prices.

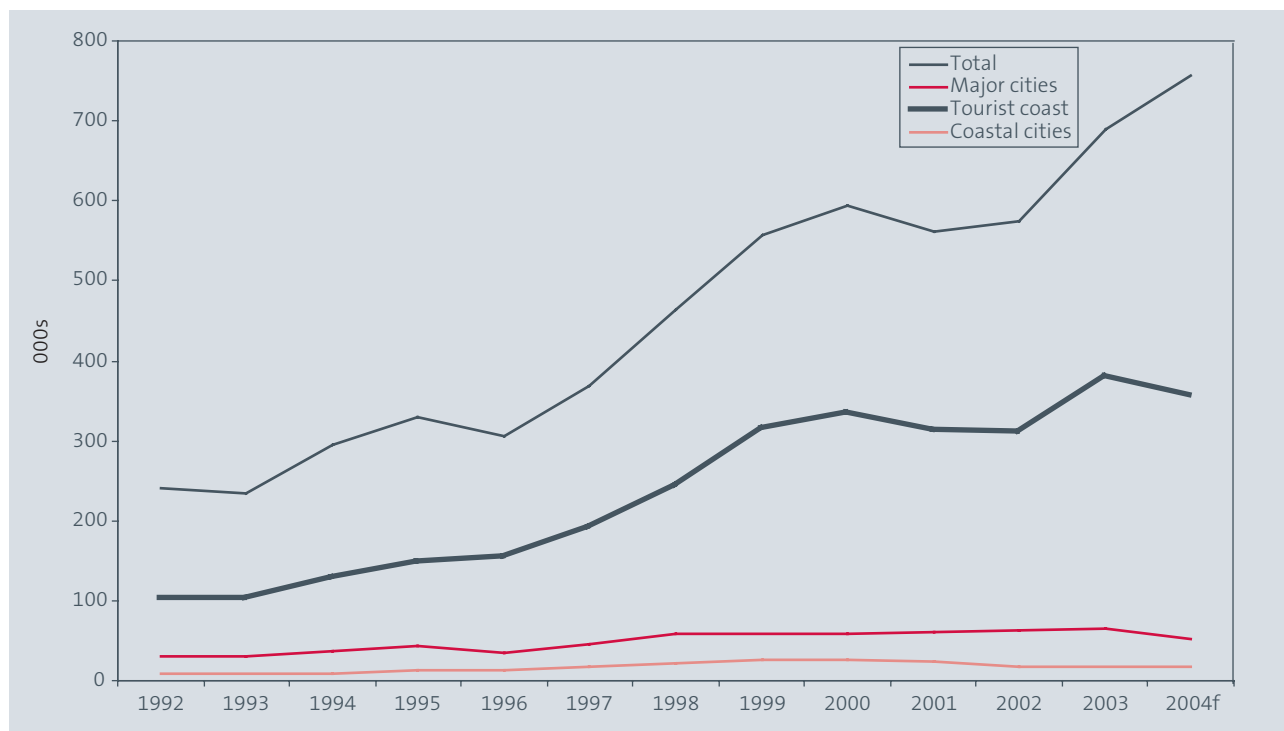
Planning constraints in attractive localities have often limited supply responses to rising prices. However, in some places, especially around the Mediterranean littoral, new housebuilding has been substantial. The most spectacular case has been along the Spanish mainland coast and on its islands (Figure 2.3). Housebuilding in those coastal regions reached a peak of 380,000 in 2003, more than the housebuilding of that year for the whole of Germany and the Benelux countries combined!

Figure 2.2 : Price of Swedish primary residences and second homes 1996-2004 quarterly with 4qr moving averages



Source: Statistics Sweden

Figure 2.3: Housebuilding levels by Spanish region, 1995-2004



Major cities: Madrid, Barcelona, Valencia, Seville, Zaragoza & Malaga
 Tourist Coast: Mediterranean, Canaries, Cadiz & Huelva
 Coastal cities: Barcelona, Valencia & Malaga

Source: College of Architects & BBVA

Consistently from 1999 to 2003, the tourist areas excluding the major cities of Barcelona, Malaga and Valencia represented over half of total Spanish housebuilding output (Table 2.1).

Spanish citizens and others from many countries have bought in these coastal tourist regions as investors in rental homes, usually for holiday-makers; second-home buyers; and as people moving their prime residence to Spain. Boosters were justifying these extraordinary levels of output by classifying the Spanish Mediterranean coast as the new European Florida. In reality, it was hard for the market to absorb this level of output, despite buoyant demand, and some projects were taking over two years to sell. Tourism also appears to have peaked in the Spanish coastal resorts as costs rise, crowding increases and cheaper and more exotic locations become increasingly popular with Europeans. As a result, output declined somewhat in 2004, though it is still massive.³

Table 2.1: Share of housing output by Spanish region

	Major cities %	Tourist Coast %	Coastal Cities %
1992	12	42	4
1993	13	43	4
1994	13	44	3
1995	13	45	4
1996	11	50	4
1997	13	52	5
1998	13	53	5
1999	11	56	5
2000	10	56	5
2001	11	56	4
2002	11	54	3
2003	9	55	3
2004f	7	47	3
Major cities: Madrid, Barcelona, Valencia, Seville, Zaragoza & Malaga			
Tourist Coast: Mediterranean, Canaries, Cadiz & Huelva			
Coastal cities: Barcelona, Valencia & Malaga			

Source: College of Architects & BBVA

In contrast to the coast, the major cities of Spain have seen far lower increases in their housebuilding levels, despite experiencing substantial price rises. Their share of national housebuilding fell from 12-13% in the mid-1990s to only 7% in 2003.

The overall level of housebuilding in Spain is huge for a country with a population of some 40 million. Carrying on with the earlier analogy, more houses were built in 2004 in Spain than in the whole of Benelux, France and Germany combined. This is in

sharp contrast to the complaints of weak supply regularly voiced a few years earlier, though it could still be argued that the major cities face clear supply-side constraints. The extent to which the housebuilding in the interior of the country outside of the major cities, which is the main source of current growth, represents a process of decentralisation and suburbanisation of the traditional dense urban forms of the country, and the degree to which it represents further second home building, is currently unclear.

The continued urbanisation of the Spanish coast is bringing about a substantial transformation of the region. Though clearly popular with new purchasers, it has brought about concerns regarding a bubble about to burst; a planning system that has little time to think about sustainable communities; and current and future environmental problems. One of the most significant of the latter relates to water supply in regions that are naturally arid, especially in summer. This has become an important national political issue in light of the costly schemes proposed to overcome water shortages and the potential environmental damage that may be caused by them.

Similar high shares of second homes in new building seem to be occurring in a number of other countries, including Ireland, another country with record housebuilding rates. For example, Kerry, an important location for second homes, saw in one year a 45% rise in its housing output between 2002 and 2003; whereas in Dublin during that apparently boom housebuilding year, completions actually fell by 18%. So, Kerry's housing output was 80% of Dublin's in 2003, despite its much smaller population.

Is there a holiday home bubble?

House prices, as Chapter 1 noted, are notoriously difficult to forecast. It is always possible to identify underlying causes of change that seem fundamental and long-term and those that seem short-term and potentially destabilising.

The long-term factors were examined above, and they suggest more second homes are likely and, possibly, at higher prices. Yet, with a perfectly elastic supply, there is no reason to believe that house prices should rise over the long-term. However, land shortages are growing in coastal areas, as are infrastructure costs, throughout Europe. This may well raise long-run prices and encourage the periodic replacement of existing dwellings in desirable locations. The distant future of the second home market is consequently a good one but the near-future may contain some surprises.

Short-term factors have been particularly important in recent years, given the scale of price and/or output surges. In particular, low interest rates and expectations of significant capital gains on the part of buyers and developers have fuelled record performance in the second home markets. Nevertheless, both these factors must inevitably change direction at some point, with interest rate rises and price expectations falling. The question, therefore, is whether second home housing markets will be robust enough to withstand such events. A positive answer, unfortunately, is possibly an over-optimistic one, and some re-adjustment to new realities may be in the offing.

³ BBVA information.

There are four reasons to believe that second, holiday and retirement home markets are likely to be more volatile than primary homes markets.

- **Demand is more discretionary than in primary home markets.**

Second homes are not as essential to consumers as their main residences, so when times are tough they are likely to be sold first and sellers are more likely to accept lower prices for them in order to realise cash. Interest rate or other economic shocks, therefore, are more likely to be felt more strongly in second home markets than in primary ones. The same is true for retirement homes – moves, after all, can be put off for a year or two – and investment demand, which depends on another discretionary element of private consumption – holidays – as well as prevailing interest rates and property yields.

- **Lenders are more likely to be concerned about defaults.** The previous demand factor feeds into the likelihood of borrowers keeping up mortgage payments. Some second home owners may abandon their homes to creditors when interest rate burdens rise, whereas primary resident owners are likely to be more tenacious at trying to keep their homes. Credit crunches, when borrowers become reluctant to lend because of real or expected default levels, therefore, are more likely to occur in these markets than primary ones. Once a slide starts in an area dominated by second and holiday homes, the greater is the likelihood that a drying up of credit will exacerbate the market decline there.

- **There is no fallback demand.** A feature of primary markets is that some households are priced out during booms, particularly first-time buyers. During downturns, affordability improves and, so, they are induced into purchase, acting as a dampener on potential falls in demand. Apart from some bargain hunters, second home markets have no such group to fall back on.

- **The supply-side is more likely to transmit volatility.** Feast or famine is more likely in second home markets than primary ones. Both supply states tend to generate more price volatility than markets with more normal supply environments.

When supply is very low, all variations in demand are transmitted through prices, downwards as well as upwards. When supply is very high, developers (that generally will be highly geared) can easily over-estimate demand and be forced to sell-off at distressed prices, pushing down demand in a spiral as price expectations reverse.

The scale of the recent European second home boom, therefore, must raise worries. Such housing markets are now some of the most risky in Europe, and are among those most likely to be subject to downward adjustments. Even so, there is no certainty that they will experience a serious correction. Of course, that is the nature of risk. Instead, a soft landing may occur. Yet, that argument is not as strong as it is in primary housing markets for the reasons just stated.

On the bright side, the outlook for 2005 does not suggest that a market destabilising shock is just around the corner. Interest rates are low. Inflation may be creeping up but the European economy is slowing, and that alone may be sufficient to dampen inflation and head-off interest rate rises. Nonetheless, interest

rates are believed to be below their long-run equilibrium levels, and will rise at some stage. In addition, some key second home sources of demand have already seen their own housing markets falter, most notably the UK.

Much depends on confidence in the future of price rises in second home markets. Such sentiment is hard to predict, volatile and easily influenced by unforeseen events. Overall, the longer the second homes markets boom, the greater is the chance that shocks will lead to serious short-term declines. Such a statement may be a truism, but it should not be forgotten that this means it is obviously true rather than trivial.

Case study: The Algarve

As an example of both the strength of long-term trends for second, holiday and retirement homes, and short-term volatility and riskiness of those markets, it is worth looking at the history of one of the key southern European areas, the Algarve in Portugal.⁴

Until the 1960's, the Algarve was totally undeveloped for tourism. Some Portuguese families took holidays there, but basically "the kingdom of Portugal and the Algarve" lived up to its name; with the Algarve cut off from the rest of the country by a range of mountains and poor transport links, and from the rest of the world by expensive and limited air and sea routes.

The late 1960s saw the first pioneer tourist developments, especially luxury hotels and golf courses undertaken by British and Portuguese developers. The early 1970s was a period of consolidation of the area as an international tourist destination. Purchasers at that time were mainly British and Portuguese, with some Belgian, Dutch and German interest. Then, all development came to an abrupt halt after the 1974 revolution, investors lost a fortune, and tourism to the Algarve practically ceased by 1975.

The first developers to regain confidence were the Portuguese. In the late 1970s, they redeveloped some of the low density schemes based on golf courses. New medium and high rise apartment blocks were built in their place and sold on the national market, and to Portuguese emigrants who wanted a second home back in the old country.

During the 1980s, the pace of development and sales grew steadily at first and, then, frenetically during boom years in the late 1980s. Most developments, especially the golf-oriented ones, were heavily directed towards the British market. Many of the developers were British, and so too were 60 to 70% of purchasers. This left the Algarve real estate market highly exposed to the fortunes of the British economy, which faced considerable problems in the earlier 1990s. Sales of Algarve real estate collapsed as UK property prices fell heavily in the early 1990s, the pound left the Exchange Rate Mechanism, and the British economy hit a period of severe recession. This real estate crisis was then aggravated by the more general recession that spread throughout Europe during 1993-4. Algarve property prices fell between 1990 and 1994 until they were only 50% of their real level in 1988. This led to massive write-offs of debt by developers, and many bankruptcies amongst them.

⁴ Thanks to Anthony Bradford, Head of Residential & Resort Research, Abacus FPD Savills, Lisbon for providing the background information on the Algarve.

The first signs of a recovery in the Algarve market appeared in the mid-1990s, first in the luxury sector and subsequently in the middle and lower-middle sectors. Yet, by 1997, sales were still 15-20% below their 1989 peak and, most importantly, the prices of resale property were still less than replacement costs. The expectations of long-term capital gains, firmly believed to be vast during the late 1980s boom, had proved to be severe misforecasts.

International demand from Germany, especially for existing properties, had overtaken that of the chastened British buyer during the 1990s but, in contrast to the Spanish Costa del Sol, German demand did not spread down to less expensive town houses and apartments.

This long dull period was followed by another boom in sales and prices. This one lasted for 3 years from 1999 to 2001, aided by buoyant economic conditions in both northern Europe and Portugal. Sales of built properties were strong. In contrast, the volumes of plots sold suffered both from lower supply and exaggerated prices. Asking prices in 2001 for plots of 2,000m², for example, with golf frontage at Quinta do Lago were £800,000, compared to only £200,000 five years earlier in 1996.

Though demand has been reasonable during the 2000s, it has experienced none of the boom conditions seen in neighbouring Spain, partly because of the local troubles of the Portuguese economy itself (see Chapter 17). Moreover, demand from Portuguese residents for property in the Algarve has fallen considerably since the late 1990s, because of the launch of a series of leisure developments that are far more accessible to the main centres of population around Lisbon, and in other heavily populated areas of the country.

While the major concentration of tourist developments to date has been in the Faro to Armação de Pera area, recent important resorts are being established at both the eastern and western ends of the Algarve. The central area, in fact, is now seriously over-crowded during high season. Prospects in the western Algarve have been considerably enhanced by the anchor effect of the Parque de Floresta resort, the completion of a motorway link through to Lagos, and by large investments in major resort projects.

The Algarve market currently divides into 3 parts: satisfying local demand, whether from Algarve locals or others working in the tourist industry; meeting tourist demand at moderately-priced levels, usually for apartments; and targeting higher spenders through more luxurious leisure complexes. The leisure resort developments can further be subdivided into larger schemes designed around one or more golf courses, and smaller projects of 20 to 50 hectares, usually offering a swimming pool complex, tennis courts, a club with a bar and restaurant and, perhaps, a health club. Each scheme is designed for and marketed to particular target income groups of an increasingly international clientele. The typical profile of purchasers in golf developments, for instance, is predominantly British, but also includes, in order of importance, German, Portuguese, Belgian, Dutch, Swiss and, more recently, Irish buyers.

Demand dropped dramatically in 2003, when Portugal introduced new legislation on the ownership of property by foreign companies. This had been a popular method of purchase; especially for the British, in order to avoid potential capital gains tax liabilities in the UK. At the present time, there are tentative signs of a slow recuperation, but much will depend on the course of the UK and Northern European economies in 2005.

One positive outcome of the relatively quiet performance of Algarve real estate in recent years is that it may be less liable to downside risks at present than in some other parts of Europe. Nevertheless, its history shows the significance of economic, financial and political circumstances on second home and retirement market outcomes. The existence of substantial market volatility is abundantly clear. Moreover, the performance of the Algarve market has been far more subject to feast and famine than has the primary housing market in Portugal (see Chapter 17).

chapter three

Housing in the new EU countries

Introduction

In May, 2004, an additional 10 countries joined the EU – Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia. The population of the EU increased by a fifth as a result, but economic output by only 5%. Poland, with a population of almost 40 million, is a large country. The Czech Republic, Hungary and the Slovak Republic are in the 5-10 million band and the other countries are much smaller, particularly the two Mediterranean island states.

The new accession countries brought with them a diversity of housing systems and standards, and a general enthusiasm for market-based solutions to housing provision. The market emphasis is hedged around, however, with a strong keenness of governments to influence housing outcomes via their policies.

This chapter aims to raise some of the broad issues associated with housing provision in these countries. This is a difficult task in a few pages. As a result, some broad themes only will be raised. Issues in the major Central and Eastern European countries will be concentrated upon for three reasons. First, they encompass the majority of the people joining the EU; second, because they illustrate some of the most dramatic shifts in housing provision that have probably ever occurred in Europe in such a short space of time; and, third, they raise some important policy dilemmas with respect to housing at the EU level.

Housing systems

Comparative housing standards

It is always dangerous to classify countries and their housing systems into broad categories, because of the myriad of differences that always exist comparatively. Yet, generalisation does seem pertinent with respect to housing in the 10 new EU countries.

Eight of them until the 1990s had political systems that made them 'socialist states' or 'centrally planned economies' (CPEs): namely, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia in Central and Eastern Europe (CEE). The other two are island economies, with a strong emphasis on tourism within their economies. None consequently are typical of the older EU15. This is reflected in their housing systems.

All have lower standards of living than are usual in Western Europe (Figure 3.1), but high hopes of catching up with the rest of the EU. With the exception of Cyprus, Slovenia and Malta, they have noticeably lower GDPs per head than did Greece and Spain when they joined the then EU9.

The speed of catch-up inevitably varies significantly between countries as they grow, depending on such factors as economic structures and public policies – Greece, for example, is taking much longer to converge than Spain. Whatever, catch-up inevitably takes many years or, in fact, decades. The OECD estimated in 2004 that it would take Hungary 29 years, Poland 37 years and the Slovak Republic 40 years to halve their income gaps with Western Europe, based on their growth rates over the past decade. Even if these countries manage to introduce reforms that speed up their growth rates, full convergence to Western European standards of living is likely to take two generations or more.

Such dynamics provide a background against which to judge housing provision in the new accession countries. Because they have lower living standards and housing is an important element in determining them, it is to be expected that their housing volumes and qualities are far lower than in Western Europe. Dynamically, if it is going to take a very long time for incomes to catch up, it is to be expected that housing will take an equally long time to reach Western European standards as well.

Figure 3.1: GDP per capita (at purchasing power parity prices) 2003



Source: Eurostat

Whilst income levels may be a good indicator of general housing standards, there are several reasons why the gap between housing conditions in the new accession countries can be expected to be closer to those in Western Europe than is the case with incomes. As a basic necessity, expenditure on housing at lower income levels is likely to represent a relatively high proportion of incomes.¹ (In the old centrally planned economies, this expenditure was generally borne by the state in urban areas, so that out-of-pocket costs were usually very low by market standards.) Along with this basic consumption good characteristics, go high levels of national investment on housing. As incomes rise, the share of housing investment in national income then tends to go down, even though the absolute level of expenditure is likely to rise. This predicted broad-brush pattern of high investment is historically observable in the new accession states, though not from the 1990s (see later).

Moreover, faster-growing countries also tend to invest proportionately more in housing, because of rising consumption and to meet the needs of expanding workforces in the major growth regions. The characteristic can be seen strongly in such European countries as Greece, Ireland, Portugal and Spain over the past decade.

Furthermore, the past histories of Central and Eastern European countries (the CEE8) made housing investment especially important within them. Housing played particular roles in CPE frameworks. They tended to build lots of dwellings, especially during the 1970s and 1980s. What was constructed were generally standardised, industrialised-building apartment blocks containing dwellings of limited quality and size. Housebuilding became as much a component of the command economy, with five year plan targets to be met, as being aimed at satisfying consumer needs.

In addition, housing was built in rural areas and small towns by owners in piecemeal ways, using the available building materials, which were not always the most appropriate or of good quality. The legacy is a rural housing stock that has a relatively high absence of basic amenities and poor build quality.

In Poland, overall housebuilding did not manage to keep up with rising household numbers, so that it has faced an absolute shortage of about 1 to 1.5 million dwellings for a long time, despite relatively high building rates during the 1970s and 1980s. The Slovak Republic and Lithuania also face shortages.

Overall, this pre-1990 housebuilding legacy has left unique housing stocks in the CEE8 of relatively young, but often rundown, homes – with limited internal and neighbourhood amenities and poor insulation. Dwellings sizes are also notably smaller than in Western Europe. In the old EU15, dwellings have

an average of 4.4 rooms and 84 square metres of living space, whereas in the new CEE8 members, they have only 3.2 rooms and 58 square metres of living space. In East Germany, around a million of the apartments-in-industrialised-blocks types of dwellings have been abandoned since reunification,² but in the new member states they remain central elements of urban housing provision.

So, in many of the CEE8 countries the issue is as much about the quality of the existing stock as its general availability. Moreover, these dwellings are often not physically adaptable for serious upgrading to provide better sizes, nor is it often worthwhile modernising them. This suggests the need for very high levels of dwelling replacement over the long-term.

Within the more southern economies, housing has also been traditionally favoured. The built form is obviously different. It usually consists of simply-equipped one or two-storey dwellings, developed by their owners in a piecemeal, haphazard fashion, using traditional or simple concrete frame and block methods. Cyprus has the largest recorded average dwelling size in the EU25, at 145 square metres and 5.8 rooms; in Malta, the average is five rooms.³ This high level of building investment reflects the strong family and financial motives associated with housing in these countries and the importance of tourism.

Another contrasting feature of the housing systems of the new EU countries is that the land market traditionally did not play the role it does in most of the old EU15 countries in influencing urban densities and the distribution of housing opportunities over space. The urban structure of CEE cities, consequently, is differentiated far less than further west, and relates more to subtle gradations in social status than to accessibility and urban history. There is also not as much of the costly urban infrastructure in many locations that is regarded as commonplace further west.

In Southern Europe, urban forms are also less market-determined as well. Infrastructure provision is again frequently more limited. This is because housebuilding traditionally has depended on family, small-plot land ownership patterns in a context of weak local governments.

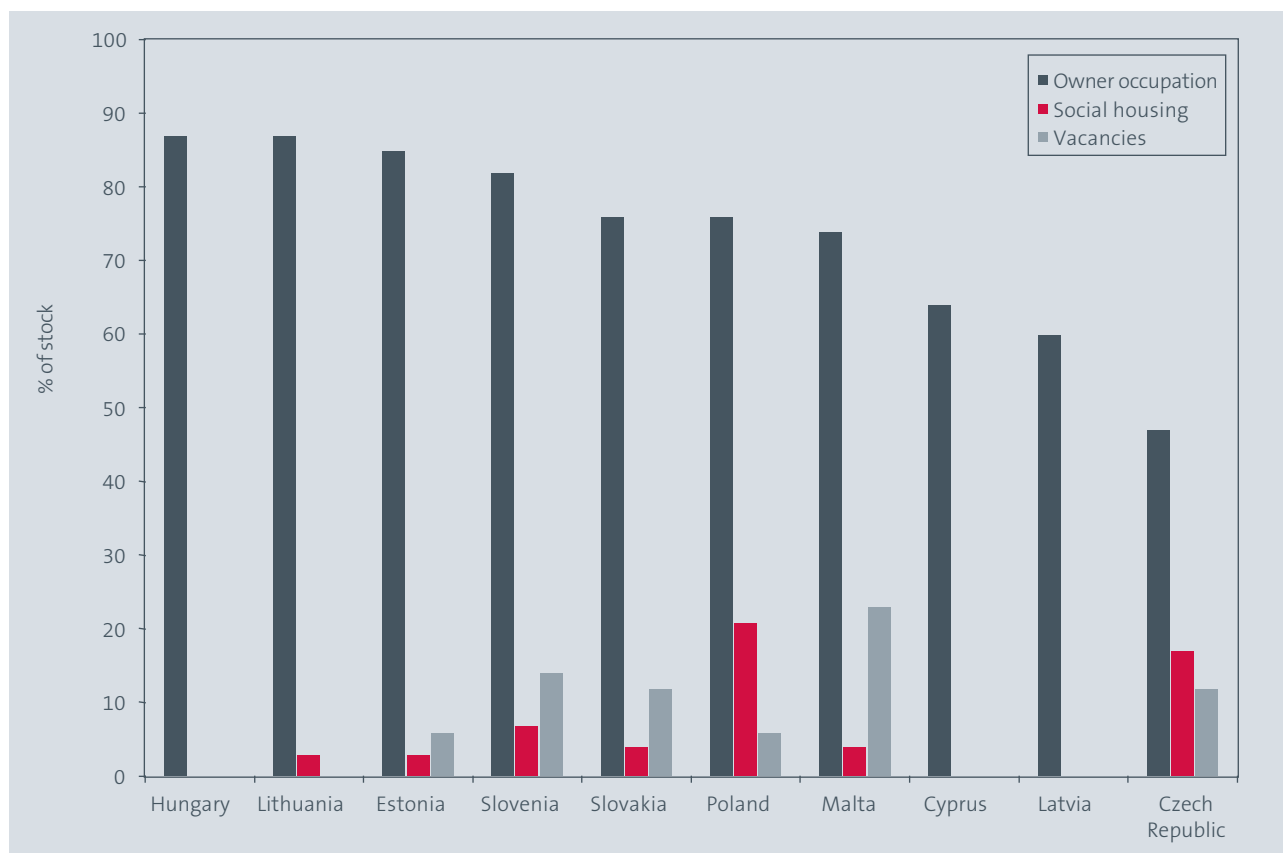
As the land market takes on a greater role in these countries in the future, given such histories, it is likely that the cities of many of the new accession countries will develop widely decentralised, spread-out urban structures, more in keeping with US models than the planning-induced emphasis on high density and historic city centres more common in Western Europe. Activities will search out the cheaper locations, lower congestion and higher amenities of the fringe without the same strong pull of city centres on them as in the west.

¹ The typical pattern is U-shaped housing consumption pattern in relation to changing average income levels over time: with a high proportion of housing expenditure at relatively low levels of income; then a falling share at somewhat higher levels; followed by a rising share of income at much higher income levels as the status and luxury characteristics of housing kick-in.

² See Chapter 10.

³ Maltese floor space data not available. Housing Developments in European Countries, Ministry of the Environment, Dublin, 2004.

Figure 3.2 : Tenure shares



Note: various years, usually 2000-2002 Source: Housing Developments in European Countries, 2003, Department of the Environment, Dublin

Housing tenures

One of the most noticeable features of the new accession countries' housing systems is the high levels of owner-occupation. They are far higher than the old EU15 average of 65% of all dwellings (Figure 3.2). Only the Czech Republic has a relatively small share of owner-occupation. Yet, it has a co-operative sector where rights can be bought and sold, which accounts for 17% of the stock; adding this brings the share of owner-occupation to 64%, and very close to the old EU15 average.

Owner-occupation has always been the dominant tenure in Southern Europe. It was also quite significant in the CEE8 prior to the 1990s, although most urban housing was either of municipal, state or co-operative-owned rental forms. Tenant rights-to-buy also existed in formal terms from the 1970s or earlier in a number of countries. With the switch to market-based economies, however, there was a major shift to the tenure, with thousands of flats sold off to sitting tenants at knock-down prices with monthly payments of less than equivalent rent levels.

The speed of the tenure transfer and its precise details, especially who owns and manages the building in which privatised flats exist, has varied from country to country.

Nevertheless, this shift to owner-occupation has been undoubtedly the most consistent and dramatic housing policy in the CEE8 – and in Europe as a whole – for a long time, and it is not entirely over yet. Bulgaria and Romania have even homeownership rates than the current new EU countries, with virtually all their housing now in owner-occupation.

The justification for this homeownership-only policy partly was based on a desire to meet personal aspirations and provide households with the freedoms of homeownership and a wealth asset. However, given the previously high levels of public expenditure associated with providing very low cost housing, the personal ownership option was also virtually the only possible one in the post-socialist state era. Governments bereft of surpluses from state enterprises, a weak tax base and requirements for more transparent public accounting had no means by which to continue to subsidise so heavily such large proportions of their housing stocks. Handing them over to tenants was the only politically feasible way out.

In the main, the privatisations have been successful and popular. There has been no overwhelming political pressure to turn back the clock and reintroduce the old systems. Some countries, such as the Czech Republic, have recently put moratoria on further social housing sales; though others are still keen to extend the process further.

Nevertheless, several difficulties have arisen. They include:

- **Poverty and ownership.** Many new owner-occupied households, especially if they are not working, have very low incomes and, so, have been able to do little with their properties. Apart from the implications for those households, this has frozen housing transactions in wide parts of the stock, which in any case were generally low, and created difficulties in renovating rundown buildings.
- **Institutional gaps.** Many of the institutional arrangements associated with developed owner-occupied housing markets are still embryonic in the CEE8, such as well-defined property rights, easy marketing and transfer of property,⁴ insurance in various ways,⁵ good valuation and building quality assessments, and effective mortgage finance.⁶ Considerable efforts to overcome these problems have been made, and more are currently underway, as the country chapters on Hungary and Poland illustrate. However, the results may take years to become fully embedded into the framework of housing markets and, unfortunately, as with any machine, all the interconnected bits have to work for a housing market to function well. Owner-occupation has come to predominate, therefore, in the context of only rudimentary markets. It is not clear, however, that it is easy or quick to make the leap to the institutional structures typical of Western European and other advanced economies. Of course, there is no lack of competing advice over which one is supposed to be the best.
- **Constraints on mobility.** Paradoxically, private ownership has frozen up mobility, which in any case was already low. Often most households cannot afford to purchase, especially if they fall outside of the screening criteria of mortgage lenders; and many owners cannot find anyone to sell to, and so they cannot move either. New households, unless they have been lucky in the job market, may find their housing options extremely limited. This has significant effects on labour mobility in countries where structural change and economic flexibility in the face of shocks are vital for much-needed economic growth.

The collapse of housing investment

Another consequence of the shift to owner-occupation from extensive state subsidy has been a sharp fall in housing investment. This is mainly because large proportions of the population cannot afford the building costs of new housing and, often, have only limited means to spread the burden of those over time.

The CEE8 are, therefore, at present confounding the generalisation, noted earlier, that lower income countries – above the level of desperate poverty – tend to invest proportionately more in housing than higher income ones. Instead, for large parts of the 1990s, housebuilding virtually ground to a halt.

The situation has improved in recent years, but building rates are still generally far below even those Western European countries with low construction rates; while the high-growth countries in the old EU15 have dramatically higher

Table 3.1: Number of dwellings built per 1,000 inhabitants, EU countries compared

Latvia	0.4
Lithuania	1.1
Hungary	2.2
Poland	2.3
Slovak Republic	2.4
Czech Republic	2.5
Slovenia	3.1
Cyprus	7.6
France	5.1
Germany	3.5
UK	3.1
Ireland	14.1
Spain	13.8

Notes: 2000-2002 depending on latest available figures; data unavailable for Estonia & Malta

Source: Housing Developments in European Countries

housebuilding rates (Table 3.1). New building, moreover, is targeted almost exclusively at the most affluent segments of populations. Some renovation and repair is taking place in existing housing stocks, but never enough to have much impact on the huge backlog of necessary work.

Severe deficiencies in housing investment mean that the housing stocks of most of the CEE8 are effectively frozen in time, and at current rates will take forever to change. Only relatively low (or negative) rates of population and household growth are stopping housing shortages spiralling upwards throughout the region. Unless something changes, convergence with Western European housing standards – likely to be decades away at best – will never actually happen in most countries.

The cause of low investment cannot simply be put down to institutional constraints and low levels of national income. Turkey, for example, has an even lower GDP per head than the CEE8, a history of economic instability and a relatively limited array of standard advanced country housing market institutions, but it has extremely high housing investment levels. (In fact, possibly, too much).

There are also macroeconomic factors to consider when looking at levels of housebuilding and renovation. Micro-factors, like apparent institutional failure, may be masking serious misallocations of overall national resources. For example, housing investment should not be too high, otherwise it will crowd out other economic activities which are more socially desirable. Typically, in advanced economies housing investment varies in a quite narrow range of 4-6% of GDP on a trend basis. The crowding-out will not necessarily be that obvious, as it is likely to occur through higher interest rates, greater taxation when housing is subsidised, or via general price inflation or a mix of them.

Conversely, excessively low levels of housing investment may arise because other activities are absorbing national resources. A clear candidate in Central Europe currently is government and the scale of its deficits.

⁴ Poland's new land registry system, for example, will only be fully implemented by 2009.

⁵ Building defects insurance is often unavailable, for example, so that new house purchasers may find themselves facing large unrecoverable costs.

⁶ See, for example, M.Ball, Making Housing Markets Work, RICS, and various World Bank publications on housing.

The existence at the macro-level of idle resources, while housing shortages abound, could itself be related to distorted relative costs. Poland, for example, has a relatively high minimum wage, a fifth of its workforce unemployed, an estimated lack of a million homes and labour-driven building costs that are too expensive to allow ordinary Poles to afford even the most modest new housing. Linkage between them all is almost certainly there. Housing problems, in other words, do not always need housing-related solutions; let alone micro-based subsidies or major efforts at institution-building.

Boosting mortgage finance

Great attention in the CEE8 has been focused on mortgage finance in ways that have few parallels in the Western European tradition. Mortgage borrowing has been seen as the keystone in the transition to a normal financial and market-based housing system. Much advice has been offered, institution-building undertaken and public money spent. Many of the CEE8 governments provide mortgage interest tax relief (in contexts where marginal tax rates are often high) and subsidise long-term housing savings schemes.

Hungary offers open-ended interest rate subsidies over the life of mortgages (see Chapter 12). It and others subsidise the activities of Bausparen-style saving-and-lending institutions and those of mortgage banks. In Poland, enabling legislation permits complex indexation of mortgage loans (though not, of course, of the salaries that are used to pay them). Secondary market mortgage activity has also occurred in a number of places. Foreign banks have entered and tried their hand at mortgage lending, though national players heavily predominate.

There have been some notable increases in the use of mortgages. However, so far, despite the scale of activity and subsidy, mortgage lending has not developed to become anything like as significant as it is in Western Europe. In some respects, it is easy to see why mortgage finance faces constraints. The interest rate spreads required by lending institutions to cover their risks and other costs are frequently of the order of 5-6%. With regard to origination and screening, there is little credit history to go on. Macroeconomic performance has also frequently not been conducive to long-term lending. Subsidies, despite their high cost, cannot easily overcome such problems.

In the absence of additional housing supply, moreover, mortgage subsidies simply stoke up demand. This pushes up house prices, makes housing even less affordable and gives a boost to general price inflation in the process.

Subsidies focus on owner-occupation

The subsidies to mortgage finance have been overwhelmingly directed at owner-occupation. Part of that subsidy effort leaks out to benefit mortgage and other providers in housing systems, and it also raises the value of existing dwellings and development land. The prime intended beneficiaries, nonetheless, are the better-off owner-occupiers who can avail themselves of savings accounts and mortgage interest tax-reliefs.

There are also other potential rules enabling tax write-offs of mortgage costs, such as for people under 35 years old, those with children, first-time buyers, those buying new dwellings and those purchasing existing ones, and there may be caps on mortgage values subject to subsidy, or similar restrictions on the prices of the dwellings being bought. The array of subsidies can be seen to be complex and regressive, and invariably there is insufficient hard evidence to work out their real impact, though it is unlikely to be what was optimistically hoped for.

The lack of support for market renting

In contrast to the strongly positive stance towards the expansion of owner-occupation, rental institutions have faced substantial constraints on making investment worthwhile for them. Severe rent controls in the private rental sector frequently exist, while security of tenure provisions are strong; both of which deter investment there. In addition, social housing institutions have often been unable to raise rents to levels that make breaking even feasible for them, let alone additional investment. However, repair and heating costs are more likely to be covered by rents in recent years than in earlier ones.

Apart from borrowing as an owner, renting is the only other option available to people for financially smoothing over time the capital costs associated with living in a dwelling. This is one way of looking at rent: it is paying someone else in order to use their capital to enable habitation of a dwelling. This contrasts with repaying interest and amortisation on a capital loan to a mortgage institution as a homeowner does, but is essentially the same principle of spreading housing costs over a long period of time by using someone else's money.

Renting might even be a cheaper option, tax rules permitting, if landlords are prepared to take lower spreads on their money when they rent out property than financial institutions are prepared to when they directly lend to homeowners.⁷ But the rental approach is frequently blocked in CEE countries, so private rental markets are either already extremely small or declining rapidly.

The only growing rental sectors, undoubtedly, are the informal ones that escape the tax, regulatory and statistical nets. Almost by definition, it is impossible to guess their size, though housing surveys suggest that they might be small.

In recent years, a paradox has arisen. The lack of affordable housing is encouraging a number of new accession countries to start subsidising social housebuilding again, after a decade or more of heavily privatising such rental housing on the grounds of its unpopularity, inflexibility, expense and inefficiency. The wheel may seem to have turned, but this should not necessarily be regarded as vindication of previously discredited policies. Inevitably, the subsidies are of a scale that are unlikely to have much impact on housing shortages. Their consequences are likely to be far more noticeable on already stretched government budgets. There is also scant evidence that the institutional problems of this tenure have been resolved over the intervening years.

⁷ For example, they might have lower administration costs or lower defaults on rental payments than mortgage lenders do; the latter because of their closer monitoring of tenant payment behaviour.

Given chronic problems of accommodation availability, affordability and housing quality throughout the regions of the CEE8, especially in the growth ones, there seems to be a strong case for EU structural funds to be allocated to housing investment in these accession countries. The justification would be that they would enable improved labour market flexibility and, hence, speed up economic growth and convergence. However, at present, EU subsidiarity rules mean that such moneys cannot be used for housing purposes. This seems purely an artificial barrier.

Nevertheless, the case for such subsidies is made much stronger if it can be demonstrated that resources will be freed up from elsewhere to undertake the extra housing work, or previously idle ones would be brought on stream. Otherwise additional EU finance might simply stoke up demand in already inflation-prone parts of CEE economies – as the new social housebuilding subsidies, mentioned above, might already be doing.

What happened elsewhere in Europe?

When looking at housing problems in CEE accession countries, it is worth remembering experience elsewhere in Europe, particularly in relation to the Southern European countries that have joined the EU in the past. There is a distinctive ‘southern’ tradition in housing provision that is common to Greece, Spain and, to an extent, Portugal.⁸

In the past, these countries had relatively poor housing conditions; a strong emphasis on owner-occupation; primarily self-organisation of the building process; extended cross-generation family living patterns; and dwellings for life generally funded from outside of the financial system through personal savings and informal family networks. They have, or are now, rapidly changing away from their traditional housing models towards those of their more northerly neighbours, as they prosper and develop more complex housing institutions that rely more extensively on market relations.

It should be emphasised that these features were not caused by any clear geographic factor. After all, Ireland, with its distinctly un-Mediterranean climate, could have been added to the group until a decade or so ago. Rather this common traditional pattern is more a product of several features.

In particular, those countries were latecomers to economic development, in contrast to those in northern Europe, and had resultant relatively low standards of living. They also had weak financial systems. Pervasive may have been the belief in private property, yet property rights in key spheres of real estate activity were frequently poorly defined and enforced informally, if at all. Chronic shortages of state revenue and extensive tax avoidance were typical, meaning that there was little hope of major state expenditure on housing. The use of real estate as the prime personal investment vehicle predominated, especially as chronic government deficits caused periodic and, sometimes, prolonged bursts of inflation.

Nonetheless, despite obvious similarities with current situations in the CEE8, the improvement in the housing situations in these southern countries did not occur through extensive state intervention in micro-management and institution-creating. Such experiments as there were have invariably faded into insignificance. (See, for example, the recent history of the Greek mortgage market in Chapter 11, where state-based institutions have dramatically lost market share to their more responsive private competitors.) Southern Europe also is by no means an ideal case. Extensive tax breaks and other subsidies have persisted and grown in importance, and micro-management philosophies seem to now be at the forefront in Spanish housing policy, for example.

One condition of these southern countries’ increasing convergence towards EU9 housing standards has already been highlighted: growing prosperity and increasingly stable macroeconomic environments. Yet, these two factors may by no means be the most important ones.

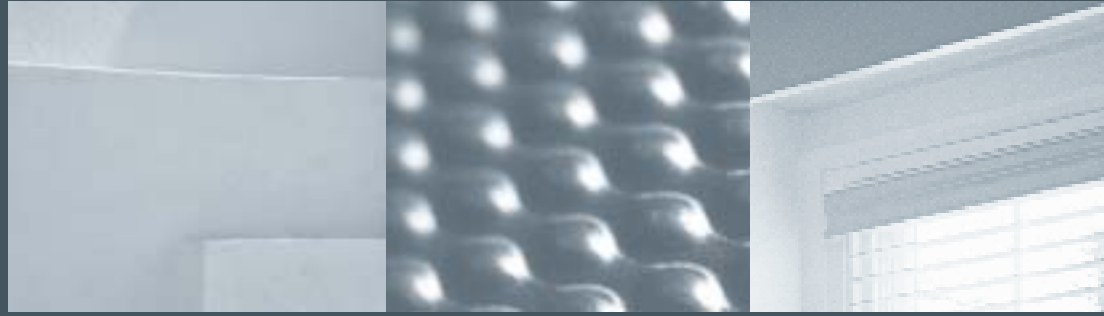
Rather, two aspects seem most relevant. They are about institution-building, but refer to the conditions under which markets operate, rather than to specific types of organisations and individuals and the costs that they face.

- **Property rights.** Housing markets are likely to prosper once property rights are firmly established, made easily transferable and, most importantly, are quickly and cheaply enforceable. The mortgage market in Italy, for example, has suddenly blossomed in recent years, because lenders can now increasingly get reasonable redress for defaults through the courts; whereas in earlier decades they could not and, so, would only lend, if at all, with huge risk-premiums added to interest rates.
- Second, **genuine competition** has to exist at all levels in housing and associated markets.

Unfortunately, neither condition can be said entirely to hold in the current situations in the CEE8.

Many positive developments have occurred in CEE countries towards improving the housing situations of their citizens and enabling a property-owning democracy in which property ownership is diffused throughout much of society. Other features such as investment and institution-building have proved harder. The extent to which policy and public expenditure focus should be put on housing is debatable, but excessive subsidisation is neither likely to generate sustainable institutional environments, better-functioning housing systems or improved long-run housing conditions. It is probably undesirable as well to undertake actions that threaten economic growth, because rising living standards are the most important cause of improved housing conditions.

⁸ See, for example, J. Barlow et al *Housing and Welfare in Southern Europe*, Blackwell, Oxford, 2004



chapter four

Country summaries

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

Austria

The market was static in 2003 and 2004, after the slight price falls of 2002, and it is still sensitive to the economic slowdown that occurred since 2001. An upturn in the economy is expected, which from 2005 should see a revival in housing market activity, both nationally and in Vienna. In the absence of a boom, the experience of the housing market over the past few years can be regarded as rather similar to that of its neighbours, Germany and Switzerland, even though it has a higher owner-occupation rate than either of them. Market behaviour over the past decade consequently contrasts sharply with that of most other EU countries.

Belgium

The prolonged price boom, though relatively modest by the standards of some other EU countries, shows few signs of abating even after seven years. House prices were 80% higher than they had been 8 years earlier in Brussels in the summer of 2004, while flats in Flanders were worth over 2.6 times as much. The mortgage market, in addition, had what can only be described as a spectacular year in 2003 as thousands of households re-mortgaged or bought homes. Growth was more subdued in 2004, yet still managed to expand even from such a high base. An improved economic environment and low mortgage interest rates have helped to boost consumer confidence in house purchase over the past two years.

Denmark

The housing market picked up towards the end of 2003, following several quarters when it looked as though prices were about to stagnate. For the first time in seven years houses also exhibited higher price rises than flats and it looked as though the increase in flat prices relative to houses was finally coming to an end. A return to economic growth, buoyant consumer expenditure and unexpectedly low interest rates all contributed to the more optimistic state of the housing market in 2004.

Finland

House price inflation peaked in the spring of 2004, but the market remained strong and overall price increases of 7% are forecast for the year. The rate of increase dipped early in 2003, followed by an acceleration over the summer, so that by the third quarter price increases were growing at an annual nominal rate of 7%. Real house prices had been rising from 1996, with spikes in 1996-7 and 1999 and a fall in 2000/01. The greatest increases were in the Helsinki region, though it has trailed national prices somewhat in the past year.

France

The housing market boom strengthened during 2004. The prices of existing housing rose by a forecast 16% over the year and new housing by a 10% annualised rate in the first half of 2004. This means that France currently has one of the most vibrant housing markets in the EU. Prices have now been rising continuously for 8 years, since the end of the mid-1990s slump in 1997, and have been accelerating on a trend basis. Over that period, nominal prices have doubled nationally with almost half of the increase occurring in the past 3 years. There have been divergent developments in house and flat prices in recent years, with a growing premium on houses.

Germany

The housing market, like the economy as a whole, continued to be flat in 2004. In general, it has had mixed fortunes over the past few years. Prices and rents in several major cities in the West have increased moderately in response to rising demand. In other regions, however, previous excess supply has left the market depressed in the face of poor general local economic conditions. In particular, the East is still suffering from oversupply which – along with its continuing economic problems – is contributing to weak prices and rents. For the country as a whole, housebuilding has been plummeting from the highs of a few years ago, though the trough may finally be close. Mortgage markets have also

grown moderately. With house prices flat or falling in real terms for almost a decade, there has been little or no additional housing equity to generate wealth effects on personal consumption or to enable sustained equity withdrawals by owner-occupiers or landlords (many of whom are private individuals).

Greece

House prices in 2004 remained in the doldrums, with a forecast 4% fall over the whole year likely in Athens, the main housing market. Greece had witnessed a house price boom from the late 1990s but this seems to have run out of steam by the summer of 2003. The picture looked more robust in terms of other market indicators. Mortgages were still growing briskly at 25% a year in late 2004, and new housing investment also remained strong. This suggests that the current upswing in the housing market is not yet over, but rather that the supply shortage has eased and that consumers are wary of paying too high a price for their new homes. The continued strength of the economy and low interest rates are helping to sustain housing demand.

Hungary

Between 2000 and 2003, there was a significant housing boom during which prices rose. The boom was stimulated by housing shortages, economic growth and substantial government subsidies to mortgage finance. A decline in housing market activity was then experienced in 2004 as those subsidies were reined in and interest rates rose. Although the use of mortgages has started to expand rapidly in recent years, they started from a very low base. Housebuilding also continues to be predominantly owner-organised for direct consumption, though a development industry has been growing strongly in recent years.

There is a long tradition of owner-occupation. In the 1980s, it was around 65%, with virtually all the rest rented from the state. Then, in the 1990s, during the era of shifting to a market-based economy, there was a concerted programme of selling off state housing. So, by 2002, over 90% of the housing stock was owner-occupied with only 4% left in state hands, and most of the rest was vacant. Hungary consequently now holds the record for the highest homeownership rate in the EU, and one of the highest in the world.

Ireland

House price rises were still in double figures in 2004, with a 12% rise on an annualised basis in September, although they had moderated slightly since 2003. They were forecast to rise by around 10% for the year as a whole. Commentators were indicating that price rises were moderating, but the slowdown in the growth rate was actually quite small and within the margins of error of an index that is not quality-adjusted. Price rises in 2004 significantly exceeded earlier expectations of a 'soft

landing' and limited price growth during the year. Transactions were also at a much higher level than in 2003, and there was still a great deal of interest from investors in rental property, despite significant falls in rent levels in recent years, with 32% of all new homes built in the Greater Dublin area sold to investors in the first half of the year.

Italy

The housing market has been on a sustained upswing for five years now, after a long period of recession in the 1990s, when real prices fell by over a fifth over a seven-year period amidst general economic sluggishness during that decade. The economy followed others into the general world slowdown in 2001, and growth has been miniscule since then. Yet, this economic gloom does not seem to have dented housing demand much and house prices have been rising in nominal terms by 6 to 8 % in recent years. In 2004, agents were reporting that market activity was still brisk – although it had fallen below its peak – and that mortgage activity was especially strong.

The Netherlands

The economy is in the doldrums, with growth at a virtual standstill for the third year running, yet the housing market has still not seen a collapse in prices as feared – though it is now four years since the great Dutch house price boom ground to a halt in 2001. House prices are still rising gently in nominal terms, though when general inflation is taken into account there was a slight drop in 2003, but not in 2004. Previously, in the decade up to 2001, the country experienced some of the greatest increases in real house prices in Europe. There is also significant long-term volatility in the housing market. This experience gives some hope of a soft landing to the other EU housing markets which have witnessed substantial price rises in recent years.

Poland

The housing system, like the rest of the economy, has undergone considerable changes since the 1980s. After an initial transition period most contemporary market features have, since the mid-1990s, developed. Private ownership now predominates but markets are still in their infancy. Although the use of mortgages has started to expand rapidly in recent years they began from a very low base and borrowers dealing in foreign currencies have suffered a severe exchange rate shock. Transactions are also relatively small in number compared to mature housing markets, while much informality and quasi-legality surrounds many housing exchanges. Housebuilding also continues to be predominantly owner-organised for direct consumption, though a development industry has been growing strongly in recent years. The sharp slowdown in the economy in 2001 and 2002 badly affected the housing market. The re-emergence of general growth in 2003 and 2004 then fed into housing demand. The medium-term prospects for the housing market continue to depend on the state of the economy and inflation.

Portugal

The housing market has been out of synchronisation with other Southern European ones in recent years, stagnating while others boomed. There was strong growth in the late 1990s and early 2000s, but this was followed by a sharp downturn in 2001 and 2002. Vacancy rates rose and prices levelled off. Since 2003, however, the housing market seems to have been leading the economy out of recession with rises in prices – up by 10% in 2003, followed by a more moderate 7% forecast for 2004. The prognosis is also good for 2005. This unique cycle is primarily due to the divergence between the country's rate of economic growth and that in the rest of Europe, with recent renewed activity in the housing market aided by low mortgage interest rates and growing consumer confidence.

Spain

The housing boom, though predicted to slow down rapidly in 2004, actually continued to power along during the first nine months of 2004. Prices were still rising by 17% nationally and 18% in Madrid, on an annualised basis, in the third quarter of 2004. The national figure was little different from what it had been since the middle of 2002. In Madrid, however, the acceleration of prices did slow down from the extraordinary levels of the previous year, but inflation was still strong.

The Spanish boom now surpasses that of other EU countries, such as France, Ireland and the UK, and may be setting a world record. Mortgage markets and housebuilding rates gave further indication of the heated nature of the housing market, though there was some slowing down of housing starts in 2004 – suggesting that developers were beginning to anticipate retrenchment.

Sweden

The housing market exhibited renewed price vigour in the Spring and Summer of 2004, with prices rising at 8%. The strength of the economy over the last few years, alongside low interest rates, are the main drivers of extra housing demand. Nevertheless, price behaviour has been more volatile in recent years than during the strong growth period from 1997 to 2001. There has been a notable downward shift in price growth in Stockholm since the heady double-digit price rises of a few years ago. Then, the capital led the country in house price growth, now it tends to trail behind.

Switzerland

The upswing in the housing market continued during 2004, although price rises were more moderate than earlier in 2002 and 2003. Rents had firmed slightly by the third quarter of 2004 for properties recently advertised, compared to the year previously, while the surge in flat prices seemed to have abated. All three main housing markets – flat-renting and buying and single-family house purchase – experienced around 2% increases in prices. This is moderate by the standards of several other European countries, but exists in a general context of very low general price inflation. It also represents a lower rate of growth than in the previous 18 months, which may indicate that extra supply is now restraining price pressures. As elsewhere, strong demand has helped to sustain the housing market – encouraged by an economy that is now growing at a noticeably faster rate than the Euro Zone, and falling interest rates. Interest rates, however, seemed to have bottomed out in 2004, with slight rises reported in the autumn of 2004.

United Kingdom

The UK housing market, after booming in 2003 and early 2004, seemed to have been brought to a sharp halt in the summer of 2004. The causes were not directly related to the economy, which remained strong, but to a series of interest rate rises in 2004 and the impact on confidence of warnings about the risks of house price falls in the media and by a series of organisations including the OECD, the IMF and, on several occasions, by the Governor of the Bank of England. So far, any price falls seem mild and within the bounds of statistical error. The general opinion, however, was that the boom was over and that 2005 would see moderate price rises or stagnation.

chapter five

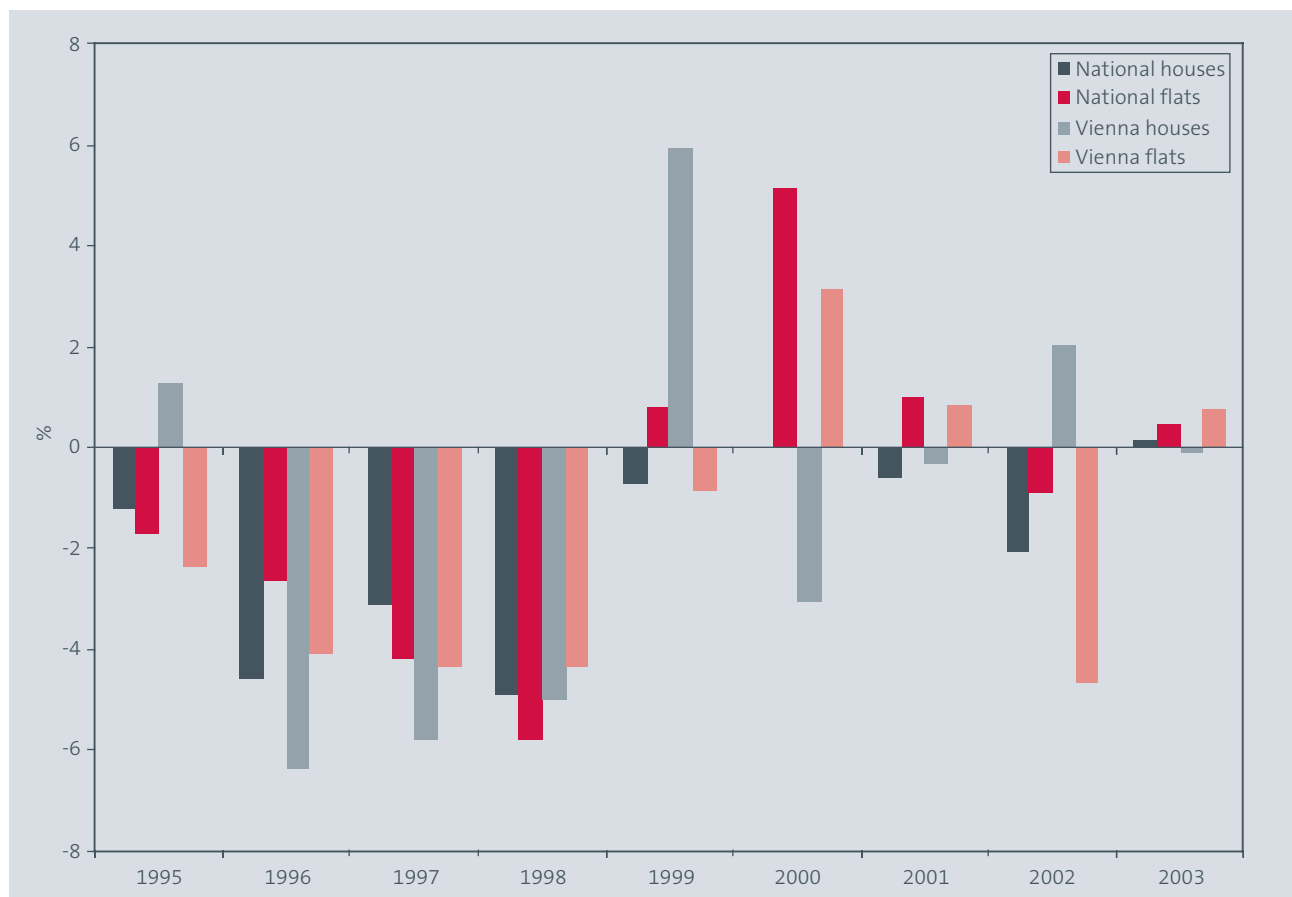
Austria

Overview

The market was static in 2003 and 2004, after the slight price falls of 2002, and it is still sensitive to the economic slowdown that has occurred since 2001 (Figure 5.1). An upturn in the economy is expected, which from 2005 should see a revival in housing market activity, both nationally and in Vienna.

With the absence of a boom, the experience of the housing market over the past few years can be regarded as rather similar to those of its neighbours, Germany and Switzerland, even though it has a higher owner-occupation rate than either of them. Market behaviour over the past decade consequently contrasts sharply with that of most other EU countries. There is a steadily increasing but still relatively low level of mortgage debt, at 27% of GDP, which means that the transmission effects from the housing and mortgage markets into the macro-economy are weaker than in many other European countries.

Figure 5.1: Recent changes in house prices, national and Vienna



Source: Austrian Immobilienspiegel, Research group EOS, TU Vienna

The housing system

Many households rent rather than own, but owner-occupation is still an important focus of people's housing aspirations, especially for households with children or those living outside of the major urban centres. The subsidy and tax system with regard to housing is broadly tenure neutral, with limited mortgage interest tax relief. Overall property taxes, however, are some of the lowest in the EU, with only a 1% share of the total tax take. This biases personal sector consumption and investment towards housing.

Owner-occupation

The tenure is growing as Table 5.1 indicates, so that it now houses almost a half of all households. The housing makeup of the country, however, is somewhat different from that of many European countries. There are many second homes, a high proportion of immigrants without citizenship, and a large number of temporarily resident foreign nationals working, for example, in the headquarters of the international agencies based in Vienna. If only the principal residencies of Austrian citizens are considered, the homeownership rate rises to more than 60% of all households. In smaller towns and communities, furthermore, the ownership rate can be as high as 85%, although Vienna is overwhelmingly a city of renters (82%).

This distinctiveness of Vienna's housing stock plays an important part in influencing the relatively low level of homeownership in national statistics. The rental share in other cities, like Graz, Linz and Innsbruck, is up to 50% of the housing stock. Salzburg, in particular, has an exceptionally high ownership rate, because the regional government there has been subsidising low-income homeownership heavily. The geographical pattern of housing tenures means that any future growth in owner-occupation will be focused in the suburban districts of the major cities, given the already high ownership shares in rural areas.

Table 5.1: Housing tenure

% share	Detached house owners	Condominium owners	Renters	Others
National				
1994	40	9	40	11
2001	42	11	39	8
Vienna*				
1994	5	11	84	-
2001	6	13	82	-

* other category excluded

Source: Statistics Austria

Owner-occupation occurs in two forms, either freehold ownership of single-family dwellings or as condominium ownership of flats. Virtually all single-family dwellings are in

owner-occupation. They tend to be among the higher quality segment of the housing stock, embodying the middle to upper-market suburban lifestyle. In contrast, most inner urban dwellings are flats. Institutional inertia will play an important part in influencing the future growth of homeownership, given the existing tenure of most multi-dwelling buildings. Private individual landlords have few incentives to sell. A right-to-buy has been introduced in the co-operative social rented sector (but not in other rental tenures) and it failed to attract much interest, though a subsequent offer to sell to institutional investors has been more warmly welcomed. Tenants also have limited incentives to buy, given tenure tax neutrality combined with the memory of recent price declines and an uncertain future for house prices.

The housing stock, furthermore, is geographically distributed in such a way that those liking the inner-city lifestyle have to live in flats, and, except for the high quality segment, that essentially means renting. Inner-city living has grown in popularity in recent years, particularly with younger households, who prefer to be renters to an even greater extent than their parents.

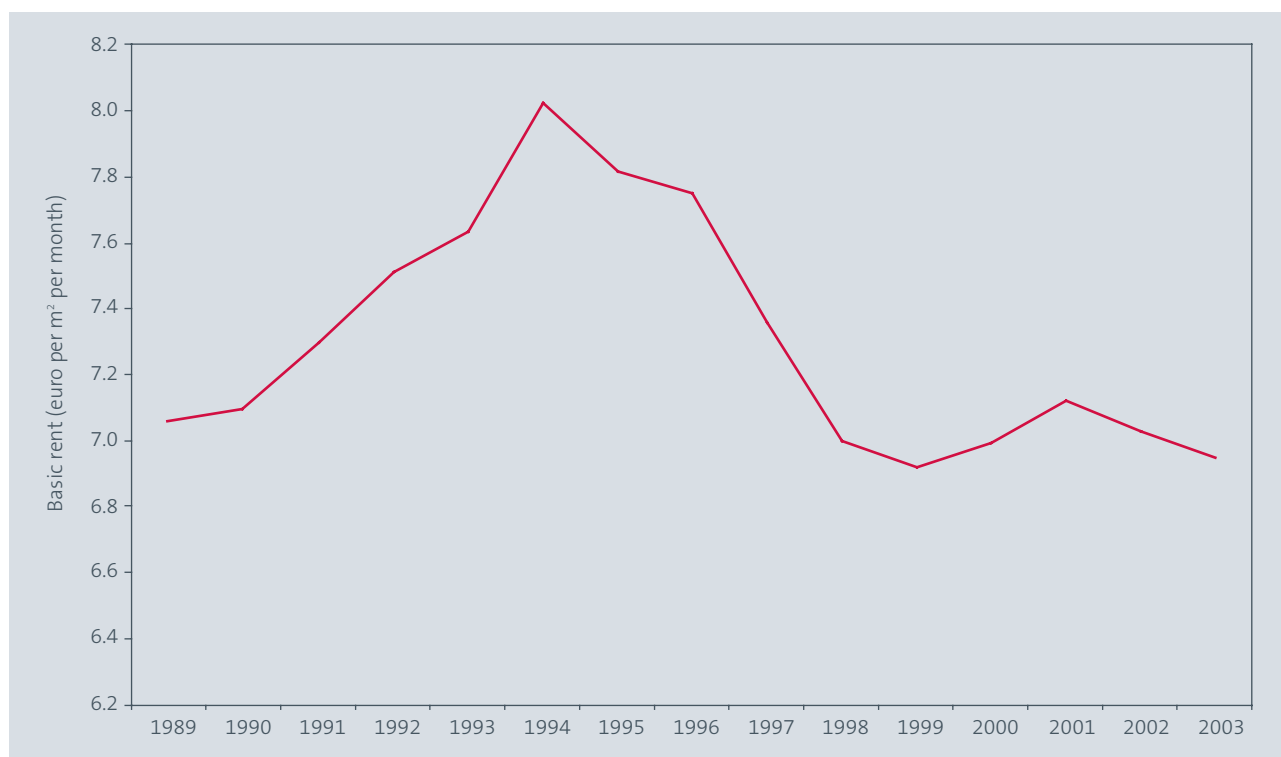
Taking all these factors together, it is unlikely that there will be a sudden surge in the homeownership rate in the near future. Rather, inner-city areas will continue with a steady, but moderate increase in condominium ownership, and suburban areas with a somewhat stronger trend for family houses.

Rental markets

To a great extent, the high rental tenure share of the cities is the result of earlier housing policies on promoting and regulating renting. In Vienna, for example, roughly half of the rental stock is private, a third municipal and the remainder co-operative. Nationally, around half of the rental stock is run by social housing institutions. Much rental housing is subject to regulations – last amended in 2003 – in which rents can only be changed depending on the inflation rate plus surcharges for more popular locations and investments in modernisation. New contracts for existing dwellings in the private rented sector are more moderately regulated, with substantial permissible surcharges in the most popular, better-quality locations. The minimum duration of a rent contract is set at three years, which is binding on landlords but not tenants.

The rental market, consequently, is segmented via tenure, regulation and market forces into a hierarchical pattern of low rents for municipal, other social tenants and long-term incumbents in the private sector, but much higher 'free market' ones for recent entrants into the private sector – most of whom are younger households. Rents have not been under undue market pressure since the early 1990s (see below), so that the current regulations have probably not had a notably distorting effect on market activity in the 'free' sector in many locations. Landlords, as was noted above, have limited interest in selling to homeowners at present, because there is no market premium in the owner-occupied sector, as has occurred in some other countries, such as Italy.

Figure 5.2: Rents excluding utility and service charges, new contracts, 1989-2003



Source: Austrian Immobilienspiegel, Institute for Econometrics, TU Vienna

Recent market developments

An important influence on market sentiment in recent years was a cycle of boom and slump in the 1990s, that initially saw prices rocket and subsequently led to declines. This means that the last few years can be regarded as a recovery phase towards more normal market circumstances, which are likely to prevail in the future.

An expansion of owner-occupation in the 1980s set off a real estate cycle. This hitherto unknown phenomenon in the post-1950s era began with an unprecedented boom in the late 1980s and early 1990s, when house prices doubled and, in some areas, even tripled. The new suburbs experienced the greatest boom, but existing dwelling prices and redevelopment site values also soared. The price rises ended as extra supply came on stream after 1994. Average price falls of 20% were recorded between the end of the boom and 2000, as excess supply dominated the market. In future, house prices should grow broadly in line with general economic performance – interest rates are less of an influence, at present, because of the relatively low use of mortgages. A further boost to the housing market should be given as a result of the expansion of the EU eastwards, which should be of major benefit to general economic activity and housing demand, given Austria's proximity to the new accession countries.

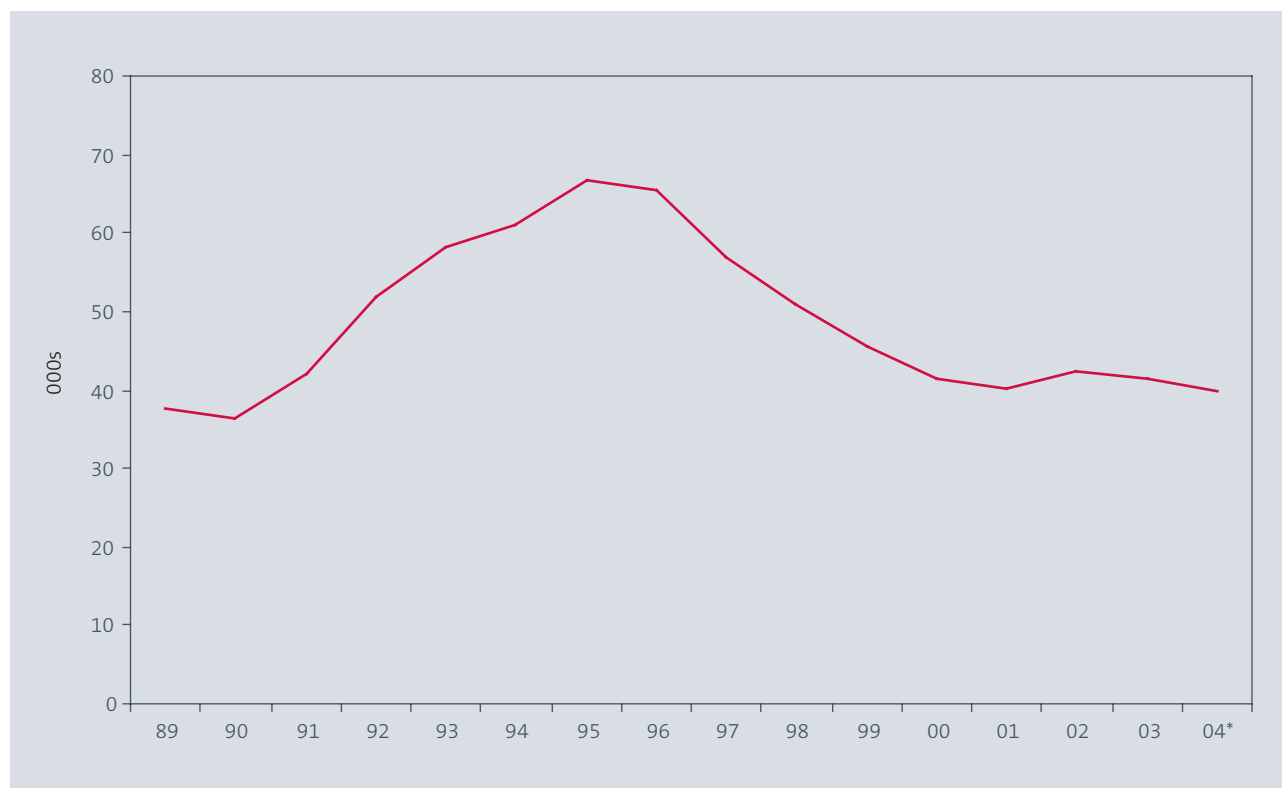
As the excess supply of rental housing grew during the 1990s, the rents paid to landlords in the free market fell. In Vienna, where the rent increase in the early 1990s was sharpest, they started to decline sooner and fell by over a quarter. The falls had stopped by the turn of the century, and rents throughout the

country have been rising, then falling, slightly over the past four years. So, in Vienna by 2003, they were only 3% higher in nominal terms than at their trough in 2000. Despite the falls in basic rents, actual gross rents continued to increase because of rising service costs, especially for public services like water, sewage and rubbish collection. Utility costs rose to offset growing local government deficits, and represent implicit reductions in previous subsidies. Recently, however, such increases have abated, coming more into line with overall inflation.

Average rents have followed a similar pattern to house prices over the past decade, with Vienna leading any changes. National rents subsequently caught up with those in the capital. It is interesting to note that average rent levels are now virtually the same in the capital as in the rest of the country, with some more highly desired cities, like Salzburg, having higher rents. These data are not dwelling quality adjusted. Even so, the absence of a locational premium for Vienna indicates that rent levels are not being fully market-determined but, instead, are influenced by the cost structures of social housing institutions which compete with the private sector and the rules of the rent regulation system.

Housing benefits are available on an income-related basis for occupants of subsidised, new dwellings and for refurbished dwellings when construction costs lead to rents that are above specified affordability limits. Housing benefits apply across all tenures, but virtually all are linked to new construction projects or to modernisations of existing rental dwellings. The Vienna City government, however, has introduced a general means-tested benefit for new and existing renters, regardless of tenure; other Länder governments are currently introducing similar schemes.

Figure 5.3: Housing starts 1989-2004



2004 data forecast. Vienna 2003 not available.

Source: Statistics Austria

Housebuilding and housing policy

A major surge in housebuilding started in 1993, when federal and regional authorities responded to the immigration wave from South Eastern Europe. From 1993 and 1996, housing starts reached more than 60,000 units annually, almost 2% of existing stock. An equal number of completions followed with a time lag of about 2 years. The rate of housebuilding was such that between 1994 and 1999 nearly 280,000 units were completed – 9% of the total stock. In 1996, however, starts began to decline sharply back towards the historically low levels that existed prior to the onset of the building boom. Some local authorities in areas where housing is still in short supply, such as Vienna, have tried to counter the slowdown with more proactive programmes to build homes and to undertake urban renewal. Such programmes, however, have not had much impact on aggregate building data.

Since the mid-1990s, the demand for new housing has been limited by the severe restrictions introduced on immigration, so that population increases have come to a virtual halt. Divorces, an ageing population and flexible lifestyles are still raising the number of households, but the impact on the housing market of such household increases has been limited to date. The only major demand stimulus has occurred in those urban locations

preferred by younger or single people and wealthy migrants from other parts of the EU. There is also trading-up demand from existing homeowners.

The bottom of the cycle was reached in 2001, with some minor increases since then. The current rate of housing starts is around 39,000 per annum, which is lower than the desired replacement rate (Figure 5.3). Overall, the current building level may now be too low for future demand, but recent data reveal no real upswing is likely in housing activity for 2005.

Modernisation expenditure held up considerably better than new build. In fact, it even increased somewhat in the late 1990s, reflecting renovation programmes in social housing estates. Since 2000, however, it too has been on a slight downward trend.

In terms of tenure, housebuilding has been primarily for homeownership, but there is still a significant element of rental housebuilding, in contrast with many other EU countries. In 2002, for example, 48% of completed dwellings were for the house proprietor's own use, 18% were freehold flats, and rented dwellings accounted for a further 29 per cent.¹ Thus, the share destined for owner-occupation, at 66%, was significantly higher than the tenure's headline share of 53% of the stock.

¹ Austrian Statistics.

Housebuilding subsidies

Housebuilding subsidies are offered to most types of housing provider: non-profit (co-operatives and social providers for the common good), for-profit developers (private companies) and private persons in the family home sector. There are three types of subsidy:

- Public loans – direct grants were abolished in the late 1990s in order to limit public expenditure;
- Annuity subsidies to reduce the cost to the borrower of bank loans;
- Personal allowances to renters and to reduce owners' loan payments.

Such subsidies only contribute part of the cost of a development. The additional finance necessary for development comes from institutions' and individuals' own capital, through Bausparkassen saving and loan contracts, and other bank mortgages that offer income tax relief. Broad market conditions, therefore, affect the rate of subsidy take-up and the number of new dwellings built. Total housing subsidies were running at an average of 1.3% of national income between 1995 and 2000, but fell below 1% from 2001, so that housing subsidies are now lower than in many other countries.

Regional Länder and local authorities actually provide the subsidies, though much of the money comes from Federal tax receipts. There is a rolling five-year contract negotiated between the Federal government, the Länder and local government, setting out the scale and form of the subsidies. The recently renewed contract between the federal government and the Länder governments keeps the level of housing subsidy fund constant over the next 5 years, albeit in nominal terms. Moreover, if housing investment continues at its current subdued levels, it is unlikely that the full amount of the subsidy agreed in the housing concordat of 2000 will actually be taken up.

In addition, subsidies no longer go to new construction alone, with a substantial part now absorbed by a variety of projects related to neighbourhood improvement, public infrastructure and services for children, local schools and the elderly. The switch has been encouraged by the years of excess housing supply. Nevertheless, the essence of the subsidy system has traditionally been that subsidy is geared to new housing rather than to housing in general as it is in most other EU countries. One important aim has been to facilitate access to rental housing in both the private and social sectors.

The primary objective of housing subsidy measures in the past has ostensibly been to improve housing conditions and affordability. Yet, these objectives have often merged with a concern to stabilise construction employment – in a way similar to Swedish housing policy up to the 1980s. In past economic downswings, including that of the mid-1990s, the employment argument was given more attention than the impact on the housing market. This style of politics involving negotiations between government, business and the unions is now mainly at an end, although it survives more strongly in regional and city politics.

Macroeconomic influences

The economy enjoyed a favourable record for a number of years up to 2001, but since then growth has fallen well below its potential. A third of exports go to Germany, so that economic activity there has a strong influence on the Austrian economy. Rapidly expanding trade and investment with the new EU countries in Central Europe has offset some of the downturn but the economy is still operating at less than full potential.

A gradual improvement in the economic situation is expected over the next couple of years.

Inflation, as noted above, was low until 2000, when it picked up due to the booming economy, rising oil prices and higher public service costs. It rose to 2.2% in 2001, but has subsequently moderated to 1.3%, well below the ECB target of 2%, but is expected to reach 2.0% again in 2005. Exports will remain the main driving force for economic growth. The weakness of consumer expenditure, therefore, will continue to influence housing market activity.

Though the current government wants to maintain a zero public sector deficit, the fiscal stance has been loosened with tax cuts not matched by expenditure reductions, and further tax reductions are planned for 2005. As they will probably be pro-cyclical, they may well stimulate personal expenditure on housing. Even so, the aim of balancing the budget helps to explain the concern to reduce housing subsidies, noted earlier.

The country has also benefited from the effects of greater international financial integration and the development of the Euro Zone. Up to the 1990s, bond and loan rates traditionally ranged up to 100 basis points above German levels. They then converged during the 1990s, and were removed with the advent of the euro.

Mortgage markets

There are several types of mortgage:

- Long-term, fixed interest loans from banks financed by issuing mortgage bonds on capital markets. These are the main form of borrowing, and it is possible to borrow up to 60% of a property's value.
- Special bank loans refinanced from convertible bonds. The bonds are free of income tax for the first 4% of the return, and have a 10-year minimum term. They save mortgage borrowers around 0.75% in interest costs, but they are currently only available for new residential construction. There is a proposal to extend them to urban renewal schemes.
- Bausparkassen loans. These are based on 5 year savings contracts, followed by a loan. About a quarter of outstanding mortgages come from this source. The loans are funded from Bausparkassen savings deposits, on which there is an interest subsidy amounting to about €200m annually, funded from federal housing subsidy expenditures.

Since 1999, Bausparkassen have been permitted to raise funds from capital markets and their loans can now be used for most types of residential investment. These reforms were encouraged by the declining competitiveness of Bausparkassen, because falling interest rates have virtually eliminated the interest rate benefit that consumers used to have by taking out loans with them.

- Public long-term (25-35 years) low interest (or even zero-interest) mortgages are available for approved schemes.
- Bank loans with flexible interest rates are used as top-up loans.
- There has been a growth in the use of foreign currency loans. Securitisation has also recently been fully permitted and real estate mutual funds are developing. So, the structure of mortgage finance may change somewhat in the future, though it is unlikely to lead to major transformations of mortgage finance but, rather, to greater competition.

Growing competition amongst lenders has forced them to offer more attractive deals. Mortgage lenders, for example, offer the option of either a fixed-rate mortgage or a graduated interest rate one, where the rate is fixed at a lower rate for the first few years.

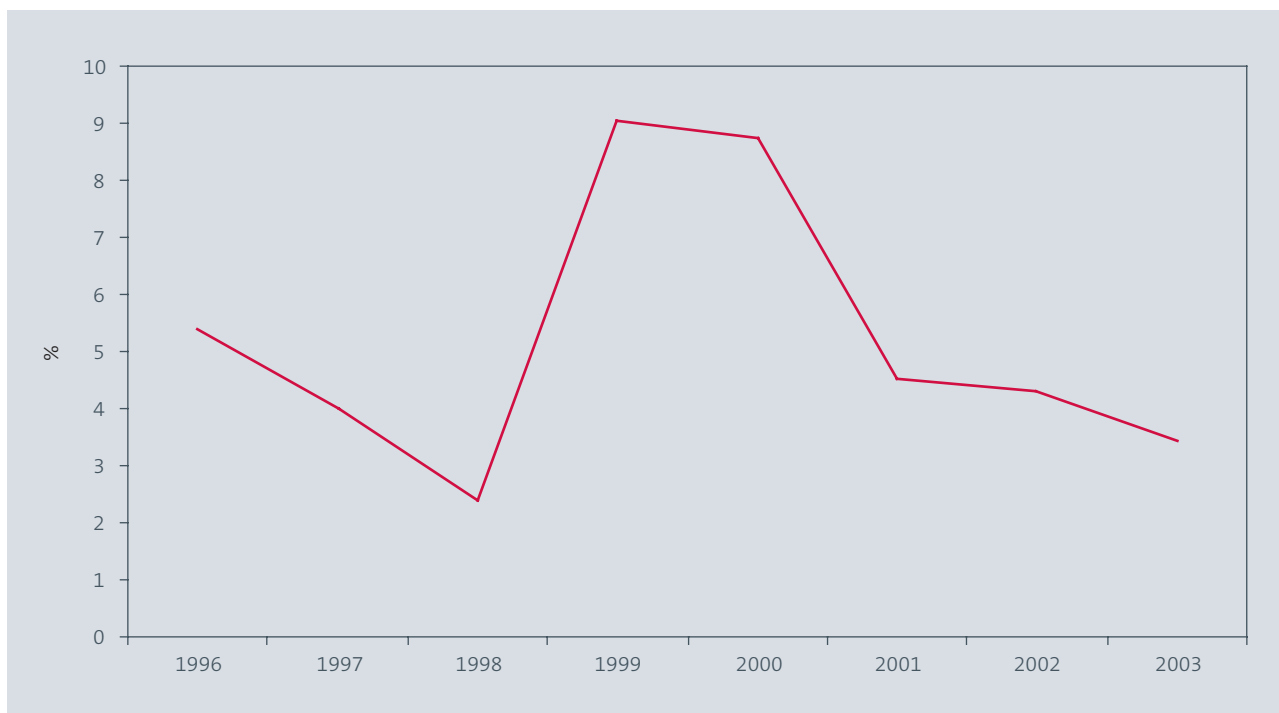
Interest rates have been falling in recent years, but the reduction in real rates has not been on the scale of that in other more inflation-prone EU economies. Fixed rates fell in real terms only

from 5.5% on average in 1996 to 4.3% in 2002. The limited interest rate stimulus, plus the fact that the housing market has only recently come out of recession, means that there has been no major rise in mortgage lending. This, as the other country chapters show, is in marked contrast to many other EU countries.

The use of mortgage debt has expanded slightly in recent years, so that the ratio of outstanding housing loans to GDP has grown from 24% in 1996 to 27% in 2002, but this ratio is still one of the lowest in the EU.² This low debt ratio arises from the relatively low homeownership rate, the large amount of own capital homeowners put in, the scale of subsidies to new building and the limited indebtedness of institutional housing providers. It also helps to explain why mortgage defaults have been minimal, despite the problems of the owner-occupied market in the 1990s.

Households, as elsewhere, have still responded to lower interest rates by borrowing more. As Figure 5.4 shows, the growth in long-term loans has been low by the standards of most other EU countries. As the majority of mortgage finance is funded through bond issues, long-term interest rates are the most important influence on the mortgage market – though 30% of mortgages are of the variable rate type. Extra competition amongst mortgage borrowers has reduced interest rate spreads. There has consequently been some added interest rate stimulus to housing demand, even though it has been relatively muted and helps to explain the flatness of the housing market.

Figure 5.4: Long-term loans to households % change



Source: Central Bank

² Many cross-EU comparisons show an even lower share of mortgage debt but they omit several key items

New international negotiations on the capital adequacy of financial institutions have implications for mortgage finance, as elsewhere. The Basle II accord will not come into force before 2006, but will eventually require a more than doubling of the asset holdings required of banks to back up their mortgage advances, from the current 4% requirement of Basle I. This will raise banks' costs, which will have to be passed on to customers in higher mortgage rates. Mortgage banks and Bausparkassen are particularly concerned that this will further erode their competitive position.³

Another development has been that the Länder, in order to improve their financial position, have now sold large parts of their outstanding public loan portfolios to domestic and international financial institutions – particularly to capital market based funds, property funds and pension funds. This means that most of the housing market loans offered by the state are now no longer in public accounts. In future, consequently, more finance for housing will be indirectly provided by the private sector, with the state switching from a funding role to one that focuses more on being a housing facilitator, through offering and promoting loans for housing and by improving loan terms through subsidy.

There are other forms of integration between the developer and financier roles in housing provision. This can be seen in joint initiatives between financial institutions and landlords. Banks, mortgage funds and mutual funds have been combining with both private and public landlords to offer packages of homes and finance. This is done particularly with rental property, where buying options are made available after a minimum renting period of 10 years. Introduction of these packages has been influenced by the new law that imposes a right-to-buy option on co-operative and non-profit landlords, but the need to generate business in a relatively weak market has been another influential factor.

Demographic background

Population changes and the house price cycle

The effect of demographic shocks on the pattern of housing starts and house prices has been marked over the past decade. After stagnating for most of the 1980s, the population increased from 7.7 million in 1988 to 8.0 million in 1994. It then rose much more slowly to about 8.1 million, according to the 2001 census. Household numbers have also grown rapidly over the past decade. The 2001 census enumerated 3.3 million households, 12% more than in 1991. A third are single person, with 45% of Viennese households being single-person.

The increase in population during the first half of the 1990s was generated by two forces. The first domestic component was brought about by a peak in births from parents who themselves were born in the 1960s' birth surge. The second component was much larger, and resulted from immigration after the opening of

the eastern borders with the collapse of the Soviet Union and its spheres of influence, as well as the impact of the Balkan wars. By 1995, permanent residents with non-Austrian citizenship represented 9% of the population, which was the highest share in the EU except for Germany. The surge was then over, as immigration rules tightened, and population growth rate has declined to be one of the lowest in the EU.

Now more than a million people, 12.5% of the population, are classified as foreign-born. In order to foster social integration, from 1995 a substantial number of longer-term immigrants have been given Austrian citizenship. Since foreigners are generally not entitled to either subsidised renting or to own, these new citizenship awards have enabled many to improve their access to housing.

Because immigrants from South-Eastern Europe have average incomes that are lower than those of domestic households, their housing demand is particularly focused on the cheaper private rented parts of the housing market. Access to the social rented market is still dependent on Austrian citizenship.

The 1990s' surge in owner-occupied house prices, consequently, cannot have been directly related to immigration, but is more likely to have reflected the demographic patterns noted above and consumer naivety about house price volatility. The expansion of immigration, nonetheless, would have encouraged what turned out to be a false perception that the country was facing a prolonged housing shortage and that housing resources would be in shorter supply in the future, factors which made housing look like an attractive investment.

Housing starts followed the population spurt with a time lag. The maximum rate of population increase was reached between 1991 and 1994 and housing starts peaked in 1995. With hindsight, the building and price boom of the mid-1990s was clearly a mistaken reaction to rising housing costs and a short-lived surge in population growth. Governments encouraged it through their subsidies, but households dramatically misforecast the future of house prices. The previous lack of experience of house price cycles may have contributed to the belief that house prices only move one way – upwards. Conversely, the reaction to the capital losses made on housing investments since the mid-1990s may now make consumers over-cautious about house purchase. This is helping to dampen any upward price movement.

Future rates of immigration are uncertain, but there is a widespread belief that the enlargement of the European Union will generate new momentum. In EU enlargement discussions, Germany and Austria have insisted on labour mobility restrictions for a seven year transitional period, but whether this proves effective will mainly depend on the economic climate, relative rates of unemployment and labour shortages. Some forecasts predict that 100,000 new immigrants can be expected, spread over a number of years, but a repeat of the early 1990s context is highly unlikely.

³ This concern is common to mortgage financiers in other countries as well.

Impacts of an ageing society

Immigration by younger people, in any case, would help to offset the current marked ageing of the population. The cohort aged between 20 and 24 years, after increasing in the late 1980s and early 1990s, began to decline, so that between 1993 and 2000, it fell by 150,000; while those aged between 40 and 55 increased by a similar number. The upwards shift in the average age of the population will continue in the future. By 2030, the number of people aged 65 and over will have risen from 22% of the population to 32%, while the number that are economically active will decline by a roughly proportionate amount (Table 5.2). As the country has generous retirement pensions paid out of taxation, the fiscal consequences are substantial, and will lead governments to look for extra sources of funding. This may well have implications for the current low level of property taxes – which both the IMF and OECD, for example, have argued should be increased.⁴

Table 5.2: Population forecasts 2002-2030

	Total millions	% aged: <15	15-64	65+
2002	8.12	16	62	22
2010	8.22	14	62	24
2020	8.32	14	59	27
2030	8.39	14	54	32

Source: Statistics Austria

There are other important housing market implications of age structure changes. The main cause of household formation – younger people setting up home – has declined, with an implied need for less housebuilding.⁵ This probably helped to exacerbate the supply overhang after the mid-1990s. Furthermore, as older people are generally wealthier than younger ones, the extra housing demand of this older group is for higher than average quality and more spacious housing. The result is that the quality profile of new housing is having to shift upwards to take account of these underlying demand changes. There is a growing demand for smaller size accommodation, as older households in urban areas have fewer children living with them than younger ones and single-person households at both the younger and older ends of the age spectrum are increasing in number. Overall demand from domestic population sources, however, is still expected to continue to fall.

Geographic implications

The greatest source of housing demand in recent years has been from households whose head is aged around thirty, still with children living in the family home. Such families prefer to reside in the suburbs and have more savings and higher incomes than young housing groups. In rural areas, households tend to enter owner-occupation at a younger age through informal markets that are often not picked up fully in the statistics, but demographics are now lowering this type of housebuilding.

Extra suburbanisation has been quite marked in the last decade. The 2001 population census showed that suburban areas had population growth rates of between 10% and 20% in the decade following 1991. This was matched by a continued loss of population from several city centres: notably, Graz -5%, Innsbruck -4%, and Linz -8%. Yet, two major cities still experienced population increases: Salzburg by 0.5%, and Vienna by 1.5%. These two cities, closely followed by Graz, have the highest average incomes of all localities. So, the extra housing demand in them undoubtedly includes a significant element in the upper echelons of the housing market, though there is still strong demand for affordable accommodation in both the private and social sectors. Yet, at the same time as the suburbs have continued to grow, there has been an increase in demand for city centre living, particularly by young, single people.

Taking into account all of these demographic and geographic factors and expected moderate net immigration, the medium-term number of required building permits (including adaptations) can be estimated at between 40,000 and 45,000 a year. This is somewhat above the current level of output, but significantly below that of the 1990s. Some 35,000 units are an estimate for the economic replacement rate, with the rest representing net additions (including quality improvements) to the stock.

⁴ See the respective country reports in 2002 by the IMF and OECD.
⁵ Economic studies that provide construction forecasting models at TU Wien have highlighted the significant of population change for housing demand.

Factfile: Austria

Background

Population (m) 2002	Population Growth % 1980-2001	Fertility Rate* 2002	Years Life Expectancy 2002
8.1	7	1.3	79

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

Services output as % of GDP 2000	Employed as % working age population 2002
65	73

* GDP per person employed 2002

Economic

	2000	2001	2002	2003	2004f
Real GDP growth %	3.4	0.8	1.4	0.7	1.5
Growth in real private consumption %	3.3	1.4	0.8	1.3	1.3
Inflation – GDP deflator	1.4	2.1	1.4	2.0	1.6
Inflation – consumer prices	2.0	2.3	1.7	1.3	1.2
Unemployment rate %	4.7	4.8	5.5	5.7	5.9

Government

	2000	2001	2002	2003	2004f
Expenditure as % GDP	52	52	52	51	51

Housing market

	2000	2001	2002	2003	2004f
Growth in residential investment	-5.2	-10.5	-6.2	1.6	0.8

Taxes

Owner occupied housing	Capital gains exempt	Imputed rental income
Mortgage interest relief – part	yes after 2 years	not taxed
Property transaction tax rate	Property taxes as share of all taxes 2002	Property taxes as share of GDP 2002
3.5%	1%	1%

Housing Statistics in the European Union 2003, Eurostat, OECD, World Bank.

chapter six

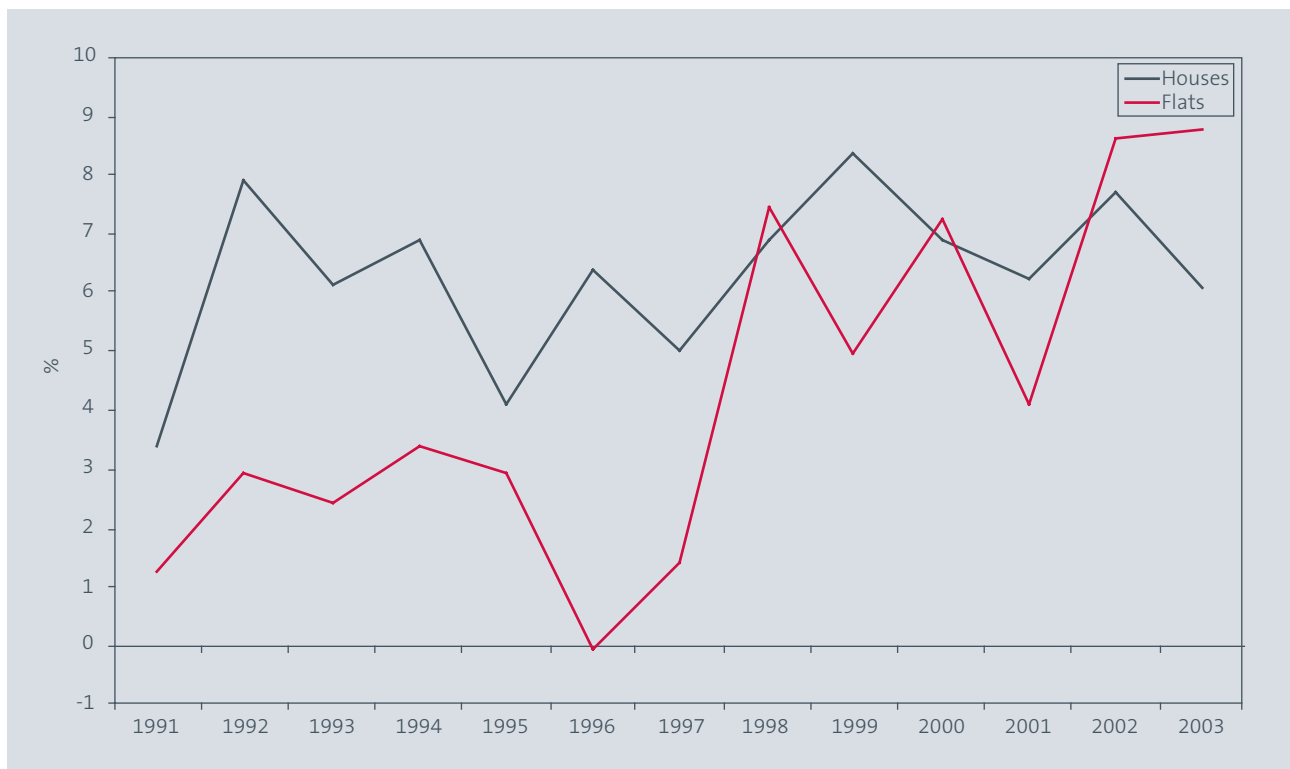
Belgium

Overview

The prolonged price boom, though relatively modest by the standards of some other EU countries, shows few signs of abating after seven years (Figure 6.1). House prices were 80% higher than they had been 8 years earlier in Brussels in the summer of 2004; while flats in Flanders were worth over 2.6 times as much. The mortgage market, in addition, had what can only be described as a spectacular year in 2003, as thousands of households re-mortgaged or bought homes. Growth was more subdued in 2004, yet still managed to expand even from such a high base.

After dips in the rate of growth of transactions and prices in 2000 and 2001 respectively, the housing market shrugged off the general downturn in the economy and has been expanding steadily since (Figures 6.1 and 6.2). An improved economic environment and low mortgage interest rates have helped to boost consumer confidence in house purchase over the past two years. Enthusiasm for house buying has also been encouraged by the capital gains experiences of homeowners, at least in nominal terms, for many years. Only in Brussels have owners faced price falls since the 1980s and, even then, the effect was a mild one. Furthermore, the tax system is highly favourable to property ownership, though less so to transactions because exchange costs are high.

Figure 6.1: Changes in house prices % 1991-2003



annual % change

Source: Stadim

Figure 6.2: Annual % change in housing transactions 1991-2003

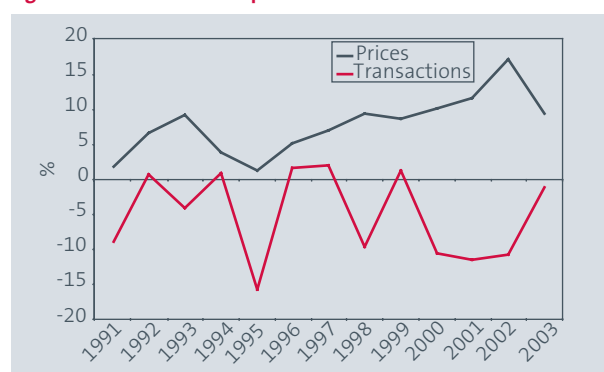


Source: Stadim

The particularly sharp growth in the prices of flats in the more dynamic localities illustrates a significant transformation in lifestyles that has been taking place in many parts of Belgium over the past decade. The traditional household emphasis on a new house on an individual plot somewhere in the suburbs, though still an important characteristic of the country, is slowly being joined by significant social cohorts that live in new urban flats or renovated properties. This is transforming the heart of many cities and towns, where previously run-down but attractive inner-city districts are belatedly, by international standards, benefiting from a hearty dose of rebuilding, gentrification and a switch to owner-occupation.

One of the more surprising developments of recent years has been the accelerating increases in the square metre prices of new building plots, from the mid-1990s onwards (Figure 6.3). Historically, it was generally rare for the prices of land plots to increase more quickly than those of existing dwellings. As Figure 6.3 shows, however, land supply has been drying up. Virtually every year since the price boom started in 1998, the supply of development land has fallen and, unsurprisingly, prices have been rising as supply falls. The land supply situation seemed to be levelling off in 2003, but that appears to have been temporary and the situation is forecast to deteriorate again in 2004. In 2003 in Flanders, which has the most dynamic housing market, land transactions were running at less than half their 1994 level (25% less in Wallonia), despite the fact that square

Figure 6.3: Residential land prices and transactions 1985-2003



Source: Stadim

metre prices were over 2.75 times higher. Land plots are of direct significance for house consumers, because the tradition in homeownership is for substantial self-organisation of the building process and the erection of scattered, single-family houses.

Construction organisations and other market experts have argued that the rising costs and shortages of new residential land have been prime causes of the fall in housing starts, especially in Flanders, and rising house prices. The land shortage has had spillover effects, including encouraging homeowners to buy in the second-hand market or to improve their existing homes.

The housing system

Owner-occupation

Almost three-quarters of households are now homeowners, and the number seems to have grown rapidly in recent years, rising by 7% between 1991 and 2000. The expansion of homeownership has been at the expense of private renting – though that remains quite high, at 19%. There is also a small socially rented sector (4-5%), but no rent subsidies or housing allowances.

Table 6.1: Housing tenure 1991 and 2000

% share	1998	2001 Flanders
Owner-occupation	74	71
Private rental	19	19
Social rental	4	5
Other	3	5

Source: Statistics Belgium; NIS Socio-Economic Survey, 2001.

Three-quarters of the stock consists of single-family houses. Quite a lot of the housing stock is also rundown. It was estimated in the late 1990s that about 10-15% of current owner-occupied housing is sub-standard, and the situation was worse in the private rented sector. The distribution of poor quality housing varies a lot between regions, being greatest in the old manufacturing and coal mining districts, but even the large cities have substantial neighbourhoods of poorly maintained homes. Furthermore, concerted programmes of demolition and urban renewal have been limited in the past, in contrast to other EU countries with similar building age profiles.

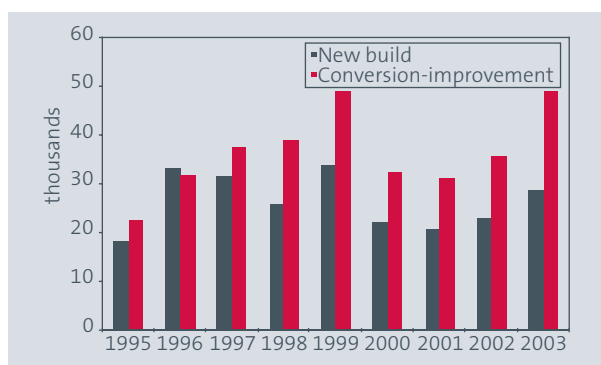
Demolition for housing rather than commercial purposes never took centre stage in government policy. There were never major social housebuilding programmes in either inner cities or suburbs, let alone on the massive scale common in neighbouring countries. Belgium remains an enclave, with starkly different housing policies from those of the strongly state interventionist housing production era that swept across most Northwest European countries from the 1950s to the 1980s. It had the housing policy characteristics of a southern rather than a northern European country, with consequences that, over the long-run, may not be so adverse.

Instead, redevelopment has tended to be piecemeal, based on individual owner initiative and quite small in scale until the last decade, because of the pull of residential decentralisation. This is despite years of extremely lax conservation policies, which made urban demolition quite easy by the standards of most European countries; though the pendulum is now swinging to greater controls in wider urban cores than was the practice in previous periods.

The current boom is eating away at this profile. Some of the recent growth in homeownership has been associated with 'gentrification' and renovation in which rental dwellings are transferred into homeownership. As a result, inner-city and older suburban districts of the more prosperous parts of the country are gradually changing as existing dwellings are renovated or demolished. This is altering the social composition of quite a number of inner-city neighbourhoods towards more affluent, younger households, and away from traditional low income and immigrant groups, who face growing affordability and availability problems.

Data on mortgage contracts give an indication of the current scale of building renovation (Figure 6.4). Perhaps the most interesting aspect of these data is the scale of upgrading of existing stock that they indicate, which reinforces the points made above about renovation and gentrification in the existing stock. The number of mortgages used for 'conversions' has generally outpaced new build since the mid-1990s, and they were 55% higher in 2003 – a 'spike' year like 1999.

Figure 6.4: Residential mortgage contracts new build & conversion 1995-2003(thousands)



Source: National Bank

There are economic reasons for this shift towards existing dwellings as well as changing preference and wealth profiles within society. One obvious economic influence is the relative price and range of choice in the shrinking supply of new accommodation. The shortage of new suburban plots and the rising cost of new housing mean that better bargains can be found in the existing stock. The general search for 'good value' housing in the existing stock can be seen by comparing the total turnovers in the two categories of conversion and new build. These have remained roughly equal, despite the far greater volume of conversion than new build activity, because newly built houses tend to be more spacious and expensive than conversions.

In addition, as in other countries, many households have chosen to upgrade their existing properties in face of the high cost of moving. However, in Belgium, it is not simply the cost of better housing that deters mobility but, also, the transactions costs associated with moving, which are amongst the highest in Europe. For example, transactions taxes are high, with a 21% VAT on new housing and 10-12% stamp duty, which is now vigorously pursued by the tax authorities. Recent proposals to tighten up on payment suggest the introduction of assessed values, rather than to query unreasonably low reporting of purchase values as occurs at present. The effective incidence of these taxes, however, is complex to calculate, as part of it is likely to be capitalised into house selling prices.

Despite the high costs of moving, owner-occupation as a whole is well-treated tax wise in relation to other assets. Apart from mortgage income tax relief, tax payments can also be offset against expenditure on housing-related life insurance and the repayment of the capital element in a mortgage. These tax breaks represent the largest reductions of any sort in the overall income tax take: in 1999, over 900 million euros of potential tax revenue were 'lost' in this way. The High Council of Finance in 2002 calculated that the effective tax rate on owner-occupation was only 7%, against almost 20% on a risk-free long-term investment.¹

¹ National Bank Economic Review 2-2004.

Renting

Rental markets have been subdued for a number of years, because homeownership has been growing at the expense of private renting. Real rents in the private sector overall rose by 18% between 1990 and 2000, far less than the increases in the capital values of dwellings over the same period.² General rental growth tailed off from the mid-1990s, and real rents were even falling in 2000 and 2001 (Figure 6.5).

Around 20 years ago, the social and income profile of households that owned and rented was quite similar. Nowadays, there are

noticeable differences, with better-off, higher-social class households increasingly opting for homeownership, according to a survey conducted in Flanders.³ These divergences, moreover, have intensified since that survey was undertaken.

Despite the growing differences between tenures, the degree of social separation between them is still far less than that in many other EU countries. Low-income homeowners are commonly found amongst older households or those living in the poorer parts of the existing stock, part of which is in owner-occupation, and there is also a significant high income rental sector with, for example, 28% of Flanders' tenants in the top two income quintiles.

Figure 6.5: Real rental changes 1994-2001

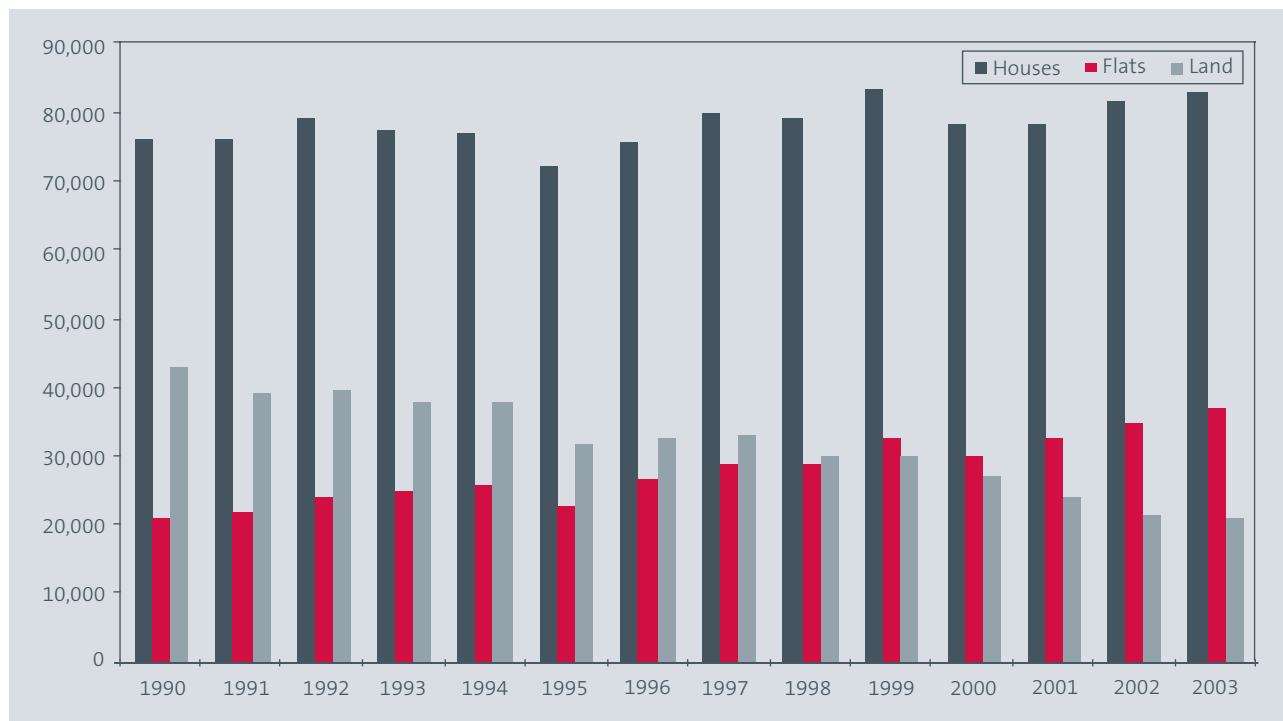


Source: Housing Statistics in the EU 2003

² Housing Statistics of the EU 2001, Finnish Ministry of Housing, 2002.

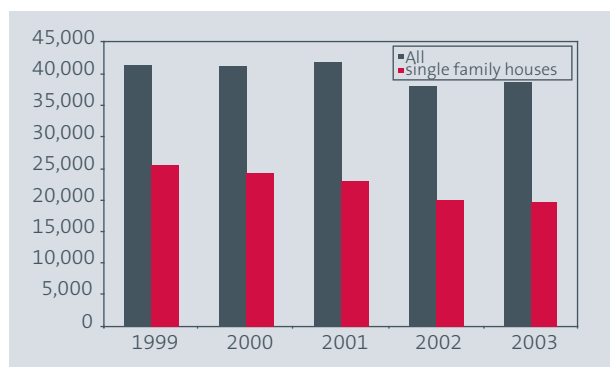
³ Pannecoucke, I., Geurts, V., Van Dam, R., De Decker, P., Goossens, L. & B. Cantillon (2001): Profiel van de sociale huurder en subjectieve beleving van de realisaties van de sociale huisvesting, OASeS, UFSIA, Antwerpen.

Figure 6.6: Dwelling and residential land transactions 1990-2002



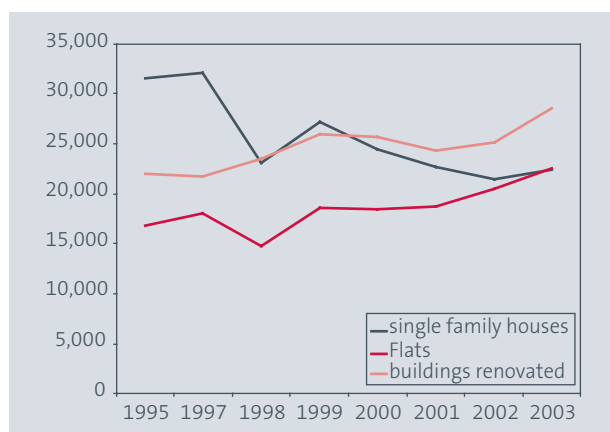
Source: Stadim

Figure 6.7: Dwelling starts 1992-2002



Source: Statistics Belgium

Figure 6.8: The growing importance of flats and improvements, 1996-2003



Source: Statistics Belgium

Source: Statistics Belgium

Recent developments

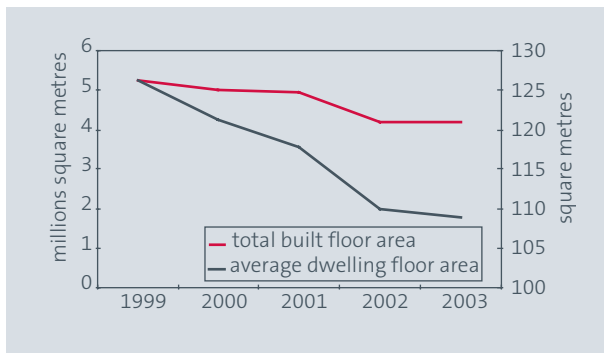
Transactions in the housing market have fluctuated on an annual basis, but not to the extent experienced in some other European countries, especially when the market is broken down into houses and flats and account is taken of their divergent trends. Land sales – an important indicator of housebuilding in the owner-occupied sector – have declined on a trend basis, and were only half of their 1990 levels in 2002, as examined above. In contrast, the sales of apartments rose by almost two-thirds over the same period, reflecting the secular changes in the housing market examined earlier (Figure 6.6).

Housing starts, however, continued to decline, as they have been since 1997 (Figure 6.7). Belgium consequently shares with several other countries in the EU the paradox that, as prices rise in the housing market, new supply is falling. This odd supply behaviour is attributed to the shortage of development land. In contrast, improvement expenditure has been growing – though with fluctuations – and is now higher in terms of the number of dwellings than either house or flat building (Figure 6.8). The number of flats built has also converged with that of house-building. The cost of land has also led to a greater density of building. For example, three storey buildings grew from 9% of new residential accommodation in Flanders in 1996, to 23% in 2001.⁴

⁴ Statistics Belgium.

Housing starts numbers do not accurately portray the decline in the volume of living space that is being created. This is because the size of newly-built dwellings has also been declining as well, so that the actual decline in new usable floor area is greater than the fall in dwelling numbers alone (Figure 6.9).

Figure 6.9: The decline in new dwelling sizes, 1999-2003



Source: Statistics Belgium

Macroeconomic influences

Economic growth was strong for a number of years, but was then affected by the 2001 slowdown in the world economy and a decline in export demand. Growth has languished at below 1% for the past three years. Consumer confidence fell and consumption has been subdued, though it increased in 2003. The upswing in world trade is expected to lead to economic revival in 2004.

Employment had been rising but the downturn has dampened further expansion, and the country still has a relatively low share of the working age population in work, at only 62%. In part this is due to the substantial level of unemployment, at 8% in 2003. Unemployment tends to be concentrated in the declining industrial regions and among social groups who either live in the old, more dilapidated parts of the owner-occupied stock, or in rented housing, so it is unlikely to have much impact on the owner-occupied market.

There have been concerns about consumer price rises from the beginning of 2000, starting with a surge in fuel and food prices, though consumer price inflation has moderated in 2003, and is expected to fall further in 2004.

Due to the weakness of the economy, a recent budget introduced measures aimed at balancing the budget and continuing the decline of public debt as a proportion of national income. A stability pact has also been introduced to constrain expenditure at the regional level. Tax cuts of around 1.25% of GDP are being implemented over a period of several years, which helped to increase private consumption in 2003.

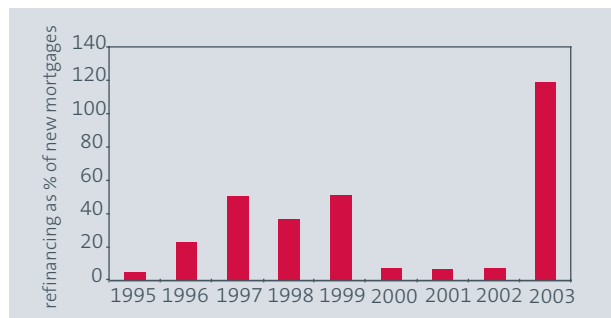
Mortgage market

Mortgages are now virtually entirely provided by private universal banks, following the privatisation of previously specialist mortgage institutions. Following a series of takeovers in recent years, the banking system as a whole is now dominated by four major groups with interests spread across banking and insurance.

Mortgages are generally offered on a long-term, fixed interest basis. Changes in mortgage products have occurred recently as a consequence of lower interest rates and greater competition between banks, so that more contracts have five-year revision clauses in them where interest rates can be changed. Adjustable rates in the first five years have around a fifth of the market and are variable only around a 5% share.⁵

Average nominal mortgage interest rates have been on a downward trend, dropping from around 10% in 1994 to around 5% in 1998. After that, rates rose to around 6.5% in 2000 and 2001, but have fallen since then (Figure 6.9), which has helped to stimulate the housing market and encouraged a revival of refinancing. There was a surge of refinancing as interest rates fell in the late 1990s, but the upswing in interest rates then led to a collapse in that market from 2000 to 2003 (Figure 6.10). Renewed interest falls then encouraged a revival early in 2003, stimulated partly by a fear that interest rates would rise again. In fact, the number of refinanced mortgages in the second quarter of 2003 was greater than for the whole of the previous year.

Figure 6.10 : Mortgages and refinancing 1995-2003



Source: National Bank

Outstanding residential mortgage loans grew by 80% between 1993 and 2003. Yet, the increase was pretty much in line with nominal GDP, so that the share of mortgages to GDP has remained fairly constant, at around 30% – far lower than in many other European countries. Nevertheless, a tradition of using considerable own resources is gradually dying out, because of greater financial sophistication on the part of homeowners, declining interest rates and preferential tax breaks on mortgage borrowing. Tax breaks are given on capital repayments, interest charges and insurance costs, though transaction costs are exceptionally high, at over a fifth of the price for a typical medium-sized dwelling.

⁵ ECB.

Table 6.2. : Population, current and forecasts, by age group 2000-2050

	2000	2010	2020	2030	2040	2050
Total population (mln)	10.3	10.5	10.7	10.9	11	11
0-19	24	22	21	21	21	20
20-65	60	60	58	55	53	53
65+	17	18	21	24	26	27

Source: Statistics Belgium

Demographic influences

The principal demographic stimulus to the housing market is rising household numbers, as overall population growth is limited. Between 1995 and 2010, for example, it is forecast that the population of Flanders will rise by only 2%, whereas household numbers will grow by 14%.

General population growth is expected to be similar throughout the country – but the Brussels Capital Region is still expected to lose population, though the regional government is trying to reverse the trend. This population decline is unlikely to cut housing demand in the capital, however, because the trend to smaller household sizes is pronounced there. The premium on house prices in the capital relative to the rest of the country, however, has been declining in recent years, because of the stronger growth of prices in the Flanders region.

An ageing population is likely to have some impact on the housing market in the future, though not to the same extent as in a number of other EU countries. The share of the population represented by those in the economically active range, between 20-65 years, is not expected to decline until 2010, although the decline in the share will accelerate after that date. The 4% increase in those over 65 by 2020 will instead be almost matched by a fall in the number of young people (Table 6.2).

Policy and planning

Responsibilities for spatial planning and housing now lie with the regions of Flanders, Wallonia and the Brussels Capital Region, after a process of regional decentralisation. The policy framework is still influenced by 'old' federal legislation, such as the spatial planning law of 1962 and the Housing Code of 1970 but, during the 1990s, all three regions developed new legislation. They all have new spatial planning acts and new housing laws, though expenditure constraints limit their ambitions.

New spatial plans have been drawn up and recently finalised. In Flanders, spatial planning targets aim to reduce the type of uncoordinated, sprawling suburbanisation that has taken place since the 1960s. It is still too early to see the full consequences of these new regional strategies, but it seems that land shortages have been exacerbated. The Brussels Capital Region's spatial policy aims to win back lost residents. Some success has been achieved, as the number of households has been rising for several years in a row.

Factfile: Belgium

Background

Population (m) 2002	Population Growth % 1980-2001	Fertility Rate* 2002	Years Life Expectancy 2002
10.3	4	1.6	79

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

Services output as % of GDP 2000	Employed as % working age population 2002
71	62

* GDP per person employed 2002

Economic

	200	2001	2002	2003	2004f
Real GDP growth %	3.7	0.7	0.7	1.1	2.0
Growth in real private consumption %	3.4	0.9	0.4	1.7	1.7
Inflation – GDP deflator	1.2	1.8	1.7	1.7	1.7
Inflation – consumer prices	2.7	2.4	1.6	1.5	1.6
Unemployment rate %	6.9	6.7	7.3	8.1	8.3

Government

	2000	2001	2002	2003	2004f
Expenditure as % GDP	49	49	50	51	50

Housing market

	2000	2001	2002	2003	2004f
Growth in residential investment	0.9	-0.6	-1.6	1.3	2.5

Taxes

Owner occupied housing	Capital gains exempt	Imputed rental income
Mortgage interest relief – yes	yes	taxed

Property taxes as share of all taxes 2002	Property taxes as share of GDP 2002
3%	1%

Housing Statistics in the European Union 2003, Eurostat, OECD, World Bank.

chapter seven

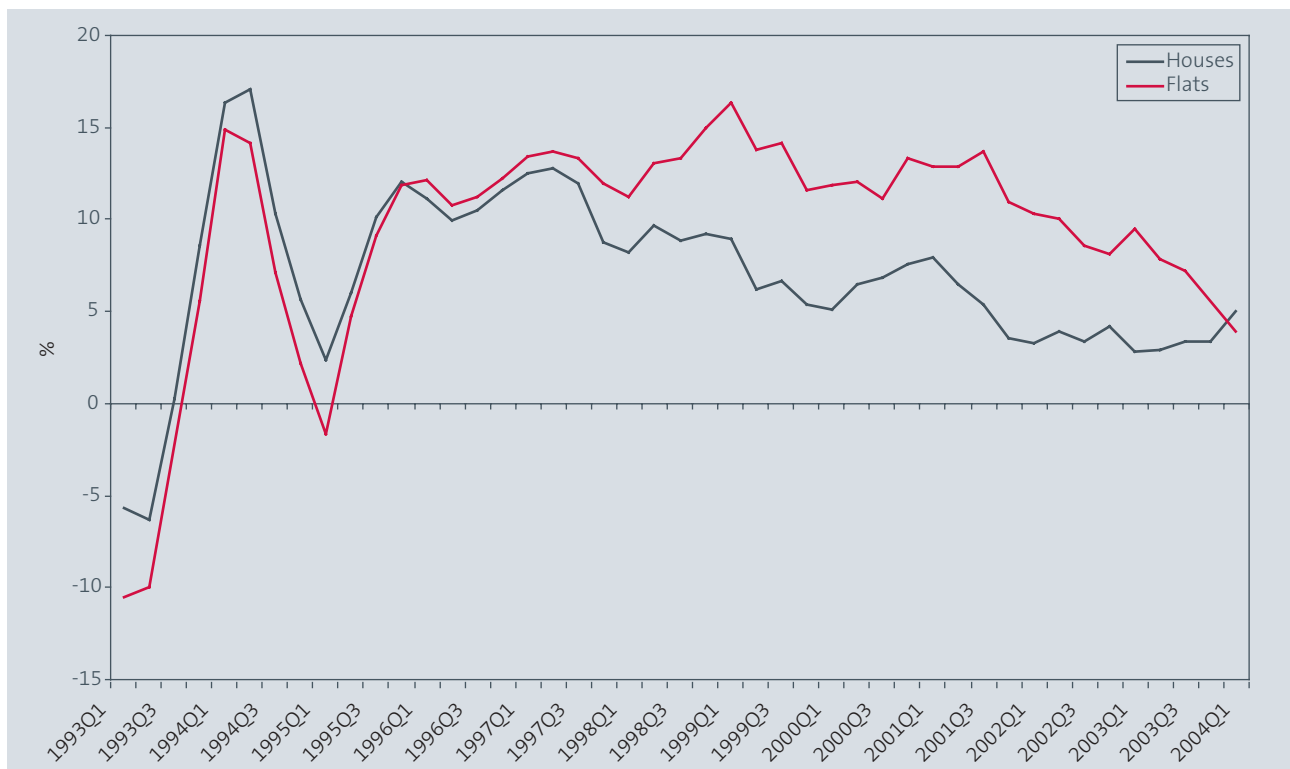
Denmark

Overview

The housing market picked up towards the end of 2003, following several quarters when it looked as though prices were about to stagnate (Figure 7.1). Houses for the first time in seven years also exhibited higher price rises than flats, and it looked as though the increase in flat prices relative to houses was finally coming to an end. A return to economic growth, buoyant consumer expenditure and unexpectedly low interest rates all contributed to the more optimistic state of the housing market in 2004.

The particular robustness of the prices for owner-occupied flats up to 2004 was due to the special characteristics of this market segment. Flats are much more common in Copenhagen and the biggest provincial towns, and are generally situated in older properties in central districts. Prolonged excess demand for this type of property has existed, especially amongst younger people and parents purchasing accommodation for their student or adult children. Parent purchasers are believed to be up to half of the buyers of such flats. Tax rules make this a financially attractive option. Furthermore, their renter children are often eligible for housing allowances of around DKK500 a month, because of the low incomes associated with being a student.

Figure 7.1: Dwelling price changes 1993-2004 quarterly



Source: Statistics Denmark

A major factor influencing recent housing market behaviour has been the measures introduced as part of a broader reform of the tax system – generally known as the 1998 ‘Whitsun Package’ tax reforms. The full measures were gradually phased in over a two year period, and raised the tax burden of owner-occupiers. Prior to the reforms, homeowners could claim relief in their tax returns for the mortgage and other interest charges they had incurred during the tax year, which were offset by a tax on imputed rental income.¹ The latter, however, was set at a low rate, so that homeownership had an overall tax benefit over other forms of investment. The reforms abolished the imputed rent tax, substituting a local property tax for owner-occupiers alone – set at 0.8 % of re-assessed property values for most owners, and at 1% for those buying after July 1, 1998. A higher rate of 3% was set for more expensive properties.² Changes were also made to mortgage interest tax relief by capping it at the 32% tax band, which is important in a country with some of the highest marginal tax rates in the EU, although the precise impact is complex, as it depends on individual household incomes and borrowings.

When implemented, it was forecast that house prices would be 15-20% lower than they would otherwise have been. It was feared that the tax reforms would lead to sharp falls in house prices. Yet, subsequent events indicate that they may, instead, by chance have limited house price inflation for a while, but that process is now fully worked through.

The housing system

General housing standards are some of the highest in the world. In contrast to many other EU countries, many households live in flats. Single detached family houses represent around 40% of the stock, while another 13% are semi-detached or terraced dwellings, so that almost half of households live in flats.

Owner-occupation: 51% of households were homeowners in 2001, most living in single-family houses.³ This proportion is below the EU average, and there has been little expansion of the tenure since the late 1970s, because of the extensive availability of rental housing and the relative high user costs of being a homeowner.⁴ Since the 1980s, in fact, the share of homeownership among younger generations has actually been falling. The overall homeownership rate, however, has only fallen by a mere 0.5%, because of an ageing population, a slight increase in homeownership amongst the over fifties, and renewed expansion of the tenure in the market upswing of the past decade.

Survey results, in which households are asked what tenure they would prefer to be living in five years’ time, show that owner-occupation is currently the preferred tenure of around 70% of households – far higher than the actual percentage of 53%. The preference for homeownership also strengthened considerably between 1986 and 2001, despite the stagnation in the homeownership rate.⁵ The reason for the stated tenure preference, however, might have more to do with the typical type of dwelling in each tenure than the tenure form itself, because most owner-occupied dwellings are houses and many are older properties in attractive suburban surroundings.

Private rental: A fifth of households live in the private rented sector, which has been declining over the long-term. Part of the reason for the decline is that rents have been controlled for many years and remain so, though housing built after 1991 is exempt. Another factor is that landlords’ yields are taxed more than net gains in other tenures. The transfer of rental dwellings to other tenures to reap capital gains is also heavily proscribed. Most conversions are to private owner co-operatives, with tenants exercising a right-to-buy (see below).

Rent-setting regulations vary, but the common procedure is a cost approach, which is based on current outgoings, property taxes, maintenance charges, and a capital charge. There have been some recent changes to regulation. The rents of luxury ‘rooftop’ apartments have recently been allowed to be freely set, as can the rents of properties that have been totally renovated, bringing them into line with the situation in new build. In a move to stimulate extra investment in the rental sector furthermore, pension funds and private investors can now get tax credits when investing in the construction of new rental housing.⁶ This may increase the small number of new private rental dwellings built each year.

The OECD has repeatedly criticised the country’s rent control policy for misallocating resources and hampering labour mobility. A recent Danish Economic Council report on housing⁷ also argued against the current regulations in the private and social sectors. The report argues that rent regulation creates significant market inefficiencies; exacerbates housing shortages because only limited groups of people can have access to accommodation at below market rents; reduces mobility and leads to hidden payments to secure below market price accommodation. The report calculated that rent levels would have on average to be increased by 43% in the private sector to bring rents up to market levels. It argues that rent regulation cannot easily be justified on grounds of social justice or income redistribution. The analysis shows that both tenants in the lowest and the highest income deciles receive the greatest financial gains, but that most benefit goes to the better-off.

There is a backlog of disrepair amongst the older parts of the stock, partly because a switch in policy towards the preservation of older buildings means that there has been little demolition of older stock since the early 1980s. Private renting is home to the worst conditions.

Private co-operative housing: This is a form of house ownership in which households share ownership of a co-operative and have a right to a flat owned by it – similar to the system in Sweden, though with greater price controls.⁸ The co-operative decides on the management, maintenance and improvement of its stock, so that members are reliant on the co-operative’s skilfulness in these tasks. Shares in a co-operative can be sold, but are subject to maximum price ceilings that limit the potential for capital gains.

The tenure has expanded over the past two decades, and around 6% of households now live in it. During the 1990s, the number of co-operative dwellings rose by 45%, with the majority arising

¹ Imputed rental income is the implicit rental value of an owner occupier’s home. ² Since 2002, charged on properties valued over DKK3,040,000. ³ Statistics Denmark.

⁴ User costs are a measure of the true cost of living in a tenure.

⁵ Source: Statens Byggeforskningsinstitut & Amternes og Kommunernes Forskningsinstitut: “Det danske boligmarked – udvikling i boligforsyning og boligønsker”. Byforum, Hørsholm. 2001.

⁶ OECD Country Report Denmark, 2003 ⁷ Det Økonomiske Råd, Formandskabet: “Dansk Økonomi Forår 2001” København 2001, chap. 3 ⁸ See Chapter 15.

from the transfer of existing dwellings from other tenures, especially the private rented sector. Private rental tenants have an option to establish a private housing co-operative in order to purchase a building at the prevailing market price when it is put up for sale, if it contains 6 flats or more, or 13 flats or more in mixed-use properties. The number of additions to the tenure varies considerably from year to year, because it depends on the willingness of landlords to sell and tenants to form co-operatives. In 1998, for example, 7,000 new co-operative dwellings were created, about a thousand of which were new build, while in 1999 only 3,000 were created, although the amount of new build stayed the same at 1,000 units.

This tenure has the advantage over owner-occupation of not having to pay the new property tax. It also attracts government subsidies, though they are to be phased out by 2005. Moreover, there are tax advantages for a household that belongs to a co-operative which has been set up to buy out a private landlord and undertake renovation of the properties purchased. Municipalities may also guarantee part of a co-operative's mortgage loans, and soon legislation may allow individuals to raise tax-deductible mortgages on the value of their interest in co-operatives. Such breaks are hard to justify in social policy terms because the beneficiaries are generally better-off households, though it is argued that they may free up housing by encouraging households to vacate larger properties.

Social housing: A fifth of the stock is rented from housing associations. Rents are cost-based and, hence, vary according to the age of the stock. Local and central governments guarantee housing association loans and provide capital subsidies for new building and improvement. From 2004, a cap on dwelling construction costs will be re-introduced to limit the scale of public subsidies.

As elsewhere in the EU, immigrants and low income groups outside the labour market or with a high risk of unemployment are becoming increasingly significant in the social sector. A small amount of housing is also rented out by public authorities.

Rents are regulated in the social sector and tend to be low. One reason for the level of rents is that the rules regarding the capital cost element payable in rents have remained the same since 1982, and they lead to charges far below any reasonable amortisation rate. Two recent policy initiatives have also led to rent reductions in properties that have social problems and/or rent arrears. Most increases in social rents, therefore, are solely the consequence of increases in administrative and repair expenses. Since the beginning of 2000, the government has required new social housing to be financed with 1 year bonds, although this has no effect on rents because the government bears the resultant interest rate risk.

Rent changes in the private and social sectors between 1995 and 2002 are shown in Figure 7.2. It can be seen that real rents have hardly increased in real terms over the 7 year period in the social

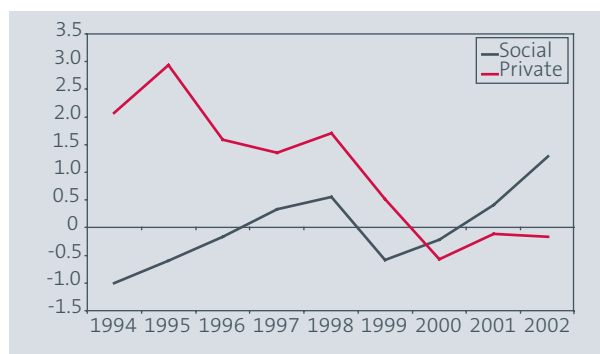
sector, with some increases in later years, and have not risen in the private sector since the late-1990s. This contrasts with the above mentioned increase in house prices, reflecting the fact that rents are broadly immune to housing market pressures. What rises there have been, moreover, tend to result from adjustments following the modernisation of properties. Rent levels are now roughly equal in the two rental sectors. Such a fixity of rents demonstrates the effectiveness of current rent controls, and the situation would undoubtedly have been very different in a free market context.

In the past, sales have been forbidden, but legislation has recently been passed to allow a series of experimental projects of sales to sitting tenants for owner-occupation. Housing experts, however, think that the number of resulting sales will be very low.

Housing benefits exist for renters, which are based on household size, incomes, rents and dwelling sizes. Three-quarters of the difference between the actual rent and an assessed minimum payment is covered, with more generous rules for pensioners. Around a fifth of all households receive benefit, 58% of social housing tenants and 32% of those in private rental.⁹ Problems of labour market inefficiency are apparent with these means-tested benefits, as they create 'poverty trap' work disincentives. Queues for social housing exist in areas of high housing demand.

Denmark has tax and benefit rules that combine with other housing regulations to create one of the most complex and distortionary housing systems in Europe. Yet, there is a great deal of political support for the status quo, and even for a further enhancing of special subsidies and tax breaks. Change is also held back by the likely severe adjustment costs that would be experienced by particular households in a shift towards a more rational system. Yet, there is a growing chorus of complaints about the inefficiencies and inequities – led by a number of influential reports by economic institutions. The most recent, and perhaps the most powerful, was published by the Danish Economic Council.¹⁰

Figure 7.2: Annual real rent changes 1995-2002



Source: Housing Statistics in the EU 2003

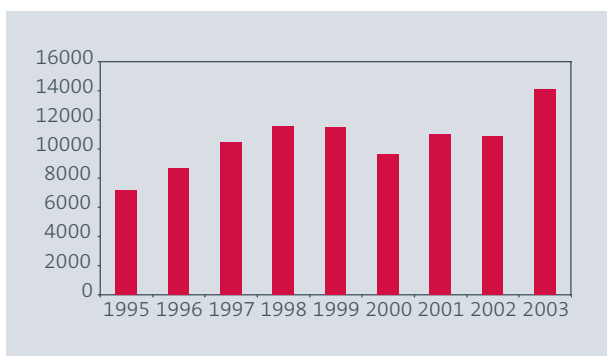
⁹ OECD Economic Survey: Denmark, 1999.

¹⁰ The Report from the Danish Economic Council: "The housing market – unequal and inefficient", 2001.

New building and renovation

Residential construction dropped to its lowest level since the Second World War in 1994, with just 11,000 completions. New building then initially responded only weakly to the upturn in the market and actually fell between 1998 and 2000, since when it has surged ahead (Figure 7.3). Overall, residential investment has see-sawed since 1999, though the surge in 2000 and the slump in 2001, shown in the Factfile, were a consequence of the rebuilding work in the aftermath of hurricane damage in 1999. The slowdown in housebuilding may indicate that supply is coming into equilibrium with demand. Another cause might be the tight planning and environmental constraints in the Copenhagen region, where demand is greatest, which are limiting the responsiveness of supply to demand pressures.

Figure 7.3: Housing completions 1995-2003



Source: Statistics Denmark

New building is not the only source of extra supply. It also comes from subdivisions of existing property, improvements and conversions from other uses. For example, in 2000, these other sources added about a fifth as much to the housing stock as new building, net of a small number of demolitions.

There has been criticism of housebuilding costs. An official report has pointed out that Danes have to spend 20-30% more for a single family house than in other, already high-cost, countries like Sweden, Finland, Germany and the Netherlands. This is blamed on lagging construction productivity, excessive materials prices, and a lack of competition. Building defects are also high, with 15 to 20% of social housing projects showing serious problems within five years of construction.¹¹

Macroeconomic influences

The slowdown in the housing market in 2003 was associated with a sharp slowdown in the economy, with growth for 2003 expected to be only 0.5%, compared to 2.1 in 2002.¹² Even in 2002, growth was erratic, being negative in two quarters. The downturn has been associated with weak export markets, cautious households deferring durable purchases, weak business confidence and rising unemployment. The economy, however, rebounded in 2004, with the central bank forecasting 2% growth for the year as a whole and a similar increase in personal consumption expenditure leading to revived activity in the housing market. The government helped in the revival of consumer demand, by bringing forward to 2004 tax cuts planned for 2005-2007. In addition, it offered incentives for housebuilding.

Unemployment has been rising to reach 6% in 2004, which has helped to moderate wage pressures. Overall inflation is relatively low, forecast to be 1.6% in 2004.

Consumption growth in recent years has been weakened by the taxation reforms discussed earlier, as well as the economy, so it has been erratic. Nevertheless, rising housing wealth and equity withdrawal – stimulated by re-mortgaging to take advantage of lower interest rates – have played a part in sustaining consumption demand.

Mortgage market influences

Annuity mortgages have traditionally been used to fund home purchases via a mortgage bond system. These mortgages have a long-redemption period of 30 years, and a maximum loan-to-value ratio of 80%. They are financed by the country's unique mortgage bank system, where mortgage banks match mortgage offer terms with bond sales on the capital market, taking a small spread for the intermediation service. First-time buyers usually cover most of the 20% of the house price that cannot be funded via a mortgage loan through additional borrowing, so that they tend to put down a deposit of only 5% of their own capital.

Borrowers have the option to prepay their mortgages at par (i.e. redemption can be made either in cash or bonds with a value equal to the remaining debt). They tend to do this when interest rates are falling. This prepayment facility typically raises the interest charged in the capital markets over government bonds by 0.1 to 1%, depending on prevailing nominal interest rates. In recent years, many households have re-mortgaged and, often, switched to 'variable' rate mortgages – rolling one-year fixed interest periods – to take advantage of the long-term decline in interest rates and the phase of the interest rate cycle. Such variable rate mortgages have been available since 1996.

¹¹ "The Danish Construction Sector in the Future – From Tradition to Innovation." Building Policy Task Force, Ministry of Housing, 2000.

¹² OECD Economic Outlook Nov., 2003.

In the autumn of 2003, an interest-only mortgage was introduced. The interest-only element lasts for the first 10 years of a 30 year fixed interest mortgage, after which time the mortgage reverts to the normal annuity terms. The 10 years of forgone capital repayments remain as an outstanding debt at the end of the 30 year period. Consumers may choose a variable rate option of the interest-only product, under which they can choose the length of the interest-only time period. These products have proved popular, particularly the variable rate version, and accounted for 12% of outstanding mortgage credit loans in 2004 2q.¹³

Mortgage bonds dominate the Danish bond market, with a 67% market share in 2002. Most mortgage bonds are bought by domestic investors, particularly banks, insurance companies and pension funds, because they are familiar with this specialist market (Table 7.1). In fact, mortgage bond holdings are more concentrated in such institutions than are other types of bond. Foreign investors are more active in public sector bonds, and households in other types of bonds, such as those issued by private firms.

Mortgage banks issue mortgages on the basis of the matching

Table 7.1: Types of bond investor				
Type of investor end 2002 % share of bond type	Mortgage bonds	State bonds	Other bonds	Total
Financial institutions	42	24	31	37
Insurance and pension funds	24	15	21	22
Public sector	7	22	4	11
Other trades	7	3	4	6
Households	6	1	33	6
Foreign investors	10	32	4	16
Undisclosed	4	3	3	4
Volume in circulation, DKK bn	1578	654	119	2351

Source: Association of Danish Mortgage Banks

bonds they sell, typically charging a 0.5% spread between their lending and borrowing rates of interest. Between 85 and 90% of mortgage credit banks' net housing loans are to owner-occupiers, with around 10% to 'private landlords' – including the owner-rental co-operatives mentioned above – and a small percentage to social housing organisations. They also provide mortgages for non-residential properties, so that homeowner mortgages were 64% of their total business in 2002. Banks have also started to offer loans resembling mortgages, and they have proved to be popular in the current situation of low short-term interest rates.

The number and relative size of the mortgage banks can be seen in Table 7.2, which omits two very small ones. Competition between them is fierce. They have all bought up estate agency chains or formed alliances with them since the mid-1990s, when legislation permitted it, in order to have direct consumer access at the point of most mortgage origination. The number of independent banks has also been shrinking through mergers and takeovers. In 2001, three of the listed banks – Realkredit Danmark, BG Kredit and Danske Kredit – merged to operate under the name Realkredit Danmark. This followed the merger of the parent banks, Danske Bank – the biggest commercial bank – and Realkredit Danmark. In the summer of 2003, Nykredit bought Totalkredit from its owners, which were a consortium of provincial commercial, business and savings banks, to become the largest mortgage bank. The degree of concentration has consequently grown rapidly, with the two largest mortgage banks now having a 77% share of outstanding debt.

Table 7.2: Market shares of major mortgage banks

% year end	Gross new loans		Outstanding debt
	2000	2002	2002
BG Kredit*	4	-	-
BRF kredit	10	9	10
DLR	4	5	4
Danske Kredit*	8	-	-
Nykredit**	29	27	31
Realkredit Danmark*	23	32	36
Totalkredit**	12	15	9
Unikredit	9	15	9

* merged 2001 ** merged 2003

Source: Association of Danish Mortgage Banks

Mortgage lending has continued to increase on a trend basis because of the long-term fall in nominal interest rates. Short-run fluctuations in mortgage volumes mainly arise from the relative attractiveness of refinancing existing loans, which depends on interest rate fluctuations. The difference between gross and net mortgage lending consequently arises primarily due to the prepayment of loans before their maturity. This occurs when a property is sold, or when mortgage borrowers simply exercise their option to prepay at the face value of the bond backing their mortgage. Refinancing peaked in recent years in 2001, though it has remained high since then.

When refinancing the mortgage debt, there is now the option of variable interest rate mortgage instruments. An interest-adjusted mortgage is termed a 'flexloan'. In it, the interest rate varies on an annual basis. Mortgage banks set up guaranteed refinancing contracts with borrowers and match the loans to them by issuing fixed interest one-year bonds on the investment market in each year of the duration of the mortgage.¹⁴

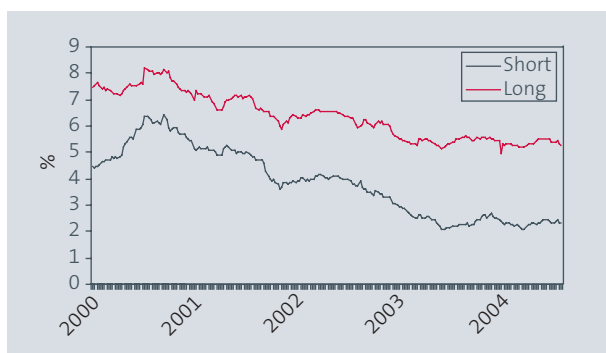
¹³ Danish Central Bank

¹⁴ Alternatively, longer term variable rate bonds are issued but these are less common.

The path of long- and short-term mortgage interest rates since 1998 is shown in Figure 7.4. Rates have fallen from over 9% in 1995 to just over 6% late in 2004 for 30 year loans, and less than 3% for flexible loans. The interest saving households can make by refinancing has therefore been substantial. At the end of 2002, variable rate lending had a fifth of the market;¹⁵ down from a third in the summer, as consumers increasingly began to realise that long-term rates were beginning a new upward phase. Lending rates were down by about 1% between the beginning of 2003 and the middle of 2004, with total household interest payments to banks down by over a million kroner to 17.9 billion,¹⁶ which helped to stimulate housing market demand. Overall, lending is rising, with bank and mortgage institution lending to households up by 8% in the summer of 2004 on the previous year.

One final feature of mortgage lending is the high mortgage -to- GDP ratio. Mortgage lending to households by the mortgage credit banks, as a ratio of GDP, had risen to 82% in 2002,¹⁷ well up on the figure in the mid-1990s. This was then the highest ratio in the EU, and has raised some concerns that households will be put in a difficult position if interest rates rise in response to renewed inflation, or there is a decline in the exchange rate. Little at present, however, seems to suggest that such problems are in the mid-range of forecast probabilities.

Figure 7.4: Long- and short-term mortgage interest rates 1998-2004 August (weekly)



Source: Nykredit

Regional and city variations

A recent survey of regional migration shows that the net movement of population has been towards Copenhagen, with much of the growth in that region's outer areas.¹⁸ In fact, the population in the inner Copenhagen County area was still falling, because of the relatively large proportion of elderly people and the relatively low number of births there. To a smaller extent, there has also been a net population movement to the Århus and Vejle regions in the past few decades, although they have started to experience population losses more recently.

Regional house price movements have broadly followed these population shifts. Since 1993, price growth has been strongest in the capital region for owner-occupied houses and flats. The central areas of the bigger provincial towns have also experienced significant price increases. In contrast, house price growth has been weakest in rural areas.

¹⁵ Danish Central Bank.

¹⁶ Danish Central Bank.

¹⁷ Housing Statistics in the EU 2003.

¹⁸ Statens Byggeforskningsinstitut & Amternes og Kommunernes Forskningsinstitut: "Det danske boligmarked – udvikling i boligforsyning og boligønsker". Byforum, Hørsholm. 2001.

Factfile: Denmark

Background

Population (m) 2002	Population Growth % 1980-2001	Fertility Rate* 2002	Years Life Expectancy 2002
5.4	4	1.8	77

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

Services output as % of GDP 2000	Employed as % working age population 2002
71	76

* GDP per person employed 2002

Economic

	200	2001	2002	2003	2004f
Real GDP growth %	2.8	1.6	1.0	0.4	1.9
Growth in real private consumption %	-0.7	-0.2	0.6	1.1	3.4
Inflation – GDP deflator	3.0	2.1	1.6	2.1	2.1
Inflation – consumer prices	2.9	2.3	2.4	2.1	1.6
Unemployment rate %	4.4	4.3	4.6	5.6	6.0

Government

	2000	2001	2002	2003	2004f
Expenditure as % GDP	55	55	55	56	56

Housing market

	2000	2001	2002	2003	2004f
Growth in residential investment	7.7	-5.3	10.5	7.8	4.9

Taxes

Owner occupied housing	Capital gains exempt	Imputed rental income
Mortgage interest relief – yes	yes	taxed

Property taxes as share of all taxes 2002	Property taxes as share of GDP 2002
4%	2%

Housing Statistics in the European Union 2003, Eurostat, OECD, World Bank.

chapter eight

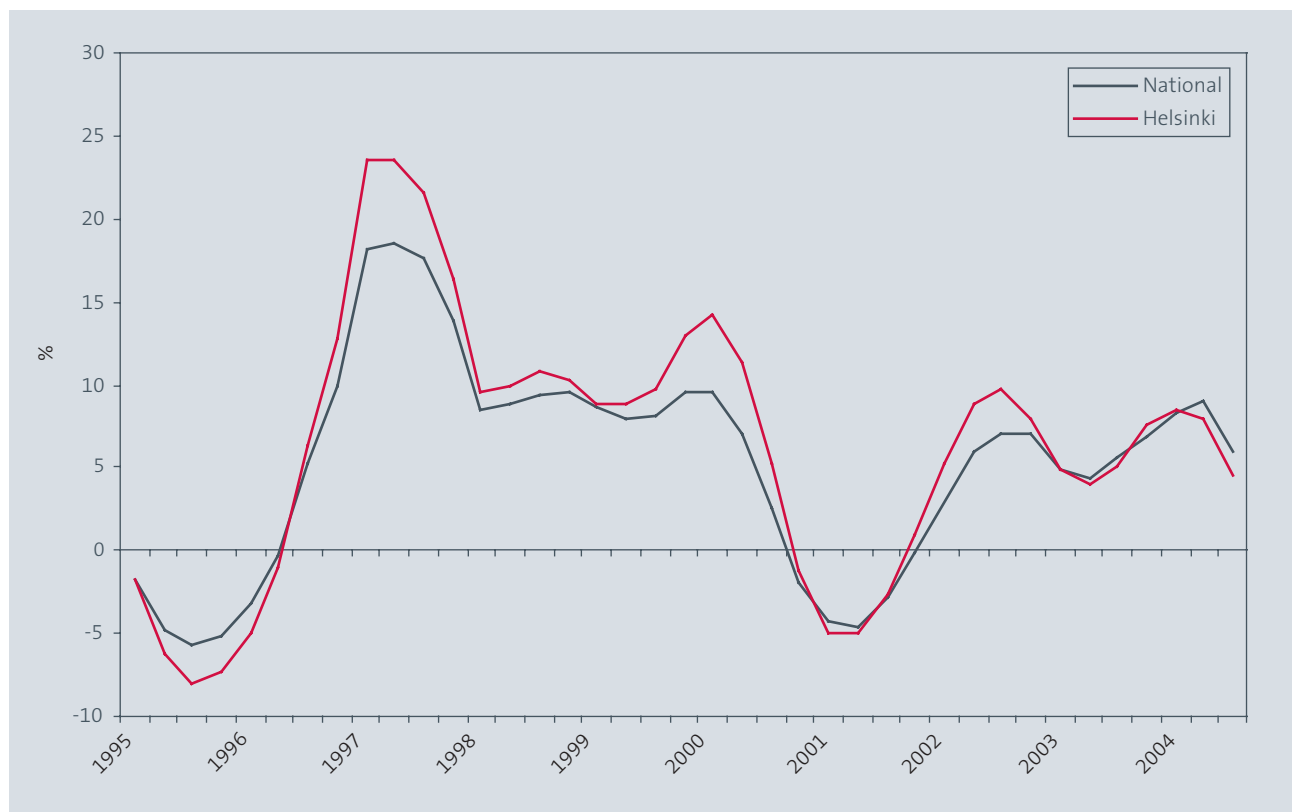
Finland

Overview

House price inflation peaked in the spring of 2004, but the market was still strong and overall price increases of 7% are forecast for the year.¹ The rate of increase then dipped somewhat early in 2003, followed by an acceleration over the summer, so that by the third quarter they were growing at an annual nominal rate of 7%. As Figure 8.1 shows, real house prices had been rising from 1996, with spikes in 1996-7 and 1999 and a fall in 2000/01. The greatest increases were in the Helsinki region, though it has trailed national prices somewhat in the past year.²

Earlier fears that the housing market may stagnate have consequently been overturned by more recent events. An important influence on the renewed revival of the market has been highly favourable mortgage interest rates. Overall, real house prices had risen by 72% nationally, and 98% in the Helsinki region, between the start of the current upswing at the beginning of 1996 and the autumn of 2004.

Figure 8.1: Changes in real house prices, national and Helsinki, 1995 q1-2004 q3



Source: Statistics Finland

¹ UPE estimates.
² These price data are drawn from information on flats and terraced houses only. The prices of detached houses are unknown.

The housing system

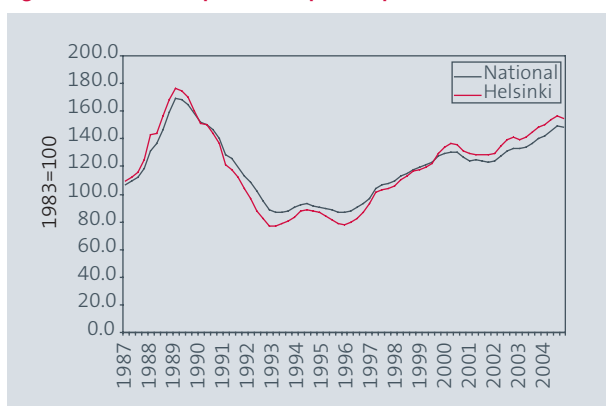
Finland is unique in the EU in that the share of owner-occupation in the stock actually fell significantly from 67% in 1990 to only 58% in 2000, and rental housing rose by 6% to reach 31% of the stock over the same period (see Table 8.1). Some of the apparent decline in homeownership, however, may be a statistical artefact, because 10% of dwellings' tenures are listed as other/unknown. Whatever the precise extent of the contraction, an important cause of the decline in homeownership has been the long drawn-out aftermath of an intense speculative housing market boom in the late 1980s. The scale of the boom can be seen in Figure 8.2. In only a two year period from the beginning of 1987 to the beginning of 1989, real house prices shot up by 60%, and real prices still have not regained those peak levels. The bubble burst as interest rates rose to deal with economic overheating. Prices then fell by almost a half in real terms in a continuous and dramatic decline over the next four years, and then stayed low until 1996. There had been two previous boom and decline periods in the 1970s and 1980s, but neither was on the scale of the late 1980s upswing, encouraged by a rapidly expanding economy and excessive lending in the wake of financial liberalisation.

Table 8.1: Housing tenure 1980-2000

%	1980	1985	1990	1995	2002
Owner-occupied	61	64	67	62	58
Rented	29	25	25	29	32
Right of occupancy	-	-	-	0.2	1.0
Other or unknown	10	11	8	9	9

Source: Statistics Finland

Figure 8.2: Real house prices 1987q1-2004q3



Source: Statistics Finland

The owner-occupied dream turned into a nightmare for many consumers at the start of the 1990s, and the memory of this traumatic period continues to influence sentiment. The dynamics of adjustment during the housing market slump lowered the homeownership rate for a number of reasons. A significant share of the large number of mortgage defaulters moved into rental housing, much higher unemployment sapped the ability to own, and potential new entrants to homeownership were put off by rapidly falling real prices. Mortgage lenders also restricted entry by imposing tighter lending requirements, particularly as defaults were running at record levels. The crisis also increased the supply of rental dwellings, thereby raising that tenure's share of the total stock. Vacant homes, for instance, were switched from being designated for homeownership into private renting. A revival in the rental sector was also encouraged by government measures, including rent decontrol and extra expenditure aimed at boosting housebuilding in the midst of the crisis by raising the output of subsidised rental housebuilding. This programme then continued after the crisis was over, with the objective of providing affordable housing in regions of high demand.

Owner-occupation, nonetheless, is seen as the prime tenure by both the majority of the population and policymakers. So, the decline in the homeownership rate may not be a long-term phenomenon. Rather, it was a reaction to the tremendous shock the housing system received around a decade ago, combined with the stresses and strains of recent rapid economic growth, the population movements associated with this, and policy reactions to current housing shortages. Yet, as long as the supply situation remains constrained, as it is likely to, the renewed expansion of homeownership will be slow.

Strictly speaking, only detached houses legally constitute real estate that is bought by owner-occupiers. 41% of the total housing stock consists of detached houses, and most of them are owner-occupied. The legal situation is different with blocks of flats and terraced housing. 44% of dwellings are flats and another 13% are terraced houses.³ Although many of them are in the rental sector, some are also owned, but through a particular type of legally recognised property vehicle. This is because the law does not permit the joint ownership of party walls and the associated condominium or leasehold types of ownership arrangement common elsewhere. Instead, a housing company has to be the legal entity that actually owns the real estate. So, a purchaser of a flat or a terraced house technically buys a share in the company associated with that dwelling. Company shares, rather than real estate, are consequently bought and sold. Sweden and Denmark have similar systems with their owner co-operatives.⁴

A subsidy policy towards such housing companies was set up in the 1990s to encourage housebuilding, renovation and employment in the construction industries. Housing companies can borrow using subsidised loans – from the same Housing Fund public agency that lends to social housing institutions (see below) – up to 40% of the value of the property built, purchased or renovated. This lowers the costs faced by owner-occupiers who buy into housing companies.

³ The data are for 1998. Source: Statistics Finland.

⁴ See Chapters 6 and 15.

Figure 8.3: Changes in real rents 1991-2002 (%)



Source: Statistics Finland

Mortgage interest costs are tax-deductible, while imputed rents⁵ and capital gains after two years' ownership of a principal residence are tax-free. These deductions occur within a dual income tax system, which divides household income into a labour income component (wages, social security benefits, pensions, etc) and a capital component (dividends, interest, rents and capital gains). When the dual tax system was introduced in 1993, it led to a significant reduction in the scale of mortgage interest tax relief, because income from capital under which housing falls was taxed at a far lower rate than the previously unified marginal income tax rate. This tax reform would consequently have exacerbated the house price falls of the period. However, since 1993, the tax rate on income from capital has been rising, and now stands at 29%, so the scale of mortgage interest tax relief has grown again. Property taxes are also low. Some additional tax issues further raise the tax incentives of homeownership.⁶ For example, first-time buyers are eligible for subsidised loans as well.

A central feature of the market for the country's 740,000 rental dwellings is that about half of them (i.e. about 18% of total stock) are owned and managed by social housing institutions, predominantly local authorities or agencies linked to them, with government funding in the form of what are termed ARA-loans (see later). The rents in such dwellings are subject to rent controls, based on capital and maintenance costs, and allocated to households on lower incomes. Tenants are allowed to sub-let up to half of their dwellings at free market prices.

Most privately rented properties are owned by private individuals (about 60 %), and the only major corporate owners are some insurance companies, such as Pohjola. 70% of rental

dwellings are in apartment blocks. Private rents were controlled until the beginning of the 1990s, when the restrictions were abolished on a two-stage basis. In the first stage, dwellings let after February 1992 fell outside of the scope of the rent controls. Then, from May 1995, decontrol was gradually extended to the rest of the stock. The only remaining controls in the privately funded sector cover the relatively small number of dwellings receiving interest rate subsidies, and relate to maximum income and wealth levels for tenants. The tax position of small landlords has also been improved and this, combined with decontrol, has led to a marked increase in private rental supply, which has helped to expand rental housing and limited the return of owner-occupation to its previous levels.

Rents rose rapidly in both the social and private sectors during the first part of the 1990s (Figure 8.3), in contrast to the real falls of the 1980s. This was more due to the nature of the rent control measures than anything else. As explained above, rent controls are cost-based, and as interest rates were very high during the early 1990s their effect was transmitted to rents. Decontrol in the mid-1990s, nonetheless, led to sharp rent increases in the private sector. Real rents, especially in the unsubsidised sector, have continued to rise in recent years. The upward pressure on rents has been greatest in the Helsinki region, where there is a marked shortage of small, one and two-room apartments. Nominal rents increased by 47% between 1995 and 2001 in the private sector, and by 25% in the subsidised sector. Existing private tenancy rents rose quicker than rents in new private tenancies, because the abolition of rent controls made it possible to bring them up to current market levels.

⁵ The implied rental value of an owner occupied home.

⁶ See OECD country report 2002.

Although decontrol at the time of an owner-occupied slump encouraged growth in the private rental stock, most of the increase was via stock transfer rather than new building. This enhanced more efficient use of the stock, because sitting tenants could no longer consume housing services at artificially low prices and because previously temporarily inhabited or vacant dwellings were now being offered for rent. Rising house prices in recent years, however, have encouraged private landlords to sell to owner-occupiers and, by 1997, stock switching away from owner-occupation had slowed, and has probably reversed since then. The current expansion of the rental sector is currently almost entirely due to the construction of new social dwellings. So, social housing is actually increasing, in contrast to the experience of many other EU countries.⁷

State subsidies take the form of loans, as noted above, which are issued by the Housing Fund of Finland (known by the acronym 'ARA'), and ARA interest subsidies on loans raised in capital markets. These latter loans are for new building and renovations, and involved competitive bidding processes between financial institutions organised by the developers applying for loans. The Housing Fund was set up in 1990-3 to run a revised ARAVA loan scheme, the original of which had been in existence since shortly after the Second World War – ARAVA itself is an acronym for a post-war housing committee. ARA also administers other state subsidies, apart from housing allowances. Its finances do not appear in the public accounts because the government does not guarantee its borrowings. However, the financial strength of the agencies to which it lends predominantly means that it gets a triple A rating in capital markets, where it raises its finance through securitised loan packages.

Loans from ARA are available on new buildings for up to 95% of construction costs, net of land, and the housing institution has to put up 5-10% of its own capital and raise the rest via bank loans. The interest subsidy varies over time, depending on the current level of interest rates and the state of the private housing market. As nominal interest rates have fallen dramatically in recent years, the differential has narrowed sharply.⁸

As a matter of policy since the 1990s, this subsidised housing is built to high standards and spatially mixed in with other housing types to avoid social segregation. The overall average size of dwellings in Finland, however, is the smallest in the EU, at 76m² – though new dwellings, on average, are 10m² bigger (The UK builds the smallest average sized new dwellings, at 76m².⁹

Tenants of social dwellings are means-tested at the time of taking up a tenancy. The current policy pressure to increase the supply of low rental properties means that sales are frowned upon in high demand areas, though the opposite is true in low demand areas. Only a handful of dwellings have been sold or demolished in regions of declining housing demand, and renovation has been extensive. Renovation grants and schemes were also used extensively during the 1990s, although as the housing market picked up subsidies were withdrawn.

There has been increased demand for state-subsidised ARA-dwellings in recent years, as private sector housing costs have risen. State-subsidised housebuilding, however, has been experiencing problems, primarily because of a discrepancy between rising construction costs and the maximum prices per square metre allowed by ARA. Between January and August, 2000, for instance, about 1,000 less state-subsidised dwellings were started in the Capital Region than in the same period in 1999. There are also difficulties with the availability of land.

Municipalities are the planning authority via zoning regulations, with no central government interference since the 2000 Planning Act. They also provide infrastructure for new housing development.

Housing allowances, in principle, can be received across all tenures, provided that household income and wealth are low enough, and owner-occupied housing wealth is not taken into account. Allowances are paid for "reasonable housing expenses", which take into account the size of the household, local rent levels and dwelling characteristics, with caps on the maximum share of a household's income that can be paid in rent, which vary locally. In 1999 about 460,000 rental households, over half of all tenants, received housing allowances, many under special pensioners' and student schemes.¹⁰ There are few claimants from other tenures.

In the 1990s, a new rental tenure emerged, a "right of occupancy" dwelling: the inhabitant initially pays 15 % of the value of the dwelling, and then a monthly "charge for use", covering capital and maintenance costs. The deposit is refundable and index-linked to building costs. The construction of such dwellings is state subsidised (ARA-loan or interest subsidy). So far, the impact of this tenure has been limited, and it represented only 1% of total housing stock in 2000 (Table 8.1).

Detached houses provide the most spacious accommodation, with an average floor area of just over 100m². The floor area in attached houses is 70m², while flats are the smallest, averaging 56m², which is why the overall average size of the stock is so small. Flats are concentrated in urban municipalities, where they comprise 61% of the dwelling stock, although this rises to 86% in Helsinki.

Housing standards have risen significantly over the past thirty years. Between 1970 and 1997, the average floor area per person in permanently inhabited dwellings rose from 15m² to 34m² per person. The average age of the stock is also relatively low, with only 11% built prior to 1945, and less than 2% built before independence in 1917. Even so, over a quarter of the population still live in dwellings where the number of inhabitants exceeds the number of rooms, and just under 10% of homes lack some basic amenities.¹¹

The country is also famous for its saunas that are an integral part of domestic life. There were over 2m saunas in total in 2000 – and 1.2m of them are in the 1.1m residential buildings in existence. All single family and terraced houses have them, and most new flats now have them – in the social as well as the private sectors.

⁷ Increases are also occurring in the Netherlands. ⁸ Source: Housing Fund of Finland.

⁹ Housing Statistics in the EU 2002. ¹⁰ Source: Ministry of Environment.

¹¹ Piped water supply, supply of warm water, indoor plumbing toilet, washing space (shower/bathroom or sauna) and central or electric heating

The desire for larger dwellings is frustrated by the fairly uniform size of the existing stock. Yet, one factor leading to an improvement in space standards has been a fall in average household sizes. In 1970, the average household consisted of 3 persons, by 1990 it was down to 2.4, and in the 1990s it continued to decline, to 2.2 in 2001. The share of single-person households is now 36%, and almost two-thirds of them live in apartment blocks.

The share of the population living in rented housing is far less than the share of households in the tenure. Only around a quarter of the population actually lives in a rented dwelling, because small, one and two-person units are concentrated in the rental sector. Traditional regional housing market differences have been growing in recent years, with the pressure of housing demand concentrated in the growth regions.

Transactions and housebuilding

There has been strong growth in housing transactions over the past decade, as indicated by data for housing companies, i.e. mainly in the flats and terraced house market segments. Transactions overall rose from under 50,000 a year in the early 1990s to over 70,000 in 1999. The setback in housing market growth in 2000 led to a slight fall in the transactions level, which continued through 2001, but transactions rose again in 2002. The much larger flat sector of the market has been more volatile than that for terraced houses (Figure 8.4).

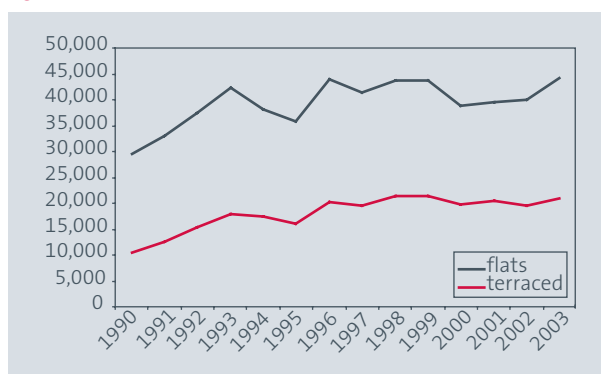
Housebuilding declined sharply during the crash years of the earlier 1990s, so that by 1996 completions were only a third of what they had been at the beginning of the decade (Figure 8.5). Output rose again as the market picked up, but the scale of the

increase was nothing like that of the 1980s' boom, so that at the peak of the latest upswing in 2000 output was approximately only half the level of a decade earlier. Starts picked up with the revival of the housing market, particularly in 2003.

Government financed and subsidised ARA-loans were the main means of funding housebuilding during the 1990s after the housing market crash. In 1993, 75% of housebuilding was funded in this way, and the percentage was still 73% in 1997. As the private sector market revived, however, public funding reduced as a share of all new building, though it still remains a significant source.

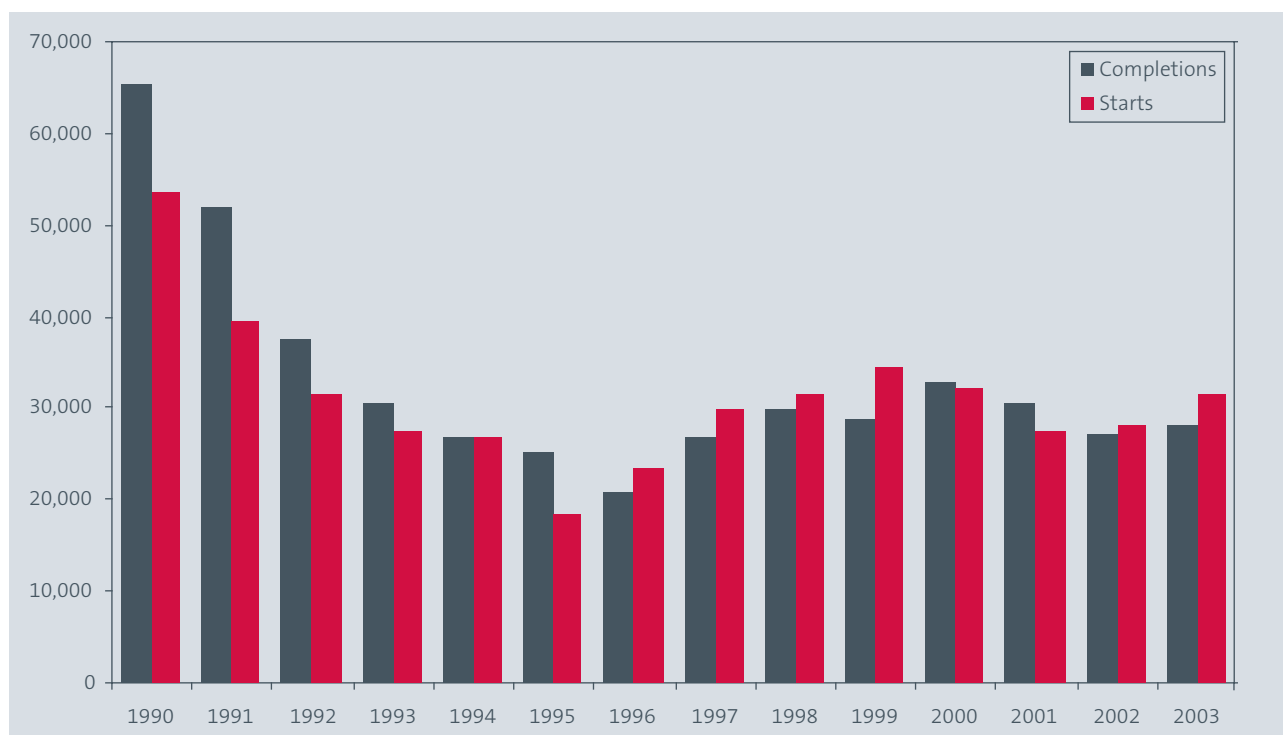
Overall residential investment levels have been volatile (see Factfile). Apart from the adverse effects of economic uncertainty, land shortages are the biggest constraint on housebuilding in the Helsinki region, though elsewhere this is not the case.

Figure 8.4: Transactions of flats and terraced houses 1990-2003



Source: Statistics Finland

Figure 8.5: Housing completions and starts 1990-2003



Source: Statistics Finland

Macroeconomic influences

The economy was in good shape for several years after the setbacks of the early 1990s. High growth rates – ranging from 4-6% a year – occurred from 1994 to 2000, driven by the success of Nokia and other IT firms in international markets and buoyant exports of timber and paper. The world economic slowdown then affected export markets, and exports fell every year between 2001 and 2003. Fiscal stimulus by the government, however, limited the overall impact of the trade slowdown. Even so, GDP fell slightly in the first half of 2003. A tax-cutting package was introduced in the summer, and a further one in early 2004. The upswing in world trade already benefited the economy late in 2003 and growth in 2004 continued to expand.

Inflation has become low. For the past three years consumer prices have risen by less than 1%. Private consumption growth was held down in 2000 because of tax increases, despite the more than 6% GDP growth rate (though the overall trend of personal taxation has been downwards since the mid-1990s). Along with the rising interest rates of the time, this helps to explain the sharp slowdown in the housing market during that year.

Unemployment is quite high, at around 9%, and stable. It had reached 17% at the end of the slump in 1994. There were tax cuts at the beginning of 2004, which have helped to stimulate consumption growth, but there are concerns about the need to raise taxes in the future to fund the costs of an ageing population, which will hit Finland harder than many other countries (see Table 8.2).

The dependency of the economy on a narrow range of export goods and markets has in the past made the economy highly sensitive to external shocks in the markets it serves with those goods. The volatility of the economy that resulted is an important factor in explaining housing market volatility. The late 1980s house price bubble, however, was exacerbated strongly by the impact of financial liberalisation. In recent years, the country's export markets have become somewhat more geographically diversified, but the external risks are still significant. Joining the Euro Zone has removed the effect of such shocks on domestic short-term interest rates, in contrast with early years, and mortgage rates are generally short-term variable rate ones. The housing market is consequently less likely to be affected by the consequences of such potential economic shocks in the future. This may help to explain why the housing market recovered so strongly from its initial hiccup as the economy slowed in 2001.

Mortgage markets

Housing loans are provided by the main commercial, co-operative and savings banks. They advance roughly 90% of household housing related loans and hold three-quarters of all outstanding housing loans, including those to social housing institutions. The state provides most of the rest of housing finance through its subsidised loans issued via the Housing Fund of Finland (ARA) and municipalities. The share of the state system in housing finance has traditionally varied with the health of the private

housing market. When the latter is poor, the state tends to take a larger role, and vice versa.

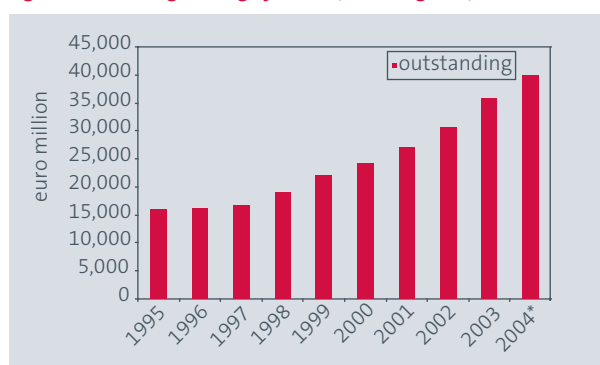
The ARA was set up in 1993 as a reform of a much earlier system, as noted earlier. It is a consolidated source of public sector finance for new and improved housing, which is funded via amortised housing loans and capital markets. It has provided funding to municipalities, right-of-occupancy dwellings and owner-occupiers, the latter now only in the form of loan guarantees for those that have difficulties in raising loans independently. The cost of its loans rose relatively as interest rates fell, causing the ARA to become uncompetitive. So, in 2003, the government changed its loan rates, which are now tied 10-year government bond rates with minimum and maximum ranges of 3.4% and 6%. Since the mid-1990s, external financing has mainly been raised by the ARA through the securitisation of its loans under the 'Fennica' programme – the six rounds of which have raised 2.7 bn euros.¹²

Loans, secured on property, are generally issued on the basis of relatively short-term interest rates linked to rates such as 3 to 12 months Euribor, or to banks' own prime rates. Maximum loan periods used to be quite short, but have now been extended to more than 20 years – though typically they are 17-18 years, less than in several other European countries, particularly Germany, Denmark and the UK where 25 years or more is common. The state, through the ARA, offers a loan guarantee system for up to 20% of loan value for single family housing and right-of-occupancy purchases in housing companies, with total loan packages offered to a maximum of 85% of value for the latter.

The stock of outstanding housing loans has grown rapidly since the housing boom started in 1997 (Figure 8.6). Since 1999, bank lending for housing has expanded at 12-14% a year. Mortgage lending, including the switching of existing loans to the best current deals, was encouraged by the abolition, in 1998, of the stamp duty on borrowing.

Overall mortgage debt, nonetheless, is low by international standards. It stood at 29% of GDP for all residential loans in 2002, and at 21% of GDP for households' debt.¹³ This is far lower than the EU average, let alone the more mortgage-indebted countries. Such low ratios, however, also existed at the time of the market crash in the early 1990s, and so cannot be regarded as a guarantor of housing market stability.

Figure 8.6: Housing lending by banks (excluding ARA) 1994-2004



Source: Central Bank

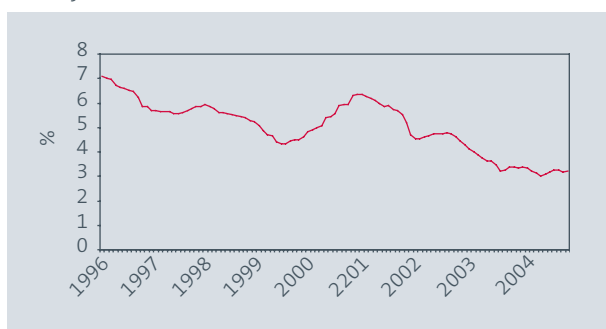
¹² Central Bank Bulletin 2, 2003. ¹³ Central Bank and Housing Statistics in the EU 2002.

Mortgages are currently some of the cheapest in the EU, because they are based on short-term interest rates in a competitive environment where bank spreads are low (Figure 8.7). Borrowers, however, are exposed to variable interest rate risks and mortgage rates will obviously rise when the ECB again decides to raise interest rates. It is possible to borrow fixed-rate mortgages, but their share is extremely low, though it may rise as the interest rate cycle turns. Interest rate rises clearly had a negative impact on the housing market in 2000/1; while the marked fall in rates from the summer of 2002 through 2004 helps to explain the renewed growth of house prices.

There has been considerable consolidation in the banking sector in recent years to create international universal banks cross-selling a wide variety of financial products, of which housing finance is a key element. The result is that the financial sector is now highly concentrated. By far the largest banking group is Nordea Bank Finland, following the takeover by the Swedish holding company Nordea, of Merita Bank in 2001. Nordea

Figure 8.7: Household sector mortgage interest rates 1996-2004

Monthly



* 2004 to September

Source: Statistics Finland

Mergers also occurred in other Nordic countries – with mergers with other major banks occurring in Denmark and Norway, so Finland's largest banking group is currently part of a large Nordic financial conglomerate. The Amalgamation of Cooperative Banks (OKO Bank group), the second largest group, also made agreements in 2001 with an insurance company and a finance group, to cross-sell each other's products.

Earlier in 2000, Leonia Bank had merged with Sampo Insurance, and a subsequent set of related mergers created the third largest financial grouping. Along with greater concentration has come the entry of some foreign institutions. For example, a German Landesbank extended its operations into Finland in 2001. Finally, a new mortgage bank was also set up in 2001, but German-style mortgage banking is still relatively small-scale with only three institutions that all operate as subsidiaries of deposit banks.¹⁴ In relation to public sector lending, Municipal Housing Finance merged with another municipal capital market specialist, to create a company called Municipality Finance.

Demographic influences

The strong inter-municipal migration which started in the mid 1990s has continued ever since, and even strengthened. These net inter-municipal migration flows are concentrated in only a few sub-regions. Most attractive is the Helsinki Region, which gets over half of all net inter-municipal migration, though the influx of people has decreased somewhat over time. The decline reflects the growing housing shortage and affordability problems in the region, which are probably constraining household moves to Helsinki.

An implication of migration for housing demand is that it continues to be highly regionally differentiated. Areas losing population are gradually experiencing surplus housing stock and growing vacancies; whereas, in contrast, new building and price pressures are concentrated in the few growth localities. The most attractive destinations for migration apart from the Helsinki Region are the areas around Tampere and Oulu, in the north, which has a booming IT industry. Rents in new free-market tenancies are about 50% higher in the Helsinki region than elsewhere, and prices of owner-occupied dwellings are double. Studies have shown that most of the differences in regional house price developments can be explained by relative movements in employment, population and housing stock.

The growing number of small households helps to explain why square metre prices and rents of one and two-bedroom room flats are usually more expensive than those of larger dwellings, because demand is outstripping supply in this market segment. There is a strong relationship between household size, age and tenure, all of which are strongly influenced by life-cycle characteristics and social and economic factors. For example, 75% of single people under 30 rent their dwelling, which is a far higher renter share than average for the population as a whole.

The other major demographic factor is the ageing population. This is having an impact greater than in many other EU countries. Forecasts, shown in Table 8.2, suggest that the share of the population aged 65 or over will rise from the current level of 15% to over a quarter by 2030, while the share of those aged between 15 and 64 will fall significantly. This could lead to further declines in household size, and alter the location and types of dwelling required. It has, for example, led to a policy of trying to install lifts in blocks of flats that currently do not have them. An ageing society, furthermore, will lead to more public expenditure on age-related public services and income support, which could lead to a reassessment of the current relatively favourable fiscal position of housing.

Table 8.2: Population forecasts by age 2001-2030

	2003	2010	2020	2030
Population 000s	5,220	5,310	5,412	5,443
0-14 years %	18	16	16	16
15-64 years %	67	67	61	58
65+ years %	15	17	23	26

Source: Statistics Finland

¹⁴ Central Bank Annual Report 2001.

Factfile: Finland

Background

Population (m) 2002	Population Growth % 1980-2001	Fertility Rate* 2002	Years Life Expectancy 2002
5.2	9	1.8	78

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

Services output as % of GDP 2000	Employed as % working age population 2002
63	68

* GDP per person employed 2002

Economic

	200	2001	2002	2003	2004f
Real GDP growth %	5.1	1.1	2.3	1.9	2.5
Growth in real private consumption %	3.1	1.8	1.5	3.6	3.0
Inflation – GDP deflator	3.2	3.0	0.9	0.7	0.6
Inflation – consumer prices	3.0	2.7	2.0	1.3	0.5
Unemployment rate %	9.8	9.1	9.1	9.1	8.9

Government

	2000	2001	2002	2003	2004f
Expenditure as % GDP	49	49	50	51	51

Housing market

	2000	2001	2002	2003	2004f
Growth in residential investment	3.4	-10.6	2.1	7.7	7.6

Taxes

Owner occupied housing	Capital gains exempt	Imputed rental income
Mortgage interest relief – yes	yes after 2 years	not taxed

Property taxes as share of all taxes 2002	Property taxes as share of GDP 2002
2%	1%

Housing Statistics in the European Union 2003, Eurostat, OECD, World Bank.

chapter nine

France

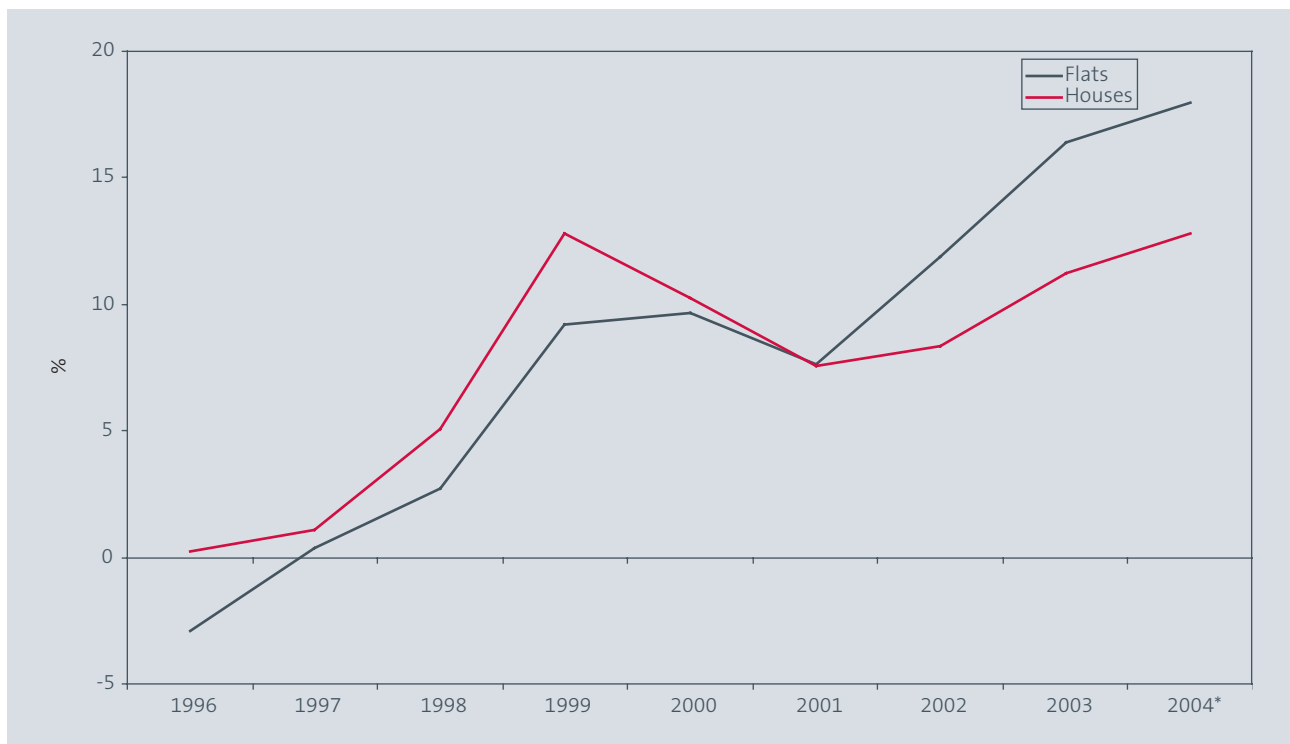
Overview

The housing market boom strengthened during 2004. The prices of existing housing rose by a forecast 16% over the year, and new housing by a somewhat slower rate (10% annualised in the first half of 2004). This makes France one of the countries with the most vibrant housing markets in the EU. The price rises have now been going on for 8 years, since the end of the mid-1990s slump in 1997, and have been accelerating on a trend basis. Over that period, nominal prices have doubled nationally, with almost half of the increase occurring in the past 3 years. Unusually, the Bank of France devoted the editorial of its monthly bulletin in September 2004 to concerns about whether a house price bubble had formed. While not categorically concluding that a bubble was indeed being experienced, as it had been in the early

1990s, the article expressed a view of the need to monitor current housing market trends with particular vigilance – indicating that the Bank was worried.

There has been a change in price behaviour between types of dwellings in recent years. In second-hand markets, the prices of houses initially rose more rapidly than those of flats but, since 2002, flats have been rising noticeably faster (Figure 9.1); whereas, in the new build sector, house prices have risen quicker than those of flats throughout the upswing. The difference, apart from statistical factors, may be accounted for by renewed interest in central city living, which primarily is associated with the purchase of existing flats, and the fact that the purchase of a new dwelling is often associated with a household moving upmarket to more spacious accommodation and living in the suburbs.

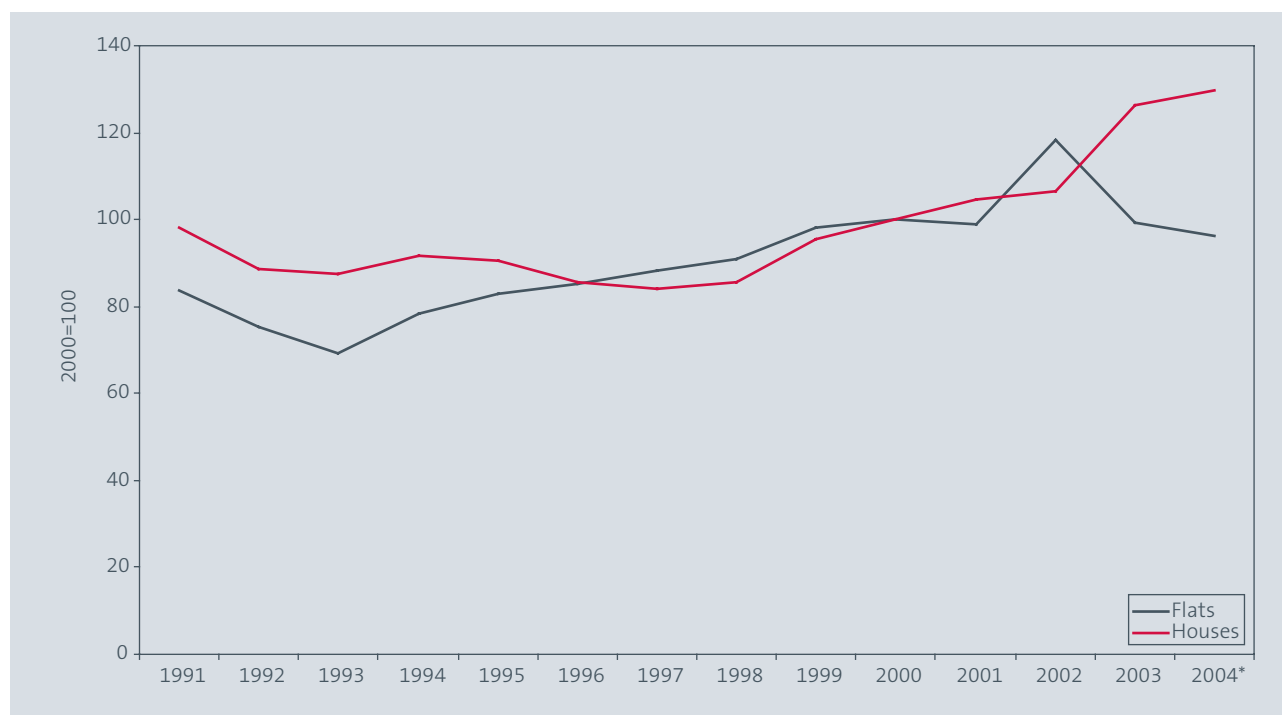
Figure 9.1: House price changes by type of property 1996-2004: Existing dwellings



*forecast

Source: FNAIM

Figure 9.2: Existing dwelling transactions 1991-2004



* based on first 9 months

Source: FNAIM

Another price pressure in the market for flats also exists on the supply side. For most of the upswing, there was strong growth in turnover in both the existing flat and housing markets (Figure 9.2). However, the level of transactions for flats was down again in 2004 for the second year running, while those of houses rose. The extent of the divergence was considerable, with transactions of existing flats falling by a fifth between 2002 and 2004, and those of houses rising by a similar amount. Accommodation in the most desirable areas may, therefore, be becoming extremely short; whereas turnover in suburban houses is still substantial, aided by now expanding new supply (see later).

House price behaviour is quite volatile over the long-term. Several years of rising real prices over the past 20 years have been followed by years of slightly falling prices in real, and sometimes nominal, terms. The mid-1990s slump, in fact, was

associated with a national drop of over 5% in nominal prices, which probably helped to delay recovery, as it dented consumer confidence in house purchase.¹ The boom in house prices since the late 1990s has been exceptionally long and strong, with price levels at historic highs.

Until the latest resurgence of house price rises, a broad pattern of the housing market moving in tandem with the economy occurred. The fact that the housing market has performed so strongly over the past 8 years is due to more than the economic cycle. The boom has been stimulated, in addition, by a complex mixture of low interest rates; a greater propensity to borrow (aided by more, if still, limited competition in mortgage markets); renewed consumer confidence in housing as a 'safe' investment that provides healthy capital gains; and government subsidies. This boom, furthermore, seems to be encouraging a gradual shift in the housing system towards owner-occupation.

¹ Regional variations are likely to be more varied. In addition, the house price indices are not quality adjusted, so that some of the apparent swings in prices may be the result of differences in the housing mix over time.

The housing system

There has been a long history of strong state involvement in housing – both in renting and owner-occupation – through subsidies, tax breaks, land use policies, rent controls and financial regulation. Policy is generally enacted for particular areas – such as social housing, stimuli to investment, savings for housing and urban regeneration – and augmented by a series of, often time-specific, pieces of legislation. For example, with regard to such time-dependent measures, the ‘Perissol’ incentives for new building lasted from 1996 to 1999; to be followed by those of ‘Besson’ from 1999 to 2003; which were then replaced with the ‘Robien’ programme. There are so many types of policies, grants and benefits available to assist households that it is impossible to cover them briefly.²

Direct state expenditure on housing, either through investment subsidies or housing allowances, is one of the highest in the EU. It is twice as high as in Germany (three times on a per capita basis); significantly more per head than in what were traditionally regarded as high housing expenditure countries, the Netherlands and Sweden; but less than in the UK, with its high spending on social housing and personal rent allowances (Table 9.1). These comparative data should be treated with caution,

nevertheless, because they exclude many explicit housing subsidies, such as those related to tax breaks on savings, or many aspects of subsidised interest rates. A true cross-EU housing subsidy comparison remains more elusive than the Arthurian Holy Grail.

Investment subsidies are spread quite thinly, so that they leverage other sources of finance to a greater extent than, say, do UK social housing subsidies. This means that quite a significant proportion of new housing receives some sort of subsidy (Table 9.2), which may help to account for the relatively high per capita building rates by European standards.

Table 9.2 shows another explicit characteristic of housing policy. It is deliberately used in a Keynesian-style way to manage demand in the economy and this is a stated goal of housing policy in a way that is rare in the EU. A greater share of subsidised housing, for example, existed between 1996 and 1998 than in earlier or later years, not simply because unsubsidised housing is more sensitive to economic change, but also because of active programmes by the Government of the day. Such an approach to housing investment subsidies seems to transcend party political differences. The subsidies typically are more easy to switch on than turn off, and may be contributing to excess demand pressures during the current housing upturn.

Table 9.1: Public budgetary expenditure on housing (€ millions)

	Type	1995	2000	2002
GERMANY	Investment	5,121	3,579	2,600
	Personal subsidies	2,938	3,426	4,500
	Total	8,058	7,005	8,925
FRANCE	Investment	3,469	3,430	3,576
	Personal subsidies	4,025	5,346	5,349
	Off budget personal subsidies	7,116	7,346	8,174
	Total	14,610	16,122	17,099
UK	Investment	7,480	8,038	7,955
	Personal subsidies	16,924	18,437	19,696
	Total	24,404	26,475	27,651

Source: Ministère de l'équipement, des transports et du logement

Table 9.2: Housing starts: subsidized and unsubsidized (thousands)

	1995	1996	1997	1998	1999	2000	2001	2002
Subsidised	106	139	140	127	139	135	123	125
Unsubsidised	171	125	121	156	178	174	180	178
Total	277	264	261	283	317	309	303	303
% subsidised	38	53	54	45	44	44	41	41

Source: Ministère de l'équipement, des transports et du logement

² See The Funding of Housing in France, Directorate General of Urban Planning, Paris; P. Balchin, Housing Policy in Europe, Routledge, London, 1996; and the website of the French housing department, Ministère de l'équipement, des transports et du logement <http://www.logement.equipement.gouv.fr/logt/>.

Table 9.3: Rehabilitation compared to new building and role of state aid, 1995-2002

	Rehab	New build	% expenditure on rehab	Thousands of dwellings rehabilitated with state aid
1995	20.9	18.7	52.8	291.6
1996	20.7	17.8	53.8	320.2
1997	21.4	18	54.3	350.4
1998	22	19.5	53.0	348.8
1999	22.9	23	49.9	355.8
2000	25.2	24.5	50.7	351
2001	26.1	25.6	50.5	287.7
2002	26.7	25.8	50.9	261.8

Source: Ministère de l'équipement, des transports et du logement

There is also a significant programme of urban regeneration and housing renovation. Some upgrading of housing utilises state grants, whilst other work does not (Table 9.3). State-aided programmes are undertaken under a number of policy rubrics and they reached a peak at the end of the 1990s, since when they have declined, but overall renovation expenditure has continued to rise as the housing market booms. In total, the share of investment going into the existing stock is now around half of all housing investment.

France has the largest stock of housing in the EU, when measured on a crude number per thousand population basis. 2.4 persons per dwelling is an indicator of the generally good space standards. Partly, this is accounted for by the relatively large number of second homes (around 10%), particularly near the Mediterranean, and the high level of vacancies (which have remained stubbornly high at around 7% of the stock for many years), which are mainly associated with the continued rural-to-urban shift of the population. A fifth of the stock has been built since 1980, and two-thirds since 1945. The housebuilding rate is quite high, at 5.2 per 1000 population in 2002.³ During the 1990s, an average of 290 000 dwellings were added to the stock each year, and the rate of growth has been even higher over the past five years. Two-thirds of the housing stock consists of houses and the rest are flats.

Almost 60% of the stock is individual houses, and the rest are in multi-dwelling structures. As two-thirds of new building typically is houses, their share in the stock is gradually growing, with consumers increasingly demanding more spacious and private accommodation.

Owner-occupation

The proportion of households who own their principal home has started to grow noticeably during the current housing boom, after being stable for many years. In 1992, it was estimated that 54% of primary residences were owned by their occupants and that share was the same in 1996 yet, by 2001, it was 56%; a ratio that will have grown further since then. As the housing stock is expanding rapidly, this means that the number in homeownership is increasing fast: by 183,000 households a year on average between 1992 and 1996, and by 216,000 in the next five years to 2001. Over that decade, therefore, owner-occupation rose by 1.8 million dwellings, accounting for 87% of the total net increase in the stock. This shift towards homeownership is not only a major economic and social change that is taking place within France, but must also be an important contributor to the current pressure on prices.

The latest upswing in the owner-occupied housing market reflects notably higher shares of owner-occupation particularly amongst the 35-54 age group, and within the existing stock of dwellings, which nowadays makes up around 75% of house purchases. Despite the overall expansion of owner-occupation, for those with Heads less than 39 years old there was evidence of a declining incidence of owner-occupation of about 5 percentage points over the decade from 1990 to 1999. This period encompassed severe downturns in both the economy and the housing market that may have deterred house purchase.⁴ Nonetheless, the reduction in homeownership rates amongst younger households is a common trend in countries that have experienced rapid house price rises.

³ Housing Statistics in the EU 2003.

⁴ See 'Recensement de la population 1999' No 750, INSEE, 2000.

Table 9.4: The zero per cent loans programme

Loans issued (000s)

1996	1997	1998	1999	2000	2001	2002
117.9	129.2	109.2	116.9	112.2	101.9	102.1

Source: Ministère de l'équipement, des transports et du logement

The high price of owner-occupied dwellings may be discouraging younger households from entering homeownership, especially as rents have risen by much smaller amounts. On a current outgoings basis, the affordability of house purchase is still better than it was for most of the 1990s, but first-time buyers are constrained by the rising costs of saving the equity required. Parents may help as in other countries, yet themselves will have to find higher sums in order to do so. It is common for younger French people to stay in their parents' home – 29% of men aged between 24 and 29, for instance, still live with their parents during which time, when possible, they can accumulate savings. The rising cost of entry to homeownership may be encouraging more to adopt this option. Another more positive factor suggests that the shift to an older entry to homeownership may have geographic causes, in that city centres are increasingly being characterised as the location of choice for many younger people. Inner city areas are simultaneously the locations of most rental housing, though the more rapid rise in the prices of flats may be indicating that owner-occupation is also growing there. Even so, the apparent tenure shifts may be reflecting changes in life-cycle choices, with suburbanisation now being more associated with 'settling down' and homeownership as well as the more traditional social class and employment decentralisation types of explanation.

The use of mortgages in the owner-occupied sector is high. Over 80% of properties are security for mortgages.⁵ This figure includes a varied mixture of mortgage types, a significant proportion of which are subsidised schemes like the Plan d'épargne-logement (used by 40% of owner-occupied households as a savings and borrowing vehicle, see below), or subsidised loans. The majority of mortgages are at fixed rates, though a fifth are variable ones.⁶ A significant subsidised loans policy relates to the zero per cent loan programme, known as 'prêt à 0 % – Ministère du logement' (PTZ). Since its introduction in the mid-1990s, over 100,000 moderate income households each year have used these loans to enter homeownership (Table 9.4).

Private renting

38% of dwellings are rented, with somewhat more in the private than the social sector (17 and 21% respectively in 2001). There is also quite a large 'other' category, at 6%, largely associated with work-related residences, although this is in gradual decline. Tenants are highly mobile: two-thirds occupy their dwelling for less than four years. The tenure is growing in absolute terms on a trend basis by around 60,000 units a year, though much of this probably reflects the commercialization of previously rent-free dwellings.

The fifth of households who rent privately are generally located in the inner-city areas of the large cities, with the greatest number in Paris. Since 1997, rents may be freely agreed in leases for new and renovated dwellings, but subsequent rent increases are then

linked to the construction price index. For existing tenancies, rents are still regulated, and renewals must stay at a level comparable with those for similar dwellings in the locality.

Real rent increases in both the private and social stocks were limited in the 1990s and bear little relation to what would be expected in a free market, as indicated by developments in owner-occupied house prices. Rents, furthermore, still vary considerably between similar dwellings because of the long-run effects of rent regulations. In the social sector, the prime determinant of rent levels remains the time a housing development was built. A recent study found that average social rents were 40% less than equivalent market rents.⁷

New private lettings, however, more closely match developments in the owner market over the medium-term. However, in the short run, the relationship between rent and house price changes is less direct, as the relative demand for each sector is affected by prevailing interest rates and expectations of capital gains from house purchase. On average, since 1995, rents for new lets in the existing stock have risen by 3.2% annually, with most of the increase occurring since 2000. During 2002, apartment rents rose by 8% – reflecting general shortages, whereas houses rose more moderately by half that amount, as more households switched into homeownership to take advantage of low interest rates. In 2003, rent increases slowed to 6%, and it looked as though the slowdown would continue in 2004.⁸

Social housing

Social housing is estimated to represent 17% of principal dwellings. Its standard has improved significantly since the mid-1980s, and the proportion of dwellings with modern facilities increased from 85% in 1984 to 96% in 1996. This upgrade 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. The government decided to regenerate social housing further in 2000 with a major FF35 billion package as part the Loi SRU – within the broader framework of the Loi d'orientation pour la ville, which was introduced in 1991. This has increased demolitions in many existing estates, and the aim is to have a greater social mix in the associated renewal projects – a policy stance also being adopted in the Netherlands.⁹ The overall rate of new social building has declined substantially since the mid-1990s – from around 50-60,000 dwellings a year to 36,000 in 2002, representing 12% of total new building at that date (Table 9.5). Some transfers of the existing stock are continuing to take place, augmenting the increase in social new build, though these increases are being offset by demolitions averaging 6,000 a year and sales now of around 3,000 a year, so that social housing stock is growing net by about 25,000 a year. If this trend remains, the sector will gradually decline further as a share of the total housing stock.

⁵ FNAIM-CREDOC, Les Français et l'immobilier, October 1999.

⁶ Housing Statistics in the European Union, 2003. ⁷ INSEE. ⁸ FNAIM ⁹ Euroconstruct.

Table 9.5: Changes in the social housing stock 1992-01

thousands	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Additions	50.8	59.4	67.7	69.8	65.2	54.8	42.6	43.4	41.9	41.6
of which: new	39.3	46.1	57	60.2	55.6	44.4	36.9	37	34.5	29.8
Reductions	9.3	6.4	7.7	12.9	12.5	10.9	7.3	12.1	10	9.4
of which:										
demolitions	3.9	2.7	3.8	5.1	5.1	3.0	3.2	6.4	4.8	5.7
sales	4.1	2.5	3.3	5.7	6.4	6.9	2.8	3.9	3.5	2.9

Source: Ministère de l'équipement, des transports et du logement

Housing allowances are paid to tenants as a consequence of several pieces of legislation. The most common one, APL,¹⁰ is also used to promote access to property ownership by partly covering mortgage costs. ALF¹¹ is paid to households with children, or young couples with no children, with household income below specified levels ; while ALS¹² 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 so experience some of the poorest housing conditions.

New housing

Housebuilding has been high in recent years, reflecting both the strength of the private market and the scale of public-subsidised social housebuilding. Outside of the historic centres, there is a preference for new housing, so that sales of newly built housing kept up better than the existing market during the mid-1990s downturn, and demand has surged since then. This preference reflects underlying migration, suburbanisation and housing demand trends in the country.

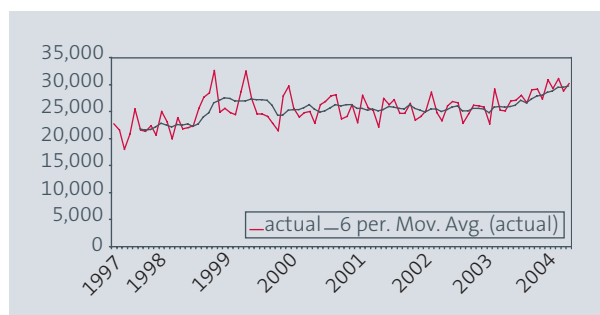
Housing starts initially surged as the housing market picked up in the mid-1990s, but then faltered and stabilised at around 290,000 dwellings per year. Though a high rate by EU standards, output did not seem to be responding to the continued rises in price. Since late 2003, however, housebuilding rates have suddenly taken off, with a 20% increase in starts between August 2004 and the year before (Figure 9.3).

Several buoyant regions have been influential in affecting overall market activity. There are also pressures from consumers in the major urban regions for improvements in their housing quality and space standards, which is leading to a wider spread of suburbanisation within the growth regions. Infrastructure improvements play a part in encouraging the outward movement of populations. The TGV routes out of Paris, for example, have stimulated housing growth in a number of cities and towns that now have greatly improved journey times to central Paris.

There are several ways in which houses are built. The most common means is when a prospective home owner commissions a dwelling to be built on a plot they have purchased or already own. Commercial developers have a much smaller market share, at just over a quarter of all new dwellings; whereas social housing's share is slightly about a tenth.

Macroeconomic influences

The economy from 1998 to 2000 was one of the most dynamic in the EU, and had the fastest growth rates of the big four of France, Germany, Italy and the UK. GDP growth was over 3% a year, a period when house prices rose strongly. The slowdown in the world economy then trimmed the growth rate, but the economy was not hit as badly as some other countries in the EU. The trough was reached early in 2003 and the economy bounced back strongly after that, with 2% overall growth forecast in 2004 and even stronger expansion in 2005. Domestic demand was the prime cause of the revival of growth, with private consumption playing a leading role. The dip in the rate of increase in house prices noticeable in Figures 9.2 and 9.3 corresponded to a period of uncertainty in the economy. That uncertainty may also account for the flat path of housing output during those years. Renewed expansion in housebuilding consequently reflects greater confidence in the economy as well as in the housing market and continued low interest rates.

Figure 9.3: Housing starts June 1997 – August 2004 monthly

Source: INSEE

¹⁰ Aide personnalisée au logement. ¹¹ Allocation de logement à caractère familial. ¹² Allocation de logement à caractère social.

General inflation was extremely low from 1998 to 2000. Consumer prices began to edge up, however, from 2000. Inflation, however, moderated after 2002-3, although it is expected to rise somewhat in 2005.

The government plays a large role in economic activity. Public expenditure, at 54% of national income in 2004, is one of the highest in the EU. The lack of concern about meeting Euro Zone public deficit rules has helped to keep up public expenditure and there seems no threat to current levels of housing subsidies. Whether such subsidies are counter-productive in an overheated housing market is a matter of debate.

A longer term fiscal concern is the future costs of pensions on public expenditure, which will create the need for structural reforms as the retired form a larger share of the population. In addition, unemployment is still high by international standards, at around 9%. The share of the employed in the population of working age is also relatively low, at 64%. International agencies have argued that there is a need to free up the labour market to increase the long-term growth potential. In housing market terms, such factors point to a greater need for housing support for those without employment. Such labour market characteristics also help to keep the rate of homeownership below that in many other EU countries.

Mortgage market

Traditionally, contractual saving schemes (Plan d'épargne-logement) have been an important source of finance for the owner-occupied sector. In this system, individuals agree to save a certain amount for at least five years. The interest they receive is below market rate, but they get an additional government bonus. At the end of the contractual period, they can then receive a below-market rate loan of 2.5 times the sum saved (and use the money saved as a deposit on a home). €37 billion is held in housing savings accounts, 10% of all passbook savings accounts, with deposits growing particularly strongly between 2001 and 2003 (Table 9.6).

Table 9.6: Housing savings accounts 1998-2002

	1998	1999	2000	2001	2002	2003	2004*
€ billions	26.0	26.9	27.7	29.9	33.2	36.0	37.2
% change		3.5	3.0	7.9	11.0	8.4	3.3
% of all passbook savings accounts	9.5	9.8	10.1	10.2	10.4	10.2	10.2

Note: End of period outstanding amounts. * at July.

Source: Banque de France

Other mortgage finance is provided by ordinary banks. However, there are some types of private loans that are regulated by the state (like the common contractual loans – Prêts conventionnés, or the former Prêt d'accession à la propriété). Under the Prêt conventionné scheme, a public or private-public organisation (like the Crédit Foncier de France) is involved in a contract with private banks, so that the mortgage rate is below the market level. But there are also other types of loans, some of them

especially directed at low-income households, such as zero % mortgages for homeownership considered earlier.

The main players in the mortgage market, when measured by the volume of outstanding loans at the end of 2002, are the commercial banks, with a 31% share; the mutual and co-operative banks, accounting for 56% of the market and consisting mainly of Crédit Agricole, Crédit Mutuel and Crédit Foncier; plus other financial companies, with a 12% share.¹³

Competition is increasing despite the regulated nature of the banking system, partly because the number of homeowners with mortgages has been falling, as the ageing profile of homeowners means that progressively more have paid off their loans. This has helped to moderate overall mortgage growth, which has been far more limited than in many other European countries (Table 9.7).

Housing-related debt is very low by the standards of many of the other leading EU economies, at only 19% of GDP in 2002. It has fallen since 1990, when it was 5% higher.¹⁴ This may be due partly to the way in which the data are calculated, but also to the relatively low level of homeownership and the role of tax-break savings-then-cheap-loan schemes that do not appear in the mortgage statistics, plus the ageing profile of homeowners. Even so, outstanding housing loans were almost 60% higher in mid-2004 than they were in 1998 (Table 9.7).

The low mortgage debt to GDP ratio highlights the far weaker direct linkages between the housing market and the national economy than exist in several other EU countries; though it is unlikely that other countries would like to trade off such potential benefits for the Exchequer costs and distortions in consumption, savings and lending profiles inherent in the French system. The difference consequently is more one of cyclical versus structural imbalances than a simple greater macro-economic stability impact.

With the household debt ratio for outstanding loans now back down to early 1980s levels, lenders are more willing to offer 100 per cent mortgages; after a period when they were particularly cautious, following widespread defaults in the early 1990s. Mortgage interest rates fell by almost 3% between 2000 and 2004, a development which has obviously helped to stimulate housing demand (Table 9.7). The securitisation of mortgage loans is a relatively recent innovation.

Table 9.7: Mortgage interest rates and outstanding lending for housing

	1998	1999	2000	2001	2002	2003	2004*
Fixed rate loans interest rate	5.98	6.75	6.70	6.02	4.23	3.98	
Outstanding housing lending by credit institution							
€ billions	264	285	305	325	351	385	415
% change in lending		8	7	7	8	10	8

Note: includes securitised loans. End of period. * at June/July.

Source: ECB, Banque de France

¹³ Banque de France ¹⁴ Housing Statistics in the EU 2002..

Demographic influences

The last census estimated the population to be 60 million in 1999. It grew faster than the European average during the second half of the 1990s, and is forecast to continue to do so over the next five years. Net immigration, at 45-60,000 a year over the past decade, has been low relative to the total population. As in many other countries, household size has been declining over time, to reach an average of 2.4 people, and the number of households has grown faster than the population. The number of households is expected to increase by 228,000 per year on average from 2000 to 2010, requiring 290,000 dwellings to be built annually during 2005-09 to satisfy the resulting potential demand for housing.

Social change has increased the number of single person households (Table 9.8). They represented 31% of all households in 1999, with a further quarter being childless couples. Demographic pressures and social changes are consequently increasing the demand for smaller accommodation, while rising living standards are pushing for greater space standards.

Table 9.8: Household type

Household type	%
Living alone	31
Couple without children	25
Family with children	39
Other	5

Source: 1999 Census, INSEE

An ageing population is contributing to the rise in household numbers. The most significant effects of population ageing, however, are likely to occur after 2010 when those over 60 will represent almost a quarter of the population, and over a third by 2050 (Table 9.9). This has long-term implications for housing provision as well as for social services and pensions.

Table 9.9: Shares of the population by age group 1990-2050

%	Less than 20 yrs old	20-59	60 yrs and older
1990	28	53	19
2002	25	54	21
2010	24	53	23
2020	23	50	27
2050	20	45	35

Source: INSEE

Forecasts for housing demand suggest that the current level of new housing output, though high, is barely meeting housing needs. This highlights how important the current growth in households and the demand for extra housing quality and space, rather than population, are in the current housing context. The latest forecast of housing demand suggests that up to 2005, 320,000 new dwellings are needed annually, while from 2005 demand will moderate slightly, but still be of the order of 290,000 dwellings until at least 2010.¹⁵ The ageing population consequently is unlikely to have a negative impact on housing demand for at least the next decade.

Economic activity and population are concentrated in urban areas. The Paris region alone (the Ile-de-France) accounts for around a quarter of national GDP. The major provincial cities are also the main economic foci in their regions. Housing costs, therefore, are greatest in the largest cities, with Paris at the peak, and in areas of rapid economic growth.

The fastest-growing cities over the past decade have been Toulouse and Nantes, with annual population increases of over 1%. Paris itself saw a decline in its number of residents, while there was some growth in the "petite couronne" (defined as the ring of suburbs closest to inner Paris); whereas the buoyant outer "grande couronne" was the principal focus of growth.

¹⁵ INSEE estimates.

Factfile: France

Background

Population (m) 2002	Population Growth % 1980-2001	Fertility Rate* 2002	Years Life Expectancy 2002
59.4	10	1.9	79

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

Services output as % of GDP 2000	Employed as % working age population 2002
72	64

* GDP per person employed 2002

Economic

	200	2001	2002	2003	2004f
Real GDP growth %	4.2	2.1	1.1	0.5	2.0
Growth in real private consumption %	3.1	1.8	1.5	3.6	3.0
Inflation – GDP deflator	0.7	1.7	2.4	1.4	1.6
Inflation – consumer prices	1.8	1.8	1.9	2.2	1.9
Unemployment rate %	9.4	8.7	9.0	9.7	9.9

Government

	2000	2001	2002	2003	2004f
Expenditure as % GDP	53	53	54	55	54

Housing market

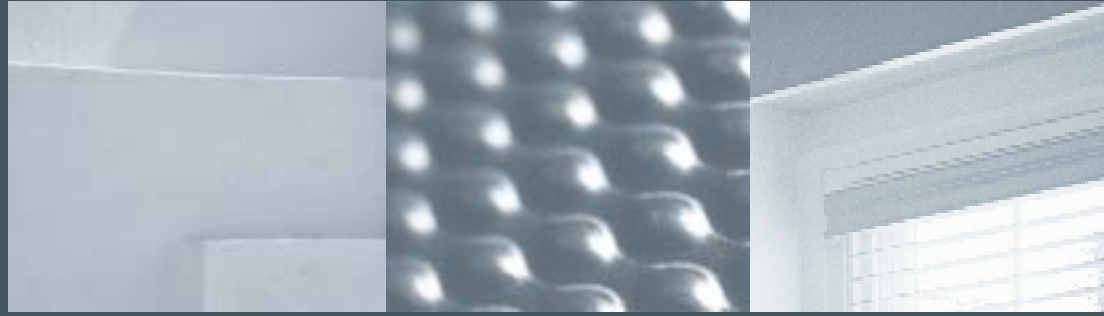
	2000	2001	2002	2003	2004f
Growth in residential investment	3.4	-10.6	2.1	7.7	7.6

Taxes

Owner occupied housing	Capital gains exempt	Imputed rental income
Mortgage interest relief – no	yes	not taxed

Property taxes as share of all taxes 2002	Property taxes as share of GDP 2002
7%	3%

Housing Statistics in the European Union 2003, Eurostat, OECD, World Bank.



chapter ten

Germany

Overview

The housing market, like the economy as a whole, continued to be flat in 2004. In general, it has had mixed fortunes over the past few years. Prices and rents in several major cities in the West have increased moderately in response to rising demand. In other places, however, previous excess supply has left the market

depressed in the face of poor general local economic conditions. In particular, the East is still suffering from oversupply which – along with continuing its economic problems – is contributing to weak prices and rents. Overall, prices have been falling moderately for a couple of years. Once statistical factors are taken account of, prices more reasonably can be said to be flat.

Figure 10.1: Changes in terraced house and land prices 1986-2003



Source: Bulwien

For the country as a whole, housebuilding has been plummeting from the highs of a few years ago, though the trough may finally be close. Mortgage markets have also grown moderately. With house prices flat or falling in real terms for almost a decade, there has been little or no additional housing equity to generate wealth effects on personal consumption, or to enable sustained equity withdrawals by owner-occupiers or landlords (many of whom are private individuals). Overall, consequently, the performance of housing and associated markets have moved downwards along with the economy rather than helped to sustain domestic demand and economic growth, as has occurred in many other EU economies. One of the objectives of what follows is to examine why this distinctive behaviour has occurred.

The housing situation in Germany, the EU's largest country both in terms of population and national income, is unique for several reasons. It has an exceptionally low level of homeownership, at a little over 40% of the housing stock. Moreover, the performance of its housing markets as a whole has been strongly affected by a unique long-cycle that has lasted for more than a decade, caused initially by reunification and the associated increase in migration into the area of the former Federal Republic. In the late 1990s, for example, residential housebuilding peaked at 8% of national income and now it is far lower. This required a major readjustment in economic activity to absorb the freed up resources at a time when both the national and international economies were going into a general downswing.

The housing system

Homeownership

Only 43% of the housing stock is owner-occupied, the lowest share in the EU. The percentage is about 10% higher in the old Federal Republic area than in the East, but the tenure is now growing fastest in the East.¹ Social housing is now only 6% of the stock, having been declining secularly through estate transfers and as loans are paid off. There is also a co-operative sector of rental housing, divided roughly 40-60 between East and West, which accounts for another 6% of the stock. Private renting consequently is a tenure of around the same size as owner-occupation, by far the highest share in the EU and only surpassed by Switzerland.

The share of owner-occupation varies considerably between cities and regions. The most urbanised parts of the country tend to have the lowest shares, and those areas with larger rural populations or more scattered urban development have higher homeownership rates. So, Berlin has the lowest share, at only 11%, and Hamburg only 20%. In contrast, Saarland reaches a homeownership rate of 58% – the highest; Rheinland-Pfalz, 55%; and Baden Württemberg, Bavaria, Lower Saxony and Schleswig Holstein all have just below 50%.

There are social distinctions as well. Only a quarter of single person households are owner-occupiers, whereas 56% of households containing more than three people live in the tenure (Table 10.1). 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. Homeownership, consequently, is a 'later in life, families with children, better-off, suburban or rural' type of housing. It is, therefore, misleading to classify Germany simply as a nation of renters. Moreover, as elsewhere, owning their own home is often something to which households aspire, particularly if they would like to live in a single family dwelling or outside of the urban cores.

Recent governments have aimed to increase the homeownership rate substantially, even if effect of these policy inclinations on the overall importance of the tenure has, so far, been limited. Policy history plays an important part, because the current low ownership rate is a product of long-past housing production programmes and more recent over-reactive supply-side policies after reunification. Housing policies in the 1950s and 1960s favoured rental building, especially in certain localities in the West and in the old East. Renovation programmes since the 1970s continued that bias.

The major housing shortage that arose at the time of reunification encouraged the government temporarily to support an expansion of rental sectors. This lowered the growth in the overall homeownership rate. Underlying consumer preferences will in future have a greater influence on housing tenure mixes, which should over time increase the homeownership rate. Owner-occupation had already expanded by around 5% points in the old Federal Republic in the 15 years prior to reunification. The purchase of condominium flats has also grown since the mid-1970s.

Table 10.1: Who are homeowners?

% of household type in owner occupation 2002

	Germany	West only
Household size		
1 person	25	27
2 persons	49	52
3 or more	56	57
Age of head		
Under 30	7	8
30 – 59	43	44
60 and more	50	54
Monthly net income (euro)		
Less than 500	16	18
500-1,300	24	26
1,300-3,200	43	45
3,200 and more	68	69

Source: Federal Statistical Office

¹ Federal Statistical Office.

Policy concern to increase the owner-occupation rate has grown in recent years as a result of concerns over the consequences of the ageing population. The government now hopes that people will be more aware of the potential life benefits of the tenure, and their asset role in retirement plans.

New owner-occupiers commonly build their own home on a plot they purchase – or, more precisely, arrange for an architect or building company to organise its construction – and then live in it for a long period of time. This practice, plus the age and social characteristics of most owners, means that homeowners tend to stay in their properties for long periods of time. They traditionally have not moved around in a sequence of stages on a life-cycle housing ladder, as is common in countries such as Ireland, the UK and USA, although this practice is growing.

Large-scale owner-occupied housebuilding may well occur over the next decade or so. The Federal Bureau for Building and Regional Planning, for example, has forecast a continued demand for 300,000 dwellings a year, with the floor area in homeownership increasing by a fifth and stagnation in the private rental sector. Whether these forecasts remain relevant with the new emphasis on rehabilitation is not clear.

Two supply-side influences put constraints on increases in owner-occupation. First, there are difficulties in obtaining land supply for owner-occupied homes because of local municipality reluctance. Apart from general planning constraints on suburban expansion, local authorities are hesitant to sanction land release for owner-occupation because they have to bear the infrastructure costs associated with suburban expansion. The second supply-side factor is the frequent existence of local-level policies that hamper the transfer of rental properties into owner-occupation. The security of tenure offered to existing tenants, furthermore, gives landlords little opportunity to sell out, even when prices make it attractive – a significant factor in cities with a relatively high demand for owner flats, such as Munich.

There is no mortgage interest tax relief as in some other EU countries. Even so, in the past, a variety of measures encouraged better-off households to invest in owner-occupation and rental housing in order to reap significant tax gains. These tax breaks have been lowered in recent years, discouraging private individuals from investing further in the rental sector. However, some significant tax concessions remain. One supports the construction of owner-occupied dwellings (*Eigenheimzulage*), and is the largest single existing tax concession to households. It is estimated to cost 7.5 billion euros in 2004.² A shift of emphasis was made within it at the beginning of 2004 to support the purchase of existing dwellings.

The regional *Länder* and local authorities have responsibility for housing and land-use policy and, hence, have an indirect influence on the 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, and via relationships to social housing institutions and to public savings and mortgage banks, which form an important part of the financial system. Part of the differences in regional homeownership rates, noted above, are consequently a product of such local policy differences, though fiscal pressures everywhere are diminishing expensive public programmes that traditionally supported the rental sectors.

Rental Housing

Private

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 one of ‘softening’ of market rental movements, so most commentators conclude that rents follow market principles with a long lag.³ There are, however, insufficient studies to verify this claim accurately.

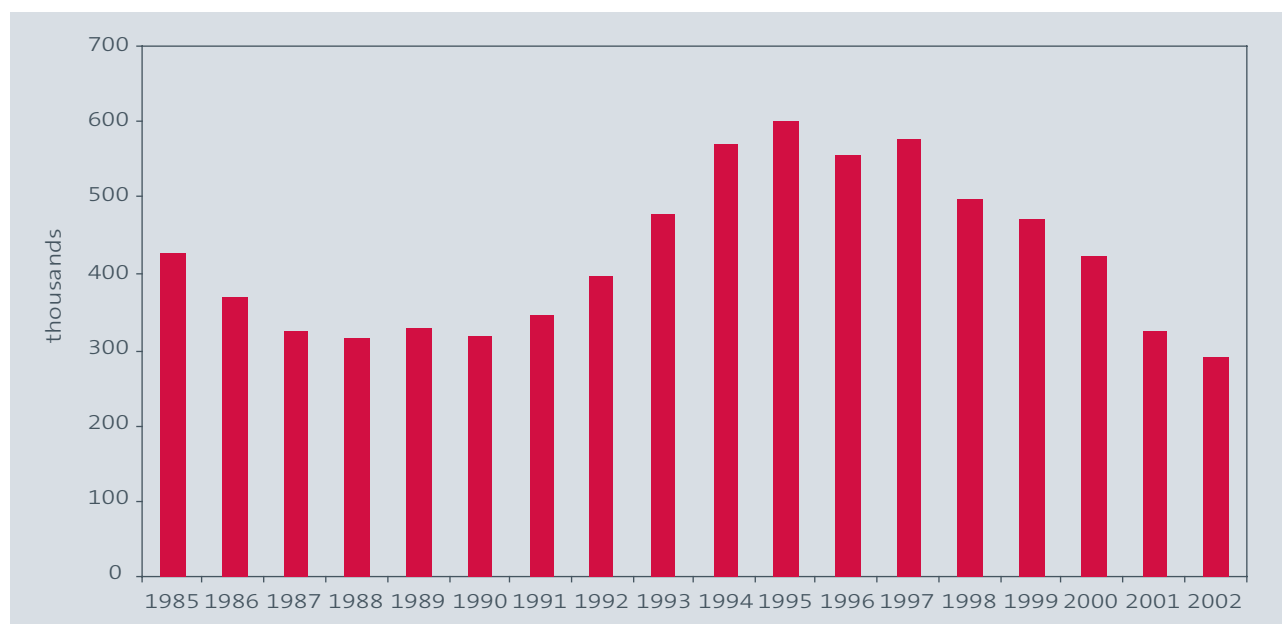
Rents are freely negotiated at the time when a household rents a dwelling. After that, however, rent controls apply. They may be linked to inflation or to rent levels in comparable dwellings, which are determined by the sheer weight of existing tenancies rather than by the relatively small number of 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 may lag far behind current market rents when there is a sudden increase in demand or inflation, but they still rise gradually to new higher levels. The general level of nominal rents, for example, rose by 16% between 1994 and 1998 following a period of sharply rising demand. This resulted in average annual real rent increases through the stock of around 1.5% a year over that time.

It could be argued that such a smoothing of rent rises is good for existing tenants. Yet, it also encourages landlords to frontload any expected future increase in market rents – caused by inflation, cost or demand factors – into rental contracts when they are agreed with new tenants. So, any benefit to existing tenants relates only to unexpected positive rent shocks, and has to be offset against the costs to new ones. Moreover, mobility is impaired. This regime may also discourage investments over the long-term through increasing uncertainty and thereby raising required yields, as landlords’ returns are pushed into the future. Nevertheless, rent controls have not been an issue for some years now, because there is a general situation of oversupply in many localities and market rents are either only rising gradually, or have actually fallen, in recent years.

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.

² OECD Country Report, 2004.
³ This is argued, for example, in *Structural Factors in the EU Housing Markets*, ECB, 2003. See also Bundesbank Monthly Bulletin September 2003.

Figure 10.2: Housing completions 1985-2002



Source: Federal Statistical Office

Social

Social housing means something different from elsewhere, as it does not refer to a specific set of non-profit housing providers with special relationships to central and local government, but rather to specific subsidy systems. The social housing subsidy system, moreover, can be used by private landlords and for low cost owner-occupation. Dwellings, furthermore, 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.

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.⁴ These companies are organised within the Gesamtverband der Wohnungswirtschaft (GdW).⁵ The privatisation of the big public companies continues. Some have been sold and others retained with the decision determined by local political factors and fiscal pressures. Members of GdW lost the privileges of their non-profit status in the early 1990s, following the 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 very rundown at reunification, so that there has been extensive renovation and rebuilding. The programme of housing privatisation in the East, however, has been far slower than was anticipated and vacancies are high. There are over one million vacant dwellings in the East, most of which will probably never be used as housing again.⁶ As part of a three billion euro programme launched in 2002, a third of these dwellings are to be demolished by 2009 and neighbourhoods upgraded. 34,000 dwellings were demolished in 2002. Similar measures on a lower scale are also underway in the older industrial towns in the West.

A major influence on recent housing market performance was the massive building boom of the 1990s. That boom was stimulated by reunification and the policies subsequently enacted in reaction to the housing shortages that arose. Those shortages were principally caused by a huge wave of migrants to the western Länder, suddenly raising their populations by 10%, and the rundown condition of housing in the eastern Länder. Policymakers over-reacted to the temporary shortages, and new housing production subsidies were rushed through. The government, in addition, provided low interest loans for housing investment and further incentives were offered in the East under the Promotional Area Act.

The scale of the government-primed housebuilding programme, which can be seen in Figure 10.2, was out of all proportion to long-term housing demand, it transpired. By the second half of the 1990s, signs of severe over-building in many localities became apparent. This led to a downswing in the housing market – as excess supply came on stream and it was only slowly absorbed. Much still remains vacant, especially in the East. This has meant that there is now a high vacancy rate in the East and in some areas in the West – though this is not the case in the main metropolitan areas of the West. Even so, much supply came on stream in the West during the mid-to-late 1990s. Therefore, even in localities that do not have a significant current supply overhang, more supply was coming on stream at the time, avoiding the major supply shortages as have been seen in many other EU countries in recent years. Those shortages have helped to stimulate booms within those countries' housing markets; whereas, in Germany, the pressures were absent.

⁴ In Berlin, for example, there are about ten public housing companies.
⁵ The organization of the private housing companies is the Bundesverband Freier Wohnungsunternehmen e.V., (BFW). However many companies are members of both organisations.
⁶ Housing Developments in European Countries 2003.

The 1990s building boom was financed through institutional investment, personal sector borrowing, public subsidies and mortgages from the wide variety of financial institutions providing them. Its effect was impressive. The value of the country's housing stock and the land on which it stands rose in value by more than 40% during the 1990s.⁷ Much of the increase was due to the amount of new building. Between 1991 and 1995, housebuilding virtually doubled, and altogether 4.4 million dwellings were completed between 1991 and 1999 – with most of the units being small to moderate sized flats. The overall housing stock rose by a substantial 11%.

The boom peaked in 1994, as vacancies started to appear in the private rental market and rents began to ease as a result. Land prices, which on some indicators had quadrupled in the preceding few years, and house prices both levelled off and then dipped slightly over the next four years. Housing market transactions and new building completions fell steadily from 1995, though transactions held up better than completions – partly because of a shift in fiscal incentives towards renovation.

The withdrawal of most additional building subsidies over the last few years has been a further necessary adjustment to more normal market conditions. Yet the process of transition that has resulted has discouraged housebuilding. It is now at levels that are probably below long-run equilibrium ones.

With current birth and death rates and with prevailing immigration policies, the overall population of the country

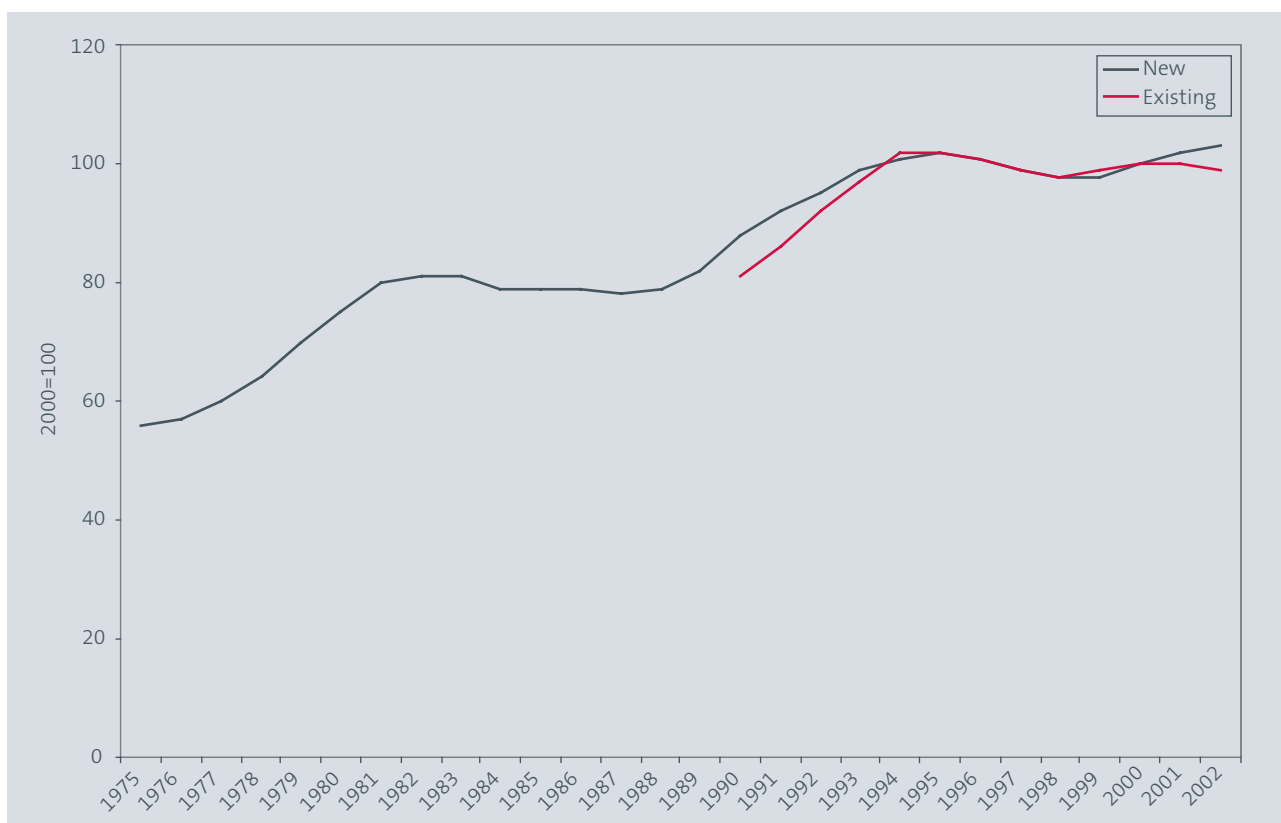
is likely to start falling significantly. Yet, this is not likely to affect the need for housebuilding in the near future, because household numbers are likely to rise for some time, households' housing aspirations are growing further, and localities of economic growth will still face housing shortages. The latter is true because the 1990s building boom misforecast the geographic distribution of demand as well as its scale.

One consequence of the recent boom-bust cycle in housebuilding is that it has had a large impact on the economy as a whole. The scale of housing investment in the 1990s – at 8% of GDP in 1998 – was far higher than the EU average. Its subsequent sharp decline, therefore, has had a significant impact on aggregate demand in the economy, with regional effects that have been especially strong in the East. The economic resources that were diverted into housing production in the 1990s, thus, are gradually being diverted to other uses, but the transition has proved rocky, particularly in a country widely criticised for the structural rigidities of its labour markets.

Recent market developments

From 1999 onwards, housing markets in the West revived, and prices and rents started to increase once again (Figure 10.3). Overall, in the West, price rises have been limited, especially in real terms. The weakness of the economy in recent years, the fragility of consumer confidence and the generally plentiful supply of rental accommodation have kept price and rent rises subdued in most parts of the country. Shortages, however, are notable in the major centres of economic activity, such as Munich and Frankfurt.

Figure 10.3: House prices 1975 – 2003



Nominal

Source: Deutsche Bundesbank calculations based on data provided by Bulwien AG

⁷ Deutsche Bundesbank Monthly Bulletin January 1999.

Prices in the East, by contrast, have continued to soften. The initial optimism that new, good-quality flats would trade at rents and prices approximately equal to those in the West has proved misplaced. The high vacancy rates there have led to a significant re-rating of values, especially in the rented sector.

The decline of housebuilding has continued throughout the country, and output in the first eight months of 2004 was 6% down on the previous year and almost 40% down on the 2000 level.⁸ The picture for 2005 suggests another year of stagnation or decline. Owner-occupied housebuilding in the West is likely to be the first sector to revive strongly.

Macroeconomic influences

Economic growth was sluggish during the mid-1990s and finally picked up from 1998, reaching almost 3% in 2000. Phased tax reductions helped to encourage an expansion of consumption and non-residential investment. They also indirectly helped the revival of the housing market. The upswing was short-lived, however, and the economy slowed significantly in 2001 and was static in 2002 and 2003, as export markets declined and domestic confidence fell. Real consumption even fell by 1% in 2001, and was flat in 2003.⁹ The worst of the downturn seemed to be over by the summer of 2003, and the economic environment became more favourable in the second half of the year.

Recovery, nevertheless, is still slow, with below capacity growth in 2004 and signs of the recovery stalling. Recovery, furthermore, will be driven by export markets rather than by private consumption. So, the continuing low level of growth and weak consumer confidence will probably have a dampening influence on the housing market in 2005.

Consumer price inflation remains low, despite some upward pressure in 2000 and 2001. Unemployment has risen and was almost 9% in 2004, and it is expected to remain at that level in 2004. Unemployment is concentrated in the East, where it is 15-20%,¹⁰ and in the older industrial areas.

One structural problem affecting the economy is the remaining huge gap between East and West. Output per employee is still far less in the East. With such low productivity, unit labour costs were much higher and unemployment remains stubbornly high. The process of economic adjustment in the East, and with it the evolution of a more typical housing structure, therefore, still has a long way to go.

Mortgage market influences

The mortgage market relies on finance provided by the commercial banks, the public savings banks or the co-operative sector. Via each route, a prospective purchaser may raise finance through loan packages. On offer are variable rate loans, but more usual are mortgages with a rate fixed for five years or more – 10 years is the most common. There are prepayment penalties during the period that the rate is fixed, or for the first ten years when mortgages are fixed for longer periods. In 2003, 95% of the housing loans held by banks of all types were long-term fixed interest ones. Mortgages secured on housing may also be used for other purposes, and are often a source of credit for the small business sector.

Mortgage banks, which have the sole right to issue mortgage bonds on the capital markets, are subsidiaries of the broader financial institutions existing in the private, public and co-operative sectors. As elsewhere, institutions lending mortgages will screen customers for their ability to repay a mortgage, and loans can be advanced up to a 100% of a dwelling's value. Such high loan-to-value ratios, however, are not common – as they are in some other countries, like the Netherlands. A typical first-time buyer would borrow a mortgage of around 80% of the value of the property they are buying. There is a legal requirement that mortgage bonds issued by mortgage banks on the capital markets have first call on properties and can only be secured up to 60% of the value of a property. This has little direct relevance to mortgage borrowers, however, because the terms and conditions of the mortgages advanced are set by mortgage providers in competition with each other, as anywhere else. It may nevertheless create confusion amongst those not used to the German financial system that loan-to-value ratios for owner-occupiers are capped at that 60% ratio, which is not the case.

Real mortgage interest rates have remained quite high in comparison to many other EU countries with higher inflation rates – including most of those that have experienced house price booms in recent years, such as Spain and Ireland. Nonetheless, interest rates have mainly fallen in recent years, and they were down slightly in 2004. Yet, pre-payment penalties have limited the possibility of existing mortgage holders taking advantage of the lower interest rates to re-mortgage.

Mortgage finance has been growing, especially during the 1990s, though since then the increases have been modest. There was a slight pick-up in mortgage demand in 2004. This low rate of increase is affected by the limited ability of households to refinance at lower interest rates, the scale of lending during the earlier boom years, and the relatively modest increases in housing market activity. A large part of mortgage borrowing is also to finance rental housing, which has been another important factor in determining mortgage market behaviour, and rental investors have experience falling capital values and valuations for borrowing purposes will be conservative.

The depressed state of rental markets and the limited amount of social housebuilding in recent years have helped to flatten off mortgage growth – as they have probably led to more mortgage debt being paid off in those sectors than taken out. Owner-occupied housing, however, has a greater share of the mortgage than of the housing market, because it tends to be associated with more expensive dwellings.

Households, on average, are relatively unencumbered by housing debt, either because they are renters, or because of the average high degree of own equity when buying, whether for investment purposes as housing landlords or for owner-occupation. Outstanding residential mortgage debt overall was only 51% of GDP in 2002. In fact, in contrast to many other countries, it was less than two years previously.¹¹

Recent years apart, however, overall ratios of mortgage debt to income tend not to be so different from those in other countries. In terms of nominal 2002 household disposable incomes, for

⁸ Deutsche Bundesbank Monthly Bulletin, Oct, 2004.
⁹ OECD. ¹⁰ IMF. ¹¹ Housing Statistics of the EU 2002.

example, outstanding mortgage debt stood at 73%. In terms of other large economies, this was more than in Canada, and only slightly less than in the USA – though significantly less than in the UK – and notably higher than in Austria, France and Italy.¹²

Too much should not perhaps be made of differences in mortgage ratios between countries at particular points in time, because much depends on the state of their housing markets as well as on institutional factors and consumer preference differences. Housing standards and supply conditions in Germany as a whole are good by international standards and they have to be financed mainly through capital markets – by private investors, homeowners and governments – in much the same way as elsewhere. House prices may be somewhat lower than in some of the major city regions in other parts of Europe; yet, that has much to do with the more dispersed nature of economic activity than in many other countries, and the recent (sometimes over-) responsiveness of supply.

The timing of the country's housing market cycle is clearly out of synchronisation with those in other major economies. This timing factor probably has much to do with why mortgage increases and equity withdrawal are now low in Germany; whereas, in other countries, they are high. Relatively depressed housing markets, taxation reforms, high unemployment and weak consumer confidence induced by a static economy are consequently important in explaining any differences in the relation between the housing market and the macro-economy in Germany and elsewhere.

The prime cause of the extent of the lack of international synchronisation, moreover, has been the result of a one-off sequence of historical events – the interlinked break up of the Soviet Union, the reunification of Germany in the late 1980s and early 1990s, and the resultant huge population movements in parts of Central and South-Eastern Europe. The two other neighbouring countries that experienced similar resultant shockwaves in their housing markets, Austria and Switzerland, have also had significantly out-of-international-sync housing markets.

Population trends

The population is forecast to decline significantly in the future. Recent estimates suggest that, at current birth rates, immigration levels and with probable increases in life expectancy, the population will fall after 2013 from 83 million to 75 million by 2050, a 10% decline, because the fertility rate is currently insufficient to replace the population at its existing level.¹³ (The scale of future population movements within Europe and the geographic centrality of Germany may make population forecasting a particularly inexact exercise.)

The population will also age significantly. By 2050, 37% of the population will be over the current retirement age of 60. The impact of an ageing society will start to have significant effects from around 2010. The current old-age ratio (retirees to people of working age) is 44 (i.e. 44 people over 60 for every 100 aged between 20 and 59). By 2020, this will have risen to 55, and by 2030 to a substantial 71. These ratios would be reduced somewhat if the retirement age was raised to 65, but the broad trends would still be in the same direction.

Not only does an ageing society have implications for pensions, health care and public finances but, also, for housing. The demand for special-need housing for the elderly will grow exponentially; the number of single person households will rise; and the aspirations of an increasing affluent post-60 age cohort could have a substantial impact on housing demand patterns. For one thing, housing demand will become less locationally tied to employment but more influenced by personal relationships (to family and friends) and living preferences.

Table 10.2 : An ageing society

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

Source: Federal Statistical Office

¹² OECD.

¹³ Federal Statistical Office forecasts.

Factfile: Germany

Background

Population (m) 2002	Population Growth % 1980-2001	Fertility Rate* 2002	Years Life Expectancy 2002
82.5	5	1.4	78

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

Services output as % of GDP 2000	Employed as % working age population 2002
68	70

* GDP per person employed 2002

Economic

	200	2001	2002	2003	2004f
Real GDP growth %	3.1	1.0	0.2	-0.1	1.1
Growth in real private consumption %	1.0	1.0	1.7	0.9	0.1
Inflation – GDP deflator	-0.3	1.3	1.6	1.0	0.8
Inflation – consumer prices	1.4	1.9	1.3	1.0	1.1
Unemployment rate %	7.3	7.4	8.1	8.7	8.8

Government

	2000	2001	2002	2003	2004f
Expenditure as % GDP	46	48	49	49	48

Housing market

	2000	2001	2002	2003	2004f
Growth in residential investment	-2.6	-6.2	-5.7	-2.7	0.0

Taxes

Owner occupied housing	Capital gains exempt	Imputed rental income
Mortgage interest relief – no (but specific tax breaks, see text)	yes	not taxed

Property taxes as share of all taxes 2002	Property taxes as share of GDP 2002
2%	1%

Housing Statistics in the European Union 2003, Eurostat, OECD, World Bank.

chapter eleven

Greece

Overview

House prices in 2004 remained in the doldrums, with a forecast 4% fall over the whole year likely in Athens, the main housing market (Figure 11.1). Earlier, a house price boom had been present from the late 1990s, but it seemed to have run out of steam by the summer of 2003. The picture looked more robust in terms of other market indicators. Mortgages were still growing briskly, at 25% a year in late 2004, and new housing investment also remained strong. This suggests that the current upswing in the housing market is not yet over, but rather that the supply shortage has eased and that consumers are wary of paying too high a price for their new homes. The continued strength of the economy and low interest rates are helping to sustain housing demand.

The housing system

There is a high rate of homeownership, at 74% of all households. Another fifth are privately rented, and there is no social renting.¹ There are around 3.5 million principal and an estimated 1.75 million second or holiday homes, by far the largest share of second residences in any European country.² In addition, about 9% of the total stock lies empty, principally because of years of rural-to-urban migration.

Around 60% of the housing stock, including second homes, is single-family housing. However, only a third of new building is such accommodation, so that multi-dwelling units are growing in importance in the stock as a whole. Owners of single-family homes often purchase their own plot of land, arrange for their home to be built, and live there for much of the rest of their lives. However, urbanisation also resulted in the development of a market for rented houses and speculatively built owner-occupied dwellings. Nevertheless, this pattern of behaviour has strong influences on the operation of the housing market. For example, there is a greater emphasis on moving into new housing, and relatively less on transactions of existing housing. Traditionally, limited recourse has been made to mortgage finance, although it has grown rapidly over the past few years (see later).

Figure 11.1: Athens and other urban house price changes 1998-2004

2004 monthly to May, Athens only



Source: Central Bank

Given that economic development came much later than in many other EU countries, it is perhaps unsurprising that housing standards are not as good as they are in Northern Europe. There have been considerable improvements in housing standards in recent decades, however, particularly in the large prosperous cities. Even so, a large part of the existing housing stock has physical inadequacies – roughly a fifth of homes are believed to be sub-standard.³

The housing stock has mainly been built since 1950, with only 12% built prior to 1946. Even so, space standards of the existing stock are some of the lowest in the EU, at an average of only 83m² – though newly built dwellings are some of the largest, at 126m².⁴ Flats of less than 60m² are common, and they are unsuited to the needs of the typical four-person family, meaning that around a third of households face severe space constraints. Children also often remain living with their parents for a long time as adults.

Overall, new housing investment as a share of GDP is the mid-

¹ 2001 Census.

² UPE Consultancy estimate.

³ Housing Statistics in the EU 2002.

⁴ Housing Statistics in the EU 2002.

range of EU shares, at around 5%. This may indicate the constraints put on the supply side by the traditional limited recourse to mortgage finance, because it compares poorly with the higher investment ratios of several other 'less developed' EU economies with quality and locational deficits in their existing stocks and a strong demand for second homes.⁵ However, much housebuilding is done on an informal basis, which might not be fully accounted for in the official statistics in an economy with a large informal sector.

Landlords tend to be small investors, with property seen as a good investment in an economy historically prone to inflation. Quality and space problems are considerable at the lower end of the rental market, but there is little accurate information about the rental sector. Deregulation in 1997, however, is believed to have stimulated expansion. There is no social rented housing and few state supports for low income groups. Rents generally have risen slightly above the rate of inflation (Figure 11.2).

During the 1970s, migration to the cities substantially increased urban populations, and extensive housing construction took place. Much of it was of dwellings to rent, so the homeownership rate in urban areas actually fell by 7% between 1957 and 1974. Rural-to-urban migration has since slowed and living standards have risen, so that in the past two decades owner-occupation has steadily risen: from 70% in 1981.

In the big urban centres, the most common way of buying a dwelling is to purchase an existing home. Around 40% of the existing owner households acquired their home in this way. Another option is to have one built on an owned plot. Around a third of owner households did this. There are important regional differences in the share of new building. In the urban conglomerations of Athens and Thessalonika, given their already built-up character, the purchase of an existing house is more usual, while new building is more frequent in other urban centres with populations of above 100,000.

Another means of obtaining accommodation is through ownership transfer from a member of the family, such as via inheritance, and this traditional system accounts for roughly 20% of owner-occupation in the big urban centres. Finally, there is a system called the exchange of land for houses of equal value, a mechanism instituted in the 1950s, but it appears to cover only 5 % of owner-occupied stock. The scheme's main effect is to generate returns for the former owners of land.

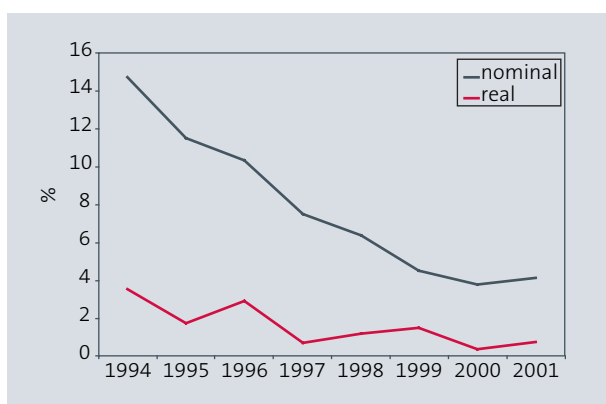
In many respects, the housing market is at a similar stage to that of the Spanish one a decade and a half ago. Rising living standards, a new easier availability of mortgage finance, the expansion of two income households, additional infrastructure expenditure, and the current stock shortages and quality deficits all combine to suggest that housing is going to be a major item in consumers' expenditure plans over the next decade or so. The enviable position of the islands as holiday retreats means that demand from throughout the EU and elsewhere will also continue to grow on a trend basis. The market for second and vacation homes has tended to exhibit similar variations to the first home market – though this may change with accession to the euro, as there are no longer exchange rate risks for most foreign purchasers.

Homeownership has been encouraged by the tax system. Many investments in housing are not reported to the tax authorities and, hence, are untaxed, while savings deposits and other financial assets fall within the tax net. So, the tax system is, by default, strongly biased towards housing. Mortgage interest is also tax deductible. This, however, has a lower aggregate effect than in many other EU countries, because mortgages are less common and the overall tax take is biased more towards consumption than to incomes. Even so, the interest rate tax break provides considerable benefits to the middle class households that do borrow – although 2003 tax reform measures have lowered them. Despite such changes, acquisition of housing remains the main investment vehicle for middle income groups.

To an extent the mono-tenure character of the housing system contains serious economic weaknesses. The implied fiscal losses and distortion of savings and investments have already been highlighted. Yet, further problems arise in the constrained ability of labour markets to respond to economic changes. The OECD has cogently argued that the high level of homeownership and the fiscal breaks given to owner-occupation hinder the growth of an efficient private rental sector. This hampers labour mobility, and so weakens attempts to modernise the economy and bring productivity up to levels existing elsewhere in the EU.⁶

The 2003 tax reforms may have indirectly addressed some of these problems by cutting the number of property-related taxes, which encourage owner-occupied informality, as well as reducing the benefits of mortgage tax relief by lowering and simplifying marginal income tax rates. In particular, the property transfer tax was lowered from 9-11% to 7-9%, and the inheritance and gift tax rates on property transfers between parents and children and primary residences were lowered, and the zero band increased.⁷ Many distortions, nonetheless, still remain.

Figure 11.2: Nominal and real rental growth, 1994-2001



Source: Housing Statistics in the EU 2002

⁵ According to Public Enterprise for Housing and Urban Planning.

⁶ OECD Country Reports Greece, 2002.

⁷ IMF Country Report 157/03 Greece. Selected Issues, 2003.

Recent market developments

Substantial housing market changes have been occurring over the past decade. On the supply side, rising living standards and a greater availability of mortgage finance have increased the significance of housing development companies in the large cities. In contrast, the first half of the 1990s saw a severe depression in the housing market and marked falls in housebuilding – anathema to housing developers. There was a partial revival from 1997, but high real interest rates kept the market subdued for the rest of the 1990s. Nominal mortgage interest rates were still at around 10% in 2000 – far higher than elsewhere in the EU – and they kept on depressing new housing demand. Since 2001, however, Euro Zone entry has cut mortgage interest rates virtually in half (Figure 11.3). There is still around a 0.5% difference between Greek mortgage interest rates and those typical elsewhere in the Euro Zone, but nonetheless interest rates have never been lower for house purchasers.

The resultant structural shift in the interest rate environment has enabled households for the first time to spread the costs of their most expensive lifetime purchase over the course of their lives in a way common in most other European countries for generations: obtaining a mortgage at an affordable interest rate. Unsurprisingly, the residential property market since 2000 has been buoyant. Other factors have also been important in stimulating housing demand: improved economic growth, a large number of infrastructure projects and, around Athens, the impact of expenditures associated with the 2004 Olympic Games.

The highest house price growth has occurred in Attica prefecture (which covers the Athens area) (Figure 11.4). House prices in the capital region rose faster than elsewhere up to 2002, increasing the house price differential with the rest of the country. Price rises, however, slowed faster in Athens in 2002, petered out in 2003 and even fell in 2004, narrowing the differential slightly again.

The future for price rises is uncertain. Lower interest rates have already been factored into prices over the past few years and supply is increasing. Yet, prices may well start to rise again, given the strongly positive nature of underlying demand conditions.

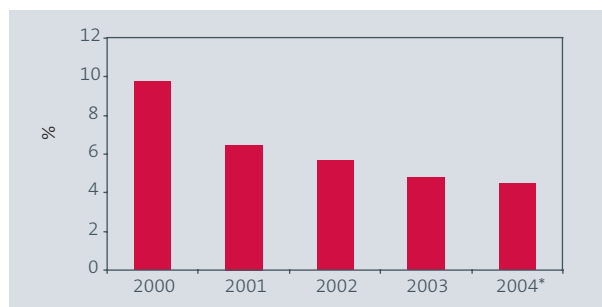
Housebuilding

Greece has had one of the highest housebuilding rates per capita in Europe for many years, because of the demand factors outlined above. In 1980, it was building far more houses than any other country in the EU, at 14 per 1000 inhabitants. Since then, housebuilding has slowed, and it stood at 9 per 1000 inhabitants in the early 2000s. Other ‘catch-up’ economies had by then overtaken its building rates, notably Ireland, Portugal and Spain.

Housebuilding rates are subject to sharp fluctuations, as can be seen in Figure 11.5. This may be because of the importance of the second homes market, but also reflects the notable historical instability of the economy. Since the mid-1990s, the scale of those variations seems to have diminished. Even so, housing investment has gone through four phases since the early 1990s. The high interest rates of the early 1990s led to

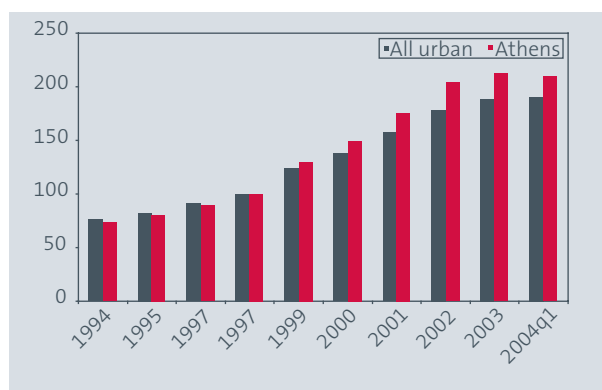
sharp falls in output, with double digit percentage declines in 1993 and 1994. Recovery was sustained from 1998, when investment surged by 10%. Expansion then slowed somewhat in 1999, and actually fell in 2000 by 4%, before recovering in 2001 and 2002, with diminished rates of increase in 2003 and 2004.

Figure 11.3: Average interest rates on new housing loans, 2000-04



Source: Bank of Greece

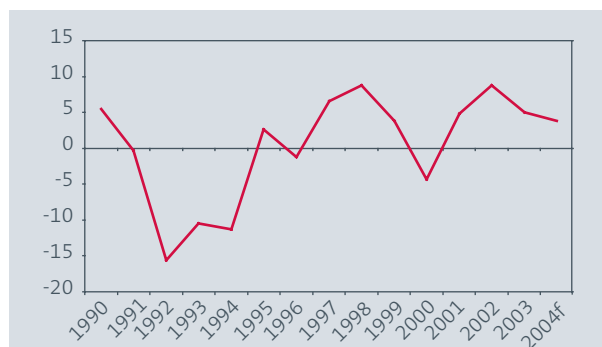
Figure 11.4: House prices, national & Athens, 1994-2004q1



Source: Bank of Greece

Figure 11.5: Real gross fixed residential capital formation 1990-2004

% change



f = forecast

Source: OECD

Macroeconomic influences

For years, macroeconomic policy was primarily directed towards the objective of entering the Euro Zone. The country had high inflation in the early 1990s, and interest rates were used to reduce it. The success in lowering inflation was substantial, with consumer price inflation falling from 20% in 1990 to only 2.1% in 1999. Since then consumer prices have risen at a steady average of 3.4%. This rate is notably higher than in the rest of the EU, which is eroding competitiveness.⁸

Interest rates remained high throughout the 1990s in order to squeeze out inflation, slowly falling from a peak of 23% in 1991. Such high historic interest rates show why mortgage use was so low until recent years. A mortgage in real terms, in effect, would have been paid back within a few years rather than over a 20 to 30 year span that commonly occurs under a more benign inflationary environment.

Real GDP growth has been good by average EU standards since the end of the mid-1990s recession, and has averaged over 4% in the past five years. According to the official data, the country still has average living standards that are almost a third lower than the EU average. On these measurements, there is still a long way to go before living standards catch up with elsewhere in the EU, so a sustained high trend growth rate can be expected in the future. Despite the world economic slowdown, GDP growth has hardly been affected, and any post-Olympic negative impact seems to be small. However, recent revisions in the size of the public sector deficit may impact on the economy and the housing market through resultant higher taxation.

One feature of the economy suggests that living standards are not as low as the official data suggest. Greece has probably the largest informal economy in the EU; one that was recently estimated to be roughly 30% of formal economic activity. A purpose of informal activities, of course, is to avoid paying taxes. This has several implications for the housing market. Structurally, housing is a classic good way of investing unrecorded income – through paying cash for purchase, new building or renovation and extension of an existing home, or the acquisition of a second one. Such untaxed funds may also be a source of finance for the widespread traditional style of borrowing by housing consumers. Family networks will be important in that process, because a lender has to invest considerable trust in a borrower's ability and willingness to repay a loan, since recourse to the law is hardly an option in the circumstances.

Unemployment has remained high in recent years, fluctuating at around 10%, and it has not fallen much since the mid-1990s. It is concentrated amongst young people and women of all ages. It is expected to remain more or less stable in the coming period. So, unlike several other EU countries, changes in labour market participation have not been a recent stimulus to housing demand. The portion of the population of working age in employment, at 57%, is one of the lowest in Europe. If this increases, as it is likely to, this would have a considerable upward impact on housing demand, as it did in several EU countries during the 1990s.

Mortgage market influences

Mortgages are far less commonly used than in many European countries. The most important source of finance is personal wealth. According to a recent study,⁹ 61% of households rely on their own savings, either exclusively or in combination with another source of funds. The second source is through a bank loan (21% of households, though this is now rising fast, see below), while only 10% use funds from selling a previous property. The final 8% consists of mainly low-income people, who say that they had only borrowed from members of the family or friends. Thus, low income households rarely resort to other forms of borrowing. Using loans is much more common when buying an existing dwelling than in the new built sector. Not surprisingly, therefore, outstanding housing mortgages form a small share of national income, and the country has one of the lowest outstanding mortgage to national income ratios in the EU, at 17% in 2003.¹⁰

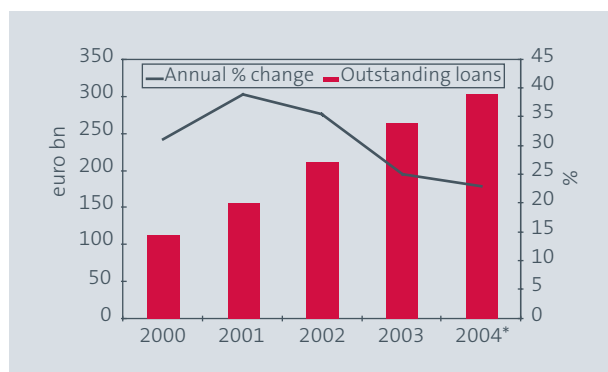
Greater financial market integration in the EU and the Second Banking Directive for the harmonisation of banking systems have both encouraged modernisation of the mortgage market. The monopoly of specialised banking institutions has been abolished and, with it, competition has increased. Commercial banks now have over 80% of the mortgage market. Even so, there are still both public and private mortgage lending institutions. In the public sector, two non-banking financial institutions specialising in housing credit are the most important: the Mortgage and Loans Fund and the Labour Mortgage Organisation. Their mortgage business has grown in absolute terms with the revival of the housing market, despite the entry of commercial banks, including foreign-owned ones, into mortgage lending. Yet, the share of publicly-owned institutions in the mortgage market is now only around 18%,¹¹ and is gradually declining in relative importance. Foreign banks have entered retail markets, but had only a 5% share of consumer credit and housing loans in 2004.

By 2003, the total outstanding value of mortgage loans was almost 10 times its 1992 nominal value. Outstanding mortgage balances rose by a substantial 40% in 2001, and were still growing strongly three years later, at a somewhat reduced rate of expansion (Figure 11.6). The value of outstanding mortgage debt rose twofold in the four years prior to August 2004. The average personal debt to disposable income ratio, however, remains low. Average household interest payments on housing and consumer loans were only 2% of gross disposable incomes,¹² though there are obviously variances around that average, as so many households have no loan at all. Further robust mortgage growth is consequently to be expected in the future.

Defaults are very low, but this is to be expected when most mortgages have so recently been taken out and the economy is strong. Lenders do not have the large-scale historical screening information that is available to their fellow institutions in countries with a long tradition of widespread mortgage borrowing. To a degree, therefore, mortgage lending is still a more risky activity than in the more developed mortgage markets of many other EU countries. Furthermore, when a

⁸ OECD Economic Outlook, June, 2004. ⁹ Undertaken by Public Enterprise for Housing and Urban Planning
¹⁰ Housing Statistics in the EU 2002. ¹¹ 2004q2. Bank of Greece. ¹² Bank of Greece.

Figure 11.6: Outstanding mortgages 2000-2004*



* August

Source: Central Bank

new mortgage involves the transfer of an old mortgage obligation to a new bank, the statistics still record it as entirely a new loan, which may highlight some hidden risks in the overall statistics.

Privatisation of state banks and liberalisation of the financial system have resulted in more competition, and the provision of new financial products. The mortgage departments of several banks now offer loans which are not dissimilar in principle from those offered in more sophisticated markets elsewhere. Competition has grown and there has been a significant switch from long, fixed-rate loans to variable ones as interest rates have fallen, and 70% of loans now have a floating rate or one that is fixed initially for less than one year. Higher loan-to-valuation ratios are also now on offer. The increased use of mortgages is one of the most dramatic housing finance changes in recent years of any EU country, and is a major contributor to the upsurge in housing market activity.

With accession to the Euro Zone settled, interest rates can confidently be expected to remain at nominal levels that are much lower than in the 1990s. This has had a major impact on consumer perceptions, because there is currently no fear of mortgage interest rates going back to the very high, but fluctuating levels that were standard during the several decades when inflation seemed ingrained in the economy. This leads to two important housing market consequences. First, homeowners have never before been able to borrow at such low nominal interest rates, and this has had a marked effect on enthusiasm for house purchase and mortgage borrowing. Second, the long-term prospect of mortgage interest rates remaining far lower than in the past has made many more households more confident of being able to afford mortgage finance over the longer term, because they are no longer putting their future at the mercy of the threat of very high interest rates at some unknown, but highly expected, future date.

Despite these developments, acquisition of a house is still mainly a 'family affair'. This means house purchase can be difficult for those who have no access to an existing property, do not meet lenders' criteria, or cannot expect to be recipients of intra-family financial transfers. For them the option of renting is also often limited, as noted earlier.

Demographic influences

The country currently has one of the oldest age structures in Europe, with 43% aged 45 or more, and 17% over 65.¹³ With a low current fertility rate, which has fallen rapidly from a high one a couple of decades ago, the population is expected to stay at around the same level in future years. The impact of an ageing population may consequently have a significant effect on the housing market in the future.

Population forecasts, however, are particularly fraught in Greece, because of the high level of legal and illegal immigration in recent years. In the first half of the 1990s, a large number of 'Greek Pontains' previously living in Georgia, Kazakhstan and other central Asian Countries moved to the country. Migrants from other Balkan countries then had a major impact from the mid-1990s. Overall, between 800,000 and 1 million immigrants have been added to the population since the late 1980s, which is around 10% of the population.¹⁴ As these migrants are generally very poor, their housing circumstances are limited, which may create significant social problems in the future in a country where traditionally the government has done little to improve low-income housing conditions. Such immigrants, furthermore, represent an, as yet, untapped pool of housing demand, which is likely to keep up pressure in the housing market as they become absorbed into the general population, and acquire incomes and housing aspirations similar to it.

¹³ Housing Statistics in the EU 2003.

¹⁴ OECD.

Factfile: Greece

Background

Population (m) 2002	Population Growth % 1980-2001	Fertility Rate* 2002	Years Life Expectancy 2002
10.6	14	1.3	78

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

Services output as % of GDP 2000	Employed as % working age population 2002
71	57

* GDP per person employed 2002

Economic

	200	2001	2002	2003	2004f
Real GDP growth %	4.4	4.0	3.9	4.2	4.0
Growth in real private consumption %	2.0	2.8	2.8	4.0	3.8
Inflation – GDP deflator	3.4	3.5	3.9	3.6	3.8
Inflation – consumer prices	2.9	3.7	3.9	3.4	3.3
Unemployment rate %	11.2	10.5	10.2	9.5	8.8

Government

	2000	2001	2002	2003	2004f
Expenditure as % GDP	49.9	47.8	46.8	47.2	47.4

Housing market

	2000	2001	2002	2003	2004f
Growth in residential investment	-4.3	4.8	8.8	5.0	3.8

Taxes

Owner occupied housing	Capital gains exempt	Imputed rental income
Property taxes as share of all taxes 2002	Property taxes as share of GDP 2002	
5%	2%	

Housing Statistics in the European Union 2003, Eurostat, OECD, World Bank.



chapter twelve

Hungary

Overview

There is a long tradition of owner-occupation. In the 1980s, it was around 65%, with virtually all the rest rented from the state. Then, in the 1990s, during the era of shifting to a market-based economy, there was a concerted programme of selling off state housing. So, by 2002, over 90% the housing stock was owner-occupied, with only 4% left in state hands, and most of the rest vacant. Hungary consequently now holds the record for the highest homeownership rate in the EU, and one of the largest in the world.

Sales of flats are mainly on a condominium basis. As it is unlikely that all tenants in apartment blocks will have bought their homes, a few households often are local authority tenants. Such buildings are mixed-tenure and local authorities remain responsible for them. In Budapest, for example, the number of local authority owned dwellings fell from 150,000 in 1996 to only 63,000 towards the end of 2000; yet, the number of residential buildings owned by local authorities fell by only 1,500 to 16,000 over the same period.¹

Housing standards are relatively better than the average for Central and Eastern Europe, though low by Western European standards. This is perhaps unsurprising, as the average standard of living is approximately half of the EU average. There are not the absolute shortages typical of neighbouring countries, though inevitably insufficient housing exists in high demand areas, like Budapest. There is also a substantial quality and repair problem in the existing stock.

Between 2000 and 2003, there was a significant housing boom, during which prices rose. The boom was stimulated by housing shortages, economic growth and substantial government subsidies to mortgage finance. A decline in housing market activity was then experienced in 2004, as those subsidies were reined in and interest rates rose.

Although the use of mortgages has started to expand rapidly in recent years, they started from a very low base. Housebuilding also continues to be predominantly owner-organised for direct consumption, though a development industry has been growing strongly in recent years.

There are no accurate data on house prices. Those that are currently published are likely to be of poor accuracy, because they are not quality-adjusted, and prices vary considerably between house types and locations. In the main urban markets, prices are currently in the range of HFF1,000 to 2,000 per m² for newly-built dwellings, and about 25-30% less for existing units, depending on location and the quality of the building.²

Although it was neglected during the 1990s, housing policy has moved up the agenda in recent years. There have been a flurry of new measures, some of which were not so well thought-out, and were short-lived. The share of national income going on housing-related public subsidies has risen sharply from a very low base as a result. The major schemes are identified at various places below.

The housing system

The average dwelling size is 75m² (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 since 1990. Almost 70% of the housing is single family and another quarter 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 single family.³

There is a considerable quality problem in the housing stock. A significant proportion lack facilities, with only 71% meeting the official comfort standard, and almost a quarter 'comfortless' or 'emergency' accommodation. 45% also lack one or more basic amenity, especially in rural areas and small towns (23% have no link to public sewerage, for example).⁴

Maintenance is also a major issue. Only a quarter of dwellings require no repairs, around two-fifths need partial restoration, and another fifth need full restoration. For the remaining 13%, it is uneconomic to do work on them.⁵ The situation is even worse in Budapest, where only 10% of dwellings require no works, and 38% full restoration or demolition. Many rural houses, in addition, especially those built prior to 1980, utilised poor quality building materials and no skilled building labour, and are now in bad shape. The backlog requiring substantial investment is consequently huge and will take many years to work through.

¹ Central Statistics Office. ² ECORYS Magyarország Kft.
³ Central Statistics Office. ⁴ Central Statistics Office. ⁵ Central Statistics Office.

Today in the larger cities, the stock is made up of three 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 – often large-scale – comprised of 5-10 storey buildings, built in suburban locations.

Most urban housebuilding took place with industrialised large panel and other concrete systems during the 1970s and 1980s, constructing standardised flats on large housing estates with around 55 square metres of living space. A fifth of the population, 2 million people, now live in such dwellings.⁶ Many of these are in a particularly poor state of repair and have bad insulation.

It has proved difficult to raise the quality of these dwellings by normal financial means. Low income people who have remained tenants cannot afford higher rents, and local authorities have been reluctant to subsidise improvements. Many new owners have also been reticent to provide their financial contributions to the repair and improvement obligations that came with ownership, either because they cannot afford them, or do not want to pay for some other reason. The law has been uncertain about the enforcement of repair obligations until recently.

In 2001 the government introduced a subsidy scheme to aid refurbishment – to date most of the expenditure has been on insulation. The scale of the programme, however, is likely to mean it has only a slow impact on the problem.

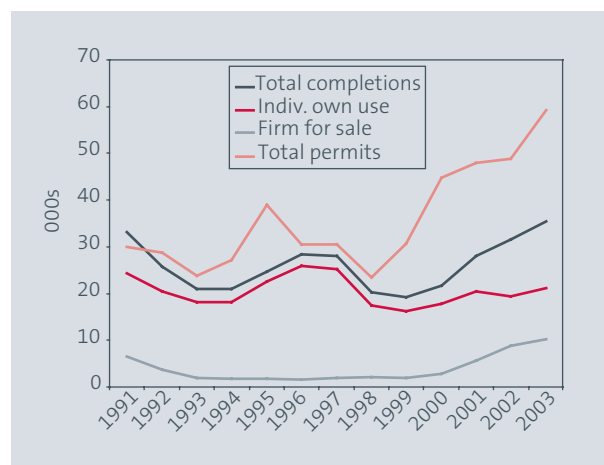
Another feature of the current housing situation is the low level of mobility. Average mobility is low, with a typical person moving 2.7 times in their life, compared to 6 or 7 times in western Europe. This is badly affecting new households and those moving for work reasons, i.e. labour mobility, particularly with regard to flats. The government re-introduced some new rental housebuilding subsidies after a long break in 2002, concentrating on 1 and 2 room properties aimed at both private and social developers. To date, around 11,000 dwellings have been built under the programme, 75% of them as social housing.

Housebuilding, subsidies and future housing demand

Social housebuilding virtually ceased after 1990. Prior to that, it had been a major part of the 80 to 100 thousand houses that were built annually. That output was not directly geared to assessments of consumer need but, rather, had become an integral part of the centrally planned economy.

Output was far lower in the 1990s, varying between 20 and 30 thousand homes a year, and virtually all of it was individuals managing the construction of custom-designed single family units, plus a few developers focusing on the upper end of the market. By the late 1990s, consequently, a general market in new housing had not really started. From 2000, with the mortgage reforms (see later), housebuilding for sale began to take off, rising to over a 10,000 units in 2003, 30% of total

Figure 12.1: Housebuilding 1991-2003



Source: Central Statistics Office

output (Figure 12.1). Output consists predominantly of condominium flats. The curtailment of mortgage subsidies in 2004, however, is likely to result in a short-term reduction in housing output.

After 2000, the government put in place a wide range of subsidies aimed at the owner-occupier market or parts of it. They include interest rate subsidies for savings deposits for housing, the purchase of new and existing housing, and for condominiums to renew common areas; grant subsidies, for younger couples with children, to construct, enlarge or buy a home; VAT relief for new housing; tax breaks on capital repayments; and stamp duty waivers. Additional interest rate subsidies have been offered to mortgage banks to kickstart a mortgage bond market. There are detailed stipulations and caps but, overall, the subsidies are generous.

Such an array of subsidies may not be entirely wise. How much subsidy, for instance, has simply gone on expenditure that would already have happened is unclear. The schemes are also regressive, as they favour higher income groups. Targeted subsidies also distort micro-behaviour in housing markets in ways that may be diffuse and not as intended. There is also the question of the market impact. The precise effect on quantities and prices depends on supply elasticities, which are unknown over the long-term but undoubtedly low in the short-term, and it is noticeable that there was a sharp rise in prices after the introduction of the measures. Moreover, some of the subsidy has been absorbed in institution-building rather than directly flowing through to the housing market. Whether the financial system needs such a helping hand is questionable. In the medium-term, the cost burden on the state exchequer, already badly in deficit, is unsustainable, and several measures have already seen their terms modified in 2004. The switching on and off of subsidies can also adversely affect market behaviour by generating volatility and uncertainty, which might even deter more investment than subsidies temporarily induce. There are also issues related to the macroeconomic impact of these boosts to consumption expenditure in an inflationary environment.

⁶ Ministry of Interior.

The reduced level of output in the 1990s could arguably be a reaction to the ending of quantitative housing shortages as much as the shock effects of transition: adding that the emphasis should now be placed on modernisation and replacement with better quality dwellings. The recent upswing, moreover, might be due to the impact of the new subsidies and diminish as they recede. However, there are still good reasons to believe in a significant demand for new housing – although housebuilding is unlikely to go back to the levels seen in the 1970s.

Demographics are playing an important part, with strong growth in the number of households, especially in the metropolitan regions. Currently, also, the 20-24 years old age cohort is entering the housing market as first-time buyers or tenants, and it is the biggest age group in the country, at about 850,000 persons. The population is also ageing, which is contributing to the growth in single-person households. Forecasts suggest that the percentage of the population aged over 65 will rise from the current 15%, to 21% in 2025 and 29% in 2050, not greatly different from experience further west in the EU.

Over the longer-term, some fall is expected in the size of the population, which has already dropped somewhat over the past decade. The fertility rate is significantly below replacement levels (see Factfile). The actual scale of the change, nevertheless, depends on assumptions made about lifestyle choices.⁷ If they remain as present, the population will dip by almost 0.5 million (out of a current 10 million) by 2020, and then remain at around that level. If, alternatively, the household formation habits of the old EU15 prevail, the decline is likely to be much greater, with an 800,000 fall by 2020, and a huge 3 million fall by 2050 – although this latter prediction is likely to be unrealistic as it assumes no inward migration, which is unlikely in what will by then be a far more affluent country.

Notable spatial shifts in population are also 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 deep processes of suburbanisation have taken place. The old centrally-planned economy actually kept suburban densities high and sustained the city centre as the peak of the urban hierarchy, yet there is no reason to expect that the future will be like that. Widespread suburban sprawl and 'edge city' type phenomena are a plausible, and probably more likely, alternative.

Aided by EU accession, incomes are expected to grow over the longer term. Unemployment has fallen, and if the percentage of working age people in work also rose this would raise household incomes and enable greater housing expenditure. It is also expected that Hungary will become more attractive for foreign individuals to settle down in or to invest in dwellings. Whereas, in general, no further price boom is foreseen, specific location-bound market segments (major cities, resort locations) are expected to gain new dynamics. The housing transactions process, as elsewhere in Central and Eastern Europe, is not as

easy, certain or as cheap as it could be. In 2004, a land and property registration law was introduced, which should improve matters with respect to title. Several estate agency services have started, though most of them deal with the specialist markets of overseas investors and new and existing upmarket housing. Otthon Centrum, for example, started in 2001, and now has a franchise network of 8 branches in Budapest and 3 elsewhere.

Macroeconomic influences

Growth over the past decade has been similar to that in the rest of Central and Eastern Europe, at around 4% yearly, although it has slowed down somewhat in recent years but was picking up again in 2004. Inflation was high in the 1990s and, although it has moderated, was still expected to be around 6-7% in 2004. This has helped to keep interest rates higher than expected.

Unemployment, at 6%, has been steady in recent years. It is higher than desired, but significantly less than in Poland. Employed people as a percentage of the population of working age is also significantly lower than in Western Europe.

Public expenditure has been rising as a share of GDP, and the public sector deficit is around 5% of GDP, limiting the options open to the government with regard to lowering the high taxes on earnings, or with regard to subsidies to housing consumption.

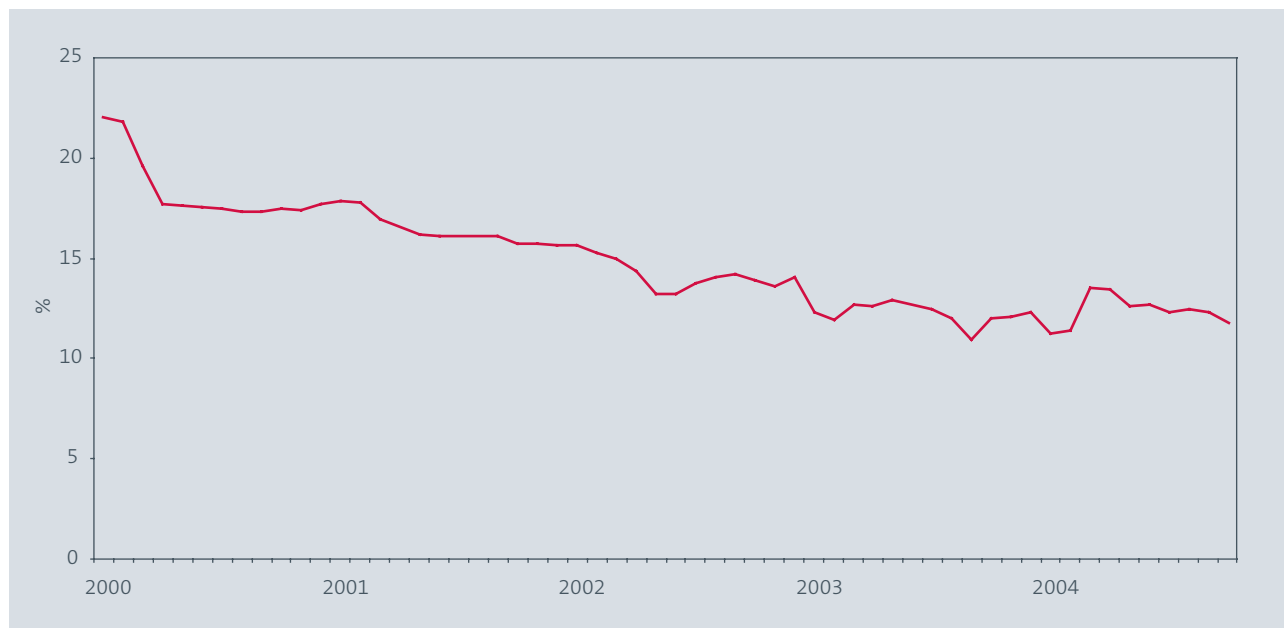
Mortgage market influences

Up to the 1990s, mortgage debt was around 15% of GDP, and most of it was used to fund social housebuilding. This all but disappeared by the mid-1990s as old debts were paid off and mortgage loans sank to low levels. Unsubsidised mortgage interest rates have fallen over time, but remain high (Figure 12.2). Then, in 2000, a policy to increase mortgage borrowing was introduced on the basis of large, open-ended government interest rate subsidies. Borrowing boomed, and by the end of 2003 outstanding mortgage loans had risen sharply, to 7% of GDP. Initially, the scheme was only opened to purchasers of new dwellings, but it was extended to second-hand dwellings. Curtailment of the subsidy scheme then discouraged further borrowings and the loans market rapidly fell in 2004, depressing the housing market (Figure 12.3). Subsidies have also been made available to support the issue of mortgage bonds to encourage the bond market.

The mortgage market is dominated by two major Hungarian firms: OTP, with 80% of general banking business and around 60% of mortgages, and FHB, the Land Credit and Mortgage Bank. Foreign banks from Austria, Belgium, Germany and Italy have entered, increasing the degree of competition somewhat. The spreads on mortgage business are still large by western European standards, at 5-6%. There is, of course, little default history in such a young market to go on when lending, so lending risks are significantly higher.

⁷ Central Statistics Office estimates.

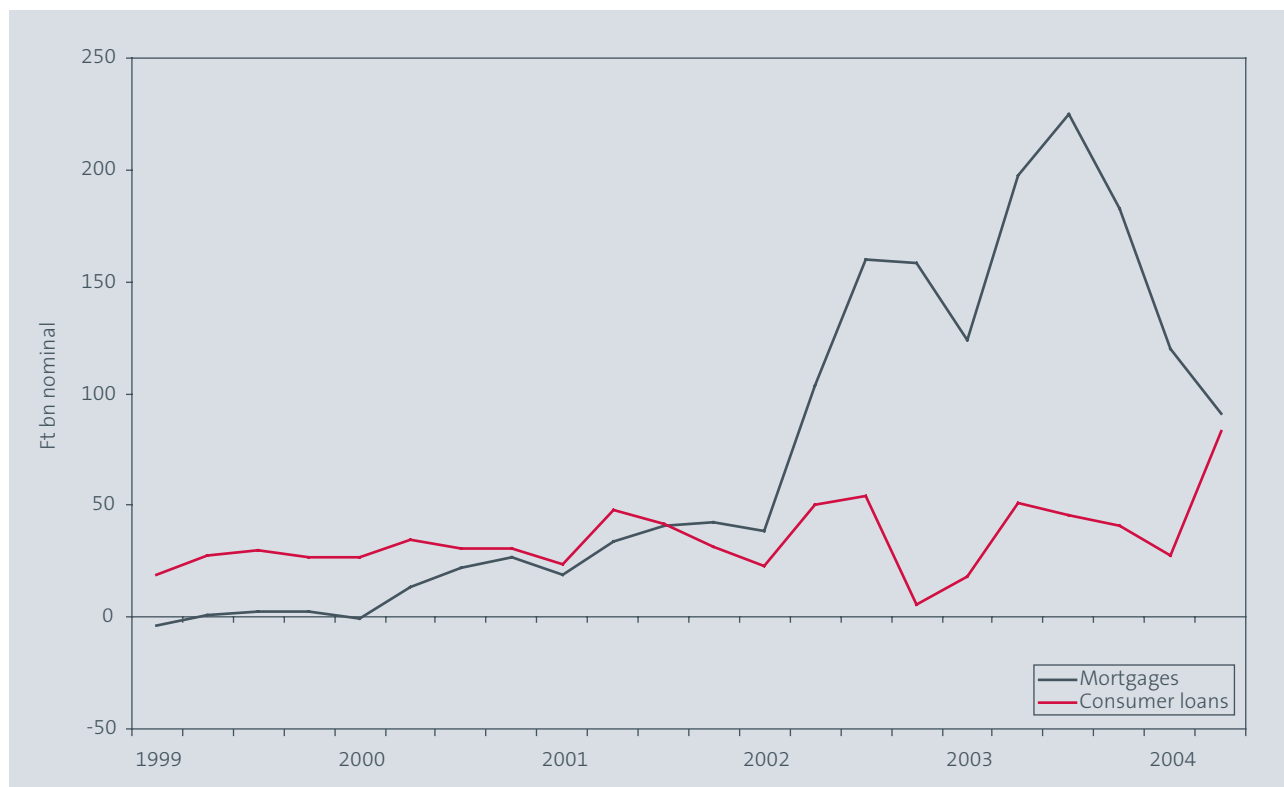
Figure 12.2: Average interest rates on mortgage loans*, Jan 2000-Oct 2004



* Before interest rate subsidies, see text

Source: Central Bank

Figure 12.3: Mortgage and consumer loans 1999q1-2004q2



Source: Central Bank

Factfile: Hungary

Background

Population (m) 2002	Population Growth % 1980-2001	Fertility Rate* 2002	Years Life Expectancy 2002
10.1	-0.4	1.3	72

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

Services output as % of GDP 2000	Employed as % working age population 2002
65	56

* GDP per person employed 2002

Economic

	200	2001	2002	2003	2004f
Real GDP growth %	5.2	3.8	3.5	2.9	3.3
Growth in real private consumption %	3.8	5.7	10.2	7.6	3.0
Inflation – GDP deflator	9.9	8.6	8.9	7.8	5.8
Inflation – consumer prices	9.8	9.2	5.3	4.7	6.9
Unemployment rate %	6.5	5.8	5.9	5.9	5.9

Government

	2000	2001	2002	2003	2004f
Expenditure as % GDP	48	49	53	50	51

Housing Statistics in the European Union 2003, Eurostat, OECD, World Bank.

chapter thirteen

Ireland

Overview

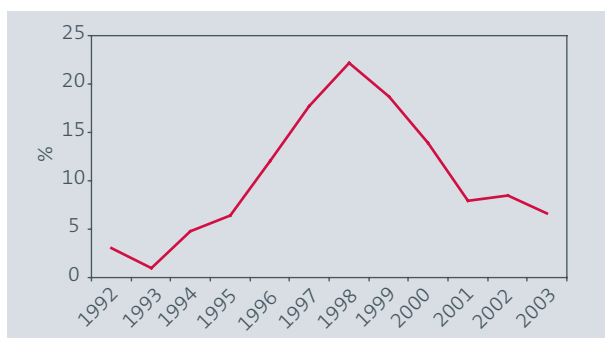
House price rises were still in double figures in 2004, according to the permanent tsb price index, with a 12% rise on an annualised basis in September, although they had moderated slightly since 2003. They were forecast to rise by around 10% for the year as a whole. Commentators were indicating that price rises were moderating, but the slowdown in the growth rate was actually quite small, and within the margins of error of an index that is not quality-adjusted.

Government data, based on all mortgage lending, consistently show a slower rise in prices. Overall, however, the available price information indicates that the great Irish housing boom has still not run out of steam, with the slowdown in 2001 so far a one-off event. In fact, price rises in 2004 significantly exceeded earlier expectations of a 'soft landing' and limited price growth during the year.

Transactions were also at a much higher level than in 2003, and there was still a great deal of interest from investors in rental property, despite significant falls in rent levels in recent years, with 32% of all new homes built in the Greater Dublin area sold to investors in the first half of the year.¹

Demographic factors and earnings growth, plus favourable tax breaks and interest rates, have all stimulated housing demand for a number of years now, particularly as the country had the smallest housing stock relative to its population in the EU in the early 1990s and still has the highest average household size – a good indicator of housing shortages.

Figure 13.1: New house price annual % changes 1991-2003



Source: Housing Statistics

The country had a major economic boom lasting for many years and weathered the world slowdown better than the rest of the Euro Zone, with significantly faster growth than the Euro Zone average. The Central Bank was forecasting 5% GDP growth for 2004 (4.5% GNP).

Industry commentators are again suggesting that prices will gradually level off and consumers, when surveyed, mainly expect a soft landing for the housing market.² The Central Bank has undertaken a number of studies of the housing market, and its evidence does not suggest a significant bubble exists; yet it still has concerns about the risk of a sharp correction, especially if price rises do not moderate soon.³ The new financial services regulator, IFRSA, has been talking to mortgage lenders about tightening up their lending criteria.⁴

The housing market

Ireland has one of the highest home ownership rates in the EU, with 78% of households living in the tenure. A further 9% live in social rented housing, consisting of local authority housing and various forms of voluntary and co-operative housing, and another 9% are in the private rented sector.⁵ The country had the lowest number of dwellings per thousand inhabitants in the EU in 1980 and, despite the huge recent building boom, is still at the bottom of the housing availability league. This is reflected in the relatively high average household size (3 persons in 2001), though this was far less than the 4 persons per dwelling in 1971.⁶ This historic lack of dwellings is a root cause of current shortages and rising house prices.

The strength and extent of the property boom can be seen in the fact that over a third of the current housing stock has been built in the past decade. Annual completions are 3.5 times what they were a decade ago, and the country has the highest per capita building rate in Europe (Figure 13.2). Residential investment grew by an incredible 20% in 2003, according to the OECD, though the rate of increase in 2004 is forecast to be far more moderate.

This continued growth has, so far, confounded the arguments of construction industry representatives, who have argued that private house construction would decline significantly with the introduction of the requirement that developers set aside land for social and affordable housing, under the provisions of the Housing Planning and Development Acts 2000-2002. Continued rises in house prices and the minimal impact of the scheme have both contributed to this result.

¹ Gunne & Co. Residential Report 2003. ² IIB Bank and ESRI Survey 'Irish Consumer Sentiment towards the property market', October, 2003. ³ Central Bank Financial Stability Report September 2004. ⁴ Mortgage Lending Study, October 2003, www.ifsra.ie. ⁵ 2000 figures. Housing Statistics in the EU 2002. ⁶ Quarterly Housing Survey, CSO; Housing Statistics in the EU 2002.

No data exists on second homes, so it is not clear how much of new building relates to them. Yet, completions data do suggest an important effect. For example, Kerry in the West, an important location for second homes, saw in one year a 45% rise in its housing output between 2002 and 2003; whereas in Dublin during that apparently boom housebuilding year, completions actually fell by 18%. Put another way, Kerry's housing output was only 44% of that of Dublin in 2002, yet it was 80% of it in 2003! Such developments, moreover, were not freak events, but illustrate underlying trends, and suggest that the apparent commendable elasticity of supply in relation to house prices is actually far worse than national data would indicate in the areas of strong primary residence housing demand, and far larger in areas where second homes are desirable consumption items. Housing shortages in such areas as Dublin, therefore, may well be fuelling the second home demand of the fortunate in other parts of the country via equity withdrawal.

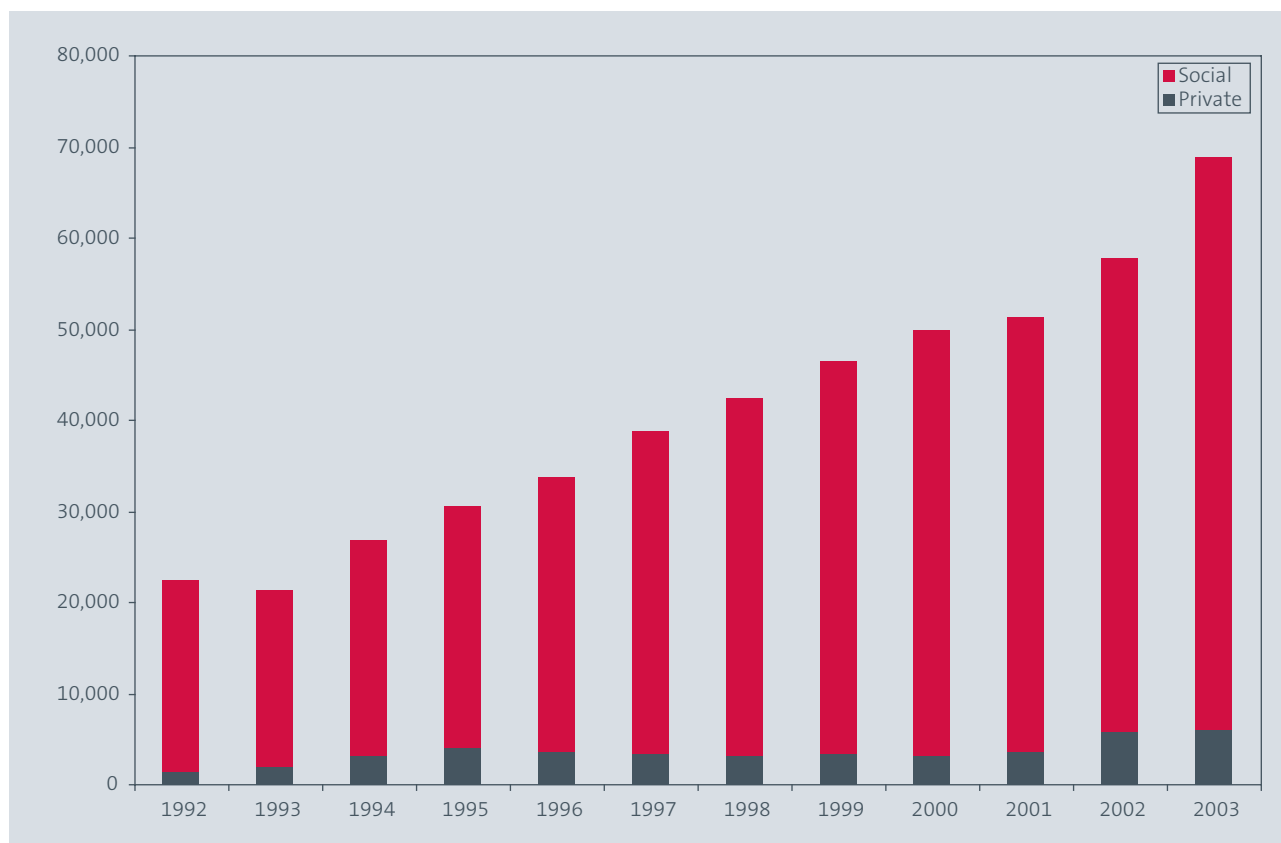
Extra public money has been allocated to social housebuilding programmes, which now represent around 10% of all output. Social completions have risen by 75% in the five years since 1999, albeit from a low base, and there are long waiting lists to enter this type of accommodation as the subsidised rents are far lower than in the private sector.

The sustained level of new housing supply may help to moderate future price pressures. The costs of private housebuilding have been raised both by a rapid escalation in construction costs – though these have recently ameliorated – and by planning-induced higher land development costs, which may dampen supply responses in the future when the era of rapid house price rises finally ends.

The structure of dwelling types is unusual for the EU, in that there are very few flats and multi-occupancy structures. A large number of dwellings (45%) are detached houses (frequently single storey); a further 29% are semi-detached and 23% terraced. Only around 3% of dwellings, consequently, are flats. However, in Dublin a far higher ratio of 14% of dwellings are bedsits or flats.⁷ The general type of housing built, therefore, is highly land-intensive and leads to spread-out suburbs, both in the Greater Dublin area and other growth areas further afield, which have often come to act as dormitory settlements for local agglomerations.

This urban form also gives rise to long commuting journeys on a frequently overstretched infrastructure network. Residential densities may well increase in the future in response to rising land prices, infrastructure costs, congestion and planning constraints. The impact can already be seen in the smaller share of detached houses in new build – 23% in 2002 – and the higher share of flats at 20%.⁸

Figure 13.2: New Dwelling Completions 1992-2003



Source: Housing Statistics

⁷ Quarterly Housing Survey, CSO. ⁸ Construction Forecasts.

Social housing

Social housing includes both the local authority housing and voluntary non-profit housing sectors, and it has played an important social function since the 1920s, when a programme of local authority-provided housing commenced. The sector is dominated by local authorities, with 8% of the total housing stock, while the voluntary sector has only 1%.

Social housing programmes traditionally concentrated on slum clearance and newly built estates on the peripheries of towns and cities, similar to policies in the UK. During the early 1950s, social housing accounted for over 50% of all housing units built, reflecting its important role and the weakness of private housing and the economy generally. During the 1960s and 1970s, there was a rapid expansion of private housing; even so, annual completions of social housing still accounted for around 20-25% of total building.

Social housing was then sharply curtailed, so that by the early 1990s social housing completions accounted for less than 10% of all new building. The amount of social housing built continued to decline in relative importance throughout the 1990s. However, a marked revival is currently underway, with 10% of new dwellings now in the social sector.

Local authorities also run affordable housing and shared-ownership housing schemes – though the aggregate impact on new supply is relatively small: 2,600 dwellings in 2002, only 4% of total completions. Of the two, subsidised shared-ownership is the most popular. Affordable housing schemes involve local authorities in partnership arrangements with private developers, whereby the developer constructs a number of dwellings for sale at below the market price, and is subsidised by the local authority. Around 900 homes were made available in this way in 2002.⁹

Housing made available under the provisions of the Housing Planning and Development Acts 2000-2002 has, so far, been limited and far below the original expectations of the legislation.

Private renting

Rent levels in Dublin peaked in 2002, and have declined by 17.5% according to one survey since then, with half of that fall occurring between the summer of 2003 and 2004. Rents, however, seem to be levelling off, and are forecast to grow in line with inflation in 2005. Average yields have dropped to only around 3.5%, which at current rates of inflation offers a negative post-tax real return to many investors.¹⁰

Low yields, nonetheless, have not deterred expansion of the rental stock. Strong investor demand for property, driven by expected capital gains in the buoyant housing market, continues to increase supply. As noted earlier, investors purchased almost a third of the new dwellings built in the Greater Dublin area in the first half of 2004. Such strong demand must have been an influence on house price inflation and can hardly have been based on expectations of rising real rents and yields. The scale of such investment solely relying on expectations of short-term capital gains may be an indication of bubble-type behaviour, which may reverberate on the rest of the market when such investors finally become convinced that house price rises are drying up.

Faced with wider choice, unsurprisingly, there has been tenant reaction to the sharp inflation in rents in the years prior to 2002. Another cause of the rent decline are the current attractive mortgage interest rates, for they encourage increasing numbers of potential tenants to buy instead, because it is significantly cheaper, based on initial costs, to purchase than to rent as long as the appropriate deposit/own equity is available. This has helped to fuel demand for starter homes in the Dublin area.

The barrier to homeownership by younger households represented by the need for a substantial down-payment before lenders will grant a mortgage – that grows ever higher in absolute terms as house prices rise – has led to substantial financial gifts by parents to their children, and the acronym ‘PG’ (parental gift at time of first mortgage) has entered the Irish vocabulary. The scale of such intergenerational transfers is cited in Central Bank studies as an important reason why equity withdrawal has had such a limited affect on aggregate consumption in Ireland, in contrast to a number of other European countries.

Rental housing has been affected by government policies aimed first at micro-managing housing demand and, more recently, strong regulation of landlord-tenant relations, only a decade after earlier decontrol.

A series of tax deterrents were introduced in 2000 to discourage landlords from buying properties that homeowners might wish to purchase.¹¹ They failed to moderate house price rises to any significant degree. Instead, the housing market was distorted by the resultant lower investment in rental accommodation. This, in turn, exacerbated shortages and forced rents upwards. Most of these measures were abolished within a few years of being introduced, when it was recognised that they were not having the desired effects. An anti-speculative annual property tax of 2% on all newly acquired residential investment (i.e. rental) properties for a three year period, introduced in the late 1990s, has been removed. The 2002 Budget also abolished the 9% stamp duty imposed on houses purchased for letting purposes in June 2000. Mortgage interest deductibility against rental income was also reintroduced. These measures had a significant effect, especially at the lower end of the market, as a marked renewal of investor activity was reported in 2002 and 2003, particularly in the Dublin area. This helped to fuel house price rises in those years, but has improved the availability of rental housing in contrast to the chronic shortages of previous years and has, thus, been a factor in the marked fall in rents since then. Late in 2004, stamp duty was lifted for first-time buyers on cheaper accommodation, giving them a tax edge over investors.

The upshot of the rental policy variations of the last few years, therefore, has unfortunately been to create additional disequilibrium in the rental market. The softening of rents, noted above, may be a reaction to the overshooting induced by the earlier constraints. Landlords have flooded back into the market since they were abolished, though whether many have made rational calculations of the long-term viability of their investments, rather than speculated on further house prices rises, is a matter of debate. 60% of existing landlords have only entered the sector in the past three years, according to a recent survey.¹²

⁹ Housing Statistics. ¹⁰ Gunne & Co Dublin Residential Survey, September, 2004.
¹¹ Resulting from the ‘Third Bacon Report’. Bacon, P. (2000) The Housing Market in Ireland: An Evaluation of Trends and Prospects, Government Publications Office, Dublin.

¹² Cited in IMF Country Report Ireland 2003.

Rents were decontrolled in the mid-1990s, which led to the investor boom in rental housing. More recently, some regulation has been introduced again. A Report in 2000 from the Commission on the Private Rented Residential Sector led to the setting up of a Private Residential Tenancies Board (PRTB), which aims to deal with disputes between tenants and landlords without recourse to the courts. In addition to dispute resolution, the Board also carries out policy research, provides policy advice and aims to develop model leases and good practice guidelines.

Most dramatic are the provisions of the Residential Tenancies Act. One important element is that only 'market' rents can be charged. This introduces a form of rent control using other currently existing local rents as the reference. In periods of rising rents, this may slow down movements to equilibrium points, because by definition new rents will be higher than current market rents. The impact of this measure will only be clear after experience of its implementation in practice. Another feature greatly enhances security of tenure, with the introduction of 4 year security of tenure cycles. After the first six months of a tenancy, landlords will have to issue 3.5 year leases under which they can only terminate a tenancy on the basis of a limited set of criteria, and with long periods of notice. Tenants will also be able to opt to continue a tenancy, so that security of tenure may end up in practice lasting much longer time periods. Furthermore, all tenancies will have to be registered by landlords with the PRTB, which can share information with Department of Social and Family Affairs, local authorities and the Revenue Commissioners to limit either tenant or landlord fiscal and regulatory abuse. The penalties for non-compliance are tough.

The impact of these measures on landlord willingness to provide accommodation will only become clear after the measures have worked in practice for a number of years. The additional regulatory requirements will raise both landlord costs and risks and, thereby, equilibrium yields. That will inevitably deter some investment, but how much is uncertain. The impact might be all the greater for the timing of its introduction when the market is forecast to soften. Landlords who have been riding the housing market for capital gains may become particularly nervous when they realise that they might not be able to sell up for four years or potentially longer, and as a result exit quicker than they might otherwise have done.

Macroeconomic influences

Growth during the 1990s was spectacular – transforming the economy and the standard of living of the population. In 1993, for example, GDP per capita was 84% of the EU average; by 2002, it had risen to 126% – one of the highest in the EU.¹³ Foreign inward investment, encouraged by the low corporate tax regime, has been an important factor behind this economic growth. Demographic factors have also helped and an increasing number of women have joined the labour force, so that labour force participation rates are markedly up on 15 years ago, and are now around the EU average.

From double digit rates in the late 1990s, a slowdown in economic growth started in 2001, but the economy still managed to expand by 6% and continued at that rate in 2002.

Growth then slowed rapidly in 2003, as competitiveness was eroded by inflation; since when, as noted earlier, growth has rebounded strongly. Even so, a long-term return to the boom rates of the late 1990s is unlikely, because labour force growth has slowed, and the earlier surge of inward investment generated by the information and communications technology bubble is unlikely to be repeated. Nevertheless, a relatively optimistic future for the economy underpins the consensus view of a soft landing for the housing market.

Unemployment was high in the early 1990s, peaking at 15%, but by 2001 the unemployment rate had fallen to 4%. Since then it has risen by 0.5% and such an increase is unlikely to have much influence on the housing market.

Inflation was running at a much higher rate in recent years than in the EU as a whole, and for consumer prices was still 4% for 2003 overall. It was forecast to be far lower in 2004 as a whole, after converging on the Euro Zone rate, but considerable uncertainty has been introduced by the surge in commodity prices.

Given membership of the Euro Zone, the country's negotiated wage system and pressure for wage increases in the public sector, inflation is hard to squeeze, unless an incomes agreement can be reached with the unions. Securing continuance of the current one is consequently a key element of the government's inflation strategy. Lower inflation, however, means that house price corrections are more difficult without nominal falls in prices, which, if they occurred, could severely dent consumer confidence in the housing market.

A booming housing market has inevitably had important effects on general inflation for a number of years – in particular, as a cost-push element given the demand for labour in housebuilding. (The limited impact of equity withdrawal on consumption was noted earlier). The system of wage bargaining, moreover, tends to increase the impact of housing costs on overall inflation, because negotiators use them as a bargaining item.

Higher than average inflation for a country in a currency zone, moreover, has a depressing impact on local economic activity, as local producers and suppliers become increasingly less competitive with those elsewhere in the Euro Zone, meaning that they gradually lose domestic market share. Such effects, however, take a long time to work through. They, do, however, reinforce the prediction that the economy will not regain its previous strength, which further indicates that the era of rapid house price rises is probably coming to an end. Consumer and investor expectations clearly need to adjust. Quite how and when they do will influence whether there is a soft landing, or a significant house price slump.

Despite such fears, it is far from clear that the sustained rises in house prices have brought about a market bubble that is about to burst. Deciding what is the long-run equilibrium price level for housing is difficult, especially in a country that has seen such change in a handful of years, and not even the most sophisticated empirical analysis can probably reveal it. On the one hand, fundamental economic changes can be cited for price increases: the entry to the Euro Zone and its implication for long-term interest rates and stability; greater competition in

¹³ Eurostat, purchasing power parity basis.

credit markets; rising living standards; unbalanced regional demand pressures; and chronic supply shortages. Yet, on the other hand, there are several short-term destabilising factors that could easily go into reverse, especially buoyant consumer and housing investor expectations and the rapid increase in borrowing.

One key indicator, the ratio of outstanding mortgage debt to personal incomes, is not particularly high by international standards – slightly less than in France, and much less than in countries like Canada, the UK and USA. Yet, counter to this is the very low indebtedness of many homeowners, which helps to depress the average figure: implying the higher indebtedness of others, who might get into market-threatening difficulty.

All that can be rationally concluded at present, consequently, is that the present market situation contains notable downside risks, and that house prices are probably somewhere near their peak in real terms.

Mortgage market

The mortgage market has become increasingly competitive. As in the UK, some building societies converted from mutual to banking plc status, such as with the conversion of First National Building Society to First Active plc in 1998. A big stimulus to competition was the entry of the Bank of Scotland in November 1999. Now all lending institutions offer mortgage packages with greater flexibility in terms of repayments than was the case a few years ago. Some institutions offer a percentage point off fixed rate mortgages for new customers during the first year of repayment. A number are also giving the inducement of "repayment holidays" at Christmas, and they encourage customers to re-mortgage via attractive re-financing packages.

Retail banks dominate the mortgage market, accounting for 80% of mortgages in 2000, with building societies taking the rest. The building societies have gradually been losing market share, falling from 26% in 1999 to 19% in 2004 q1.¹⁴

The value of outstanding mortgages on housing reached €68 billion in September, 2004, and the rate of growth has been accelerating in recent years. In 2002, outstanding mortgages rose by about a fifth year on year; in 2003, it was nudging a quarter, and in 2004 there was another 2% rise in the growth rate to 27%.¹⁵ Such mortgage levels suggest that significant housing equity withdrawal is now taking place, though it may be reinvested in housing through parental gifts and purchase in the booming investor and second homes markets.

Despite such spectacular growth in the mortgage market, the volume of outstanding residential mortgages relative to national income is still low by average EU standards, at 37% of GDP in 2002. Many owner-occupiers still own their homes outright, so that there is plenty of scope for further increases in mortgage lending no matter what happens to the housing market.

Since the early 1990s, nominal interest rates, as elsewhere, have declined significantly. More recently, they have been extremely low even by contemporary European standards. For example, in September, 2004, they were 3.25 to 3.6%. Mortgage rates are very attractive given the recent relatively high rate of inflation

and the existence of mortgage tax relief at the standard rate of tax. With inflation at 4% in 2003, for instance, net of tax real mortgage interest rates were well below zero, though the more recent reduction in inflation has raised them somewhat. The difficulties of heavily borrowed purchasers may come when interest rates rise in the Euro Zone.

As in other countries, consumers may choose a fixed or variable mortgage interest rate depending on their expectations of future interest rate changes. Variable rate mortgages are traditionally the preferred product, and consumers have been increasingly opting for them in expectation of further interest rate falls, so that they now account for 70% of the market. The biggest decline has been in fixed rate mortgages with terms of over three years.¹⁶ Repayment terms are under 20 years, which may give some scope for extending them to the longer terms common in some other countries, such as Germany and the UK. This may provide some shielding of borrowers, who find repayments eating into other consumption when interest rates start to rise again.

The long-term prospects for the mortgage market do not look particularly gloomy. This is especially the case as such a large proportion of households own their homes outright. Such households may increasingly wish to reduce their housing equity by borrowing – a trend that has been common in other EU countries over the past decade.

Demographic influences

The population in 2002, according to the Census, was 3.9 million, its highest level since 1881. That represented an 8% increase over 1996, the date of the last census. The population is forecast to grow gradually over the next few years, and to reach 4 million by 2006. Net immigration has increased significantly, but from very low levels – 8,000 in 1995-6 to 26,000 for 2000-01. This represents a new feature of the social structure, and a strong contrast to a long history of outward migration. Between the 1996 and 2002 censuses, net migration was slightly over 150,000 in total, representing around half of the total population increase.¹⁷

Apart from broad population trends, a further stimulus to housing demand arises from the current age structure of the population. The demographic legacy of high birth rates during the 1960s and 1970s has led to a disproportionately large age cohort in the 25-34 age range entering the housing market, the prime first-time property buying category. This effect, however, is gradually petering out, and being replaced by a converse trend arising from the much lower birth rates of more recent decades.

The 2002 Census also showed that rural areas located a long way from the major population centres are still losing people to the economic growth centres of the country. The most rapid growth is in the suburban fringes around the major centres. In contrast, some city centres are losing population as housing standards improve and inner city population densities decline along with them. The population of Cork City, for example, fell by 3% – while its suburbs grew by 11% – between 1996 and 2001. Even Dublin City grew by a slower rate of 3% in comparison to its suburban areas' 6%. Growth was even faster in the wider Greater Dublin area, reflecting the continuing increase in commuting.

¹⁴ DoELG housing statistics. ¹⁵ Adjusted Central Bank data. ¹⁶ Central Bank. ¹⁷ Preliminary results from 2002 Census.

Factfile: Ireland

Background

Population (m) 2002	Population Growth % 1980-2001	Fertility Rate* 2002	Years Life Expectancy 2002
3.9	13	1.9	77

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

Services output as % of GDP 2000	Employed as % working age population 2002
55	67

* GDP per person employed 2002

Economic

	200	2001	2002	2003	2004f
Real GDP growth %	10.0	6.2	6.9	1.4	3.4
Growth in real private consumption %	8.5	5.2	2.6	1.9	3.5
Inflation – GDP deflator	4.3	5.1	5.4	0.6	1.7
Inflation – consumer prices	5.3	4.0	4.7	4.0	1.8
Unemployment rate %	4.3	3.9	4.4	4.7	4.8

Government

	2000	2001	2002	2003	2004f
Expenditure as % GDP	32	34	35	35	36

Housing market

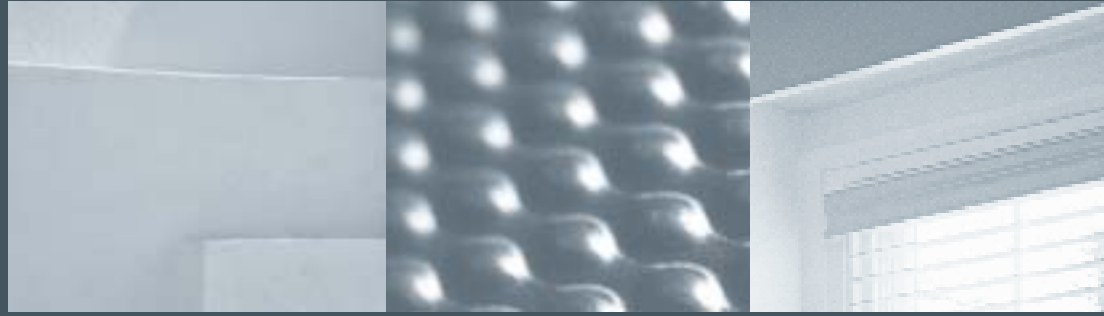
	2000	2001	2002	2003	2004f
Growth in residential investment	17.4	-6.1	6.2	20.0	3.0

Taxes

Owner occupied housing	Capital gains exempt	Imputed rental income
Mortgage interest relief – yes with caps	no	no

Property taxes as share of all taxes 2002	Property taxes as share of GDP 2002
6%	2%

Housing Statistics in the European Union 2003, Eurostat, OECD, World Bank.



chapter fourteen

Italy

Overview

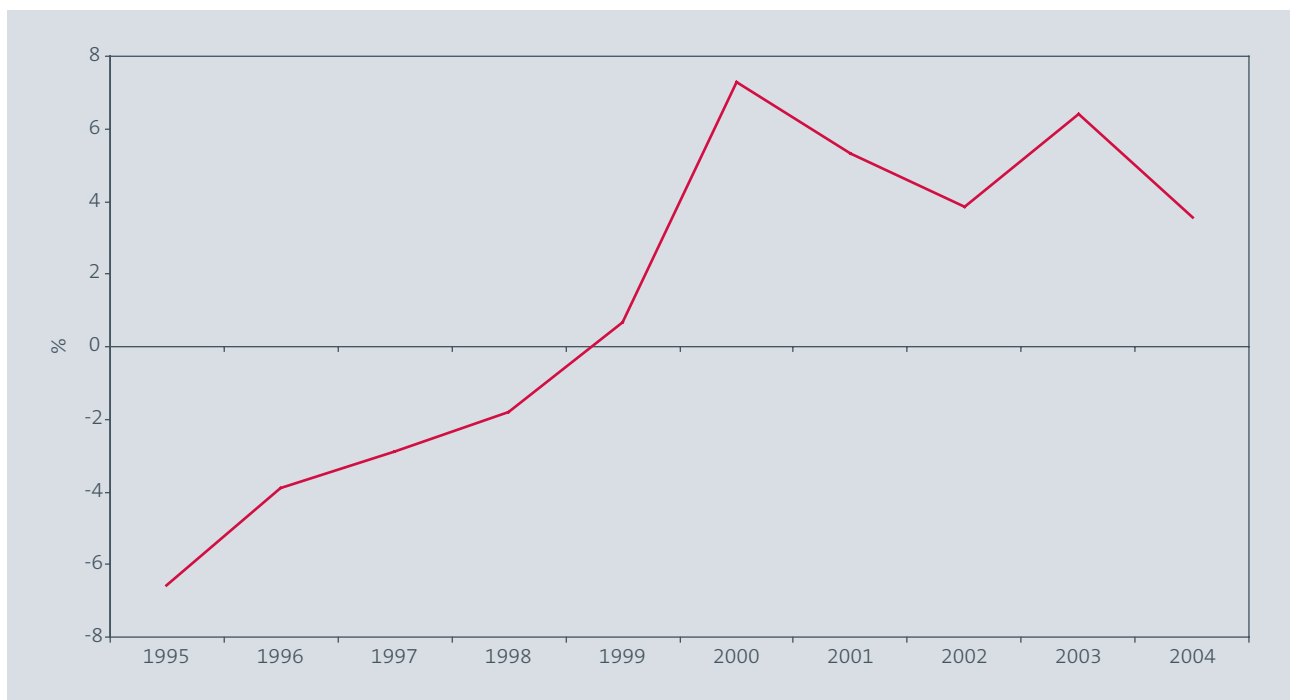
The housing market has been on a sustained upswing for five years now, after a long period of recession in the 1990s, when real prices fell by over a fifth over a seven year period amidst general economic sluggishness during that decade. The economy followed others into the general world slowdown in 2001, and growth has been miniscule since then. Yet, this economic gloom does not seem to have dented housing demand much, and house prices have been rising in nominal terms by between 6 to 8% in recent years (Figure 14.1).¹ In 2004, agents were reporting that market activity was still brisk – although it had fallen below its peak – and that mortgage activity was especially strong.

The housing system

Home ownership is high and increasing, with currently more than four-fifths of residents owning their home (Table 14.1). This is matched by a declining share for the private rental market, and there is very little social housing. The social groups that have above average shares of homeownership contain those with a mix of three criteria: older heads of household (50+), high educational achievement and medium to high incomes. Renting is greatest among lower income groups.

Spatially, homeownership shares are highest in the south and in communities of less than 20,000 people. The share of families

Figure 14.1: Real house price changes 1995-2004



Source: Scenari Immobiliari

¹ Scenari Immobiliari forecast.

owning more than one house is decreasing, in parallel with the decline in the rental market. A large share of the stock is in quite poor condition, with one quarter of dwellings estimated to need significant modernisation. Most dwellings are in multi-family structures, and single-family structures are the smallest share of the housing stock in the EU – at only 30%.²

Table 14.1: Tenure shares, 1993 & 2002

% share	1993	2003
Owner-occupation	74	83
Rental	25	16
Other forms	1	1

Source: ISTAT, National Statistical Institute

Owner-occupation has grown substantially in recent decades, rising from only 59% in 1980. The principal factors underlying this huge increase, the largest in the EU, are fourfold.

1. Probably most important is that financial and economic conditions have shifted towards purchase. Mortgage borrowing is now possible and affordable within the Euro Zone, with an expectation of moderate nominal interest rate levels continuing in the future.
2. Tax breaks are biased towards ownership, with mortgage interest relief, no tax on imputed rental income, and capital gains tax exemption for homeowners.
3. New housing supply is almost exclusively for homeownership, both in terms of new building and the renovation of existing properties, which as already noted are often in a poor state of repair. One long term-reason for the low repair standards has been extensive rent controls that had made it unprofitable for landlords to repair.
4. 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 4-year lease and continued rent controls. This made the dwellings far more valuable in the owner-occupied sector than in renting, and enabled landlords to sell out when leases came up for their 4 year renewals. The transfer of previous rental properties into owner-occupation, furthermore, has been associated with a large renovation programme, as developers and households improved the now owner-occupied dwellings. The shift was not to everyone's benefit, though, as it was accompanied by over 900,000 evictions of former tenants, and lengthy legal processes.³

The rental law of 1998 has continued to make private renting often a poor 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. There are also a minority of lettings under 'pre-defined' contracts, which are controlled by local

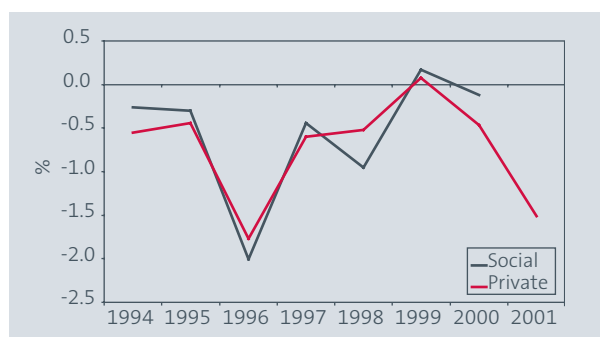
authorities at below market rents fixed by local social housing bodies. The incentives to landlords to accept such terms are exemptions from local property taxes, and some lower national taxes as well.

Overall rents for both private and social rental dwellings have failed to keep up with inflation since the mid-1990s, let alone rising housing demand, as can be seen in Figure 14.2. However, current market rents are much higher than those for existing contracts. Industry experts, for example, report that they have more than doubled in nominal terms in central city locations since 1998.⁴ Such sharp rises in market rents are themselves partly a consequence of the rent laws, because landlords are likely to 'frontload' the fixed rents of long rental contracts to take account of expected future increases in market rents (or dwelling capital values) over the course of a contract.⁵ This rental cost-push effect further encourages households to opt for owner-occupation at propitious times.

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. Growth-generated higher living standards are doing the same.

The official data suggest that transactions in the rental market are, on average, a third or more annually than in the owner market, despite the fact that it is under 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. The transactions data suggest that around between 750-800,000 houses are bought each year, mostly by homeowners. This suggests that each owner household typically stays in a dwelling for around 20 years – with many homeowners living in the same property for much of their adult lives. Such levels of homeowner mobility are far less than in countries like the UK. Even so, mobility has increased substantially in recent years, and transactions have increased significantly.

Figure 14.2: Real rent rises, 1995-2001 %



Source: Housing Statistics in the EU, 2003

² Housing Statistics in the EU 2002. ³ L. Padovani 'Italy' In P. Balchin ed. Housing Policy in Europe, Routledge, London, 1996. ⁴ Scenari Immobiliari Forecast Report 2004. ⁵ They will include elements of inflation-adjustment as well as real rent increases.

Recent developments in the housing market

The available statistics on the housing market are limited and of variable quality. Some of the best existing indicators of market activity relate to house prices and to new building and renovation, which added together constitutes 'gross fixed residential housing investment'.⁶ Figure 14.3 indicates how housing investment has fluctuated since the mid-1980s broadly in line with housing market cycles.

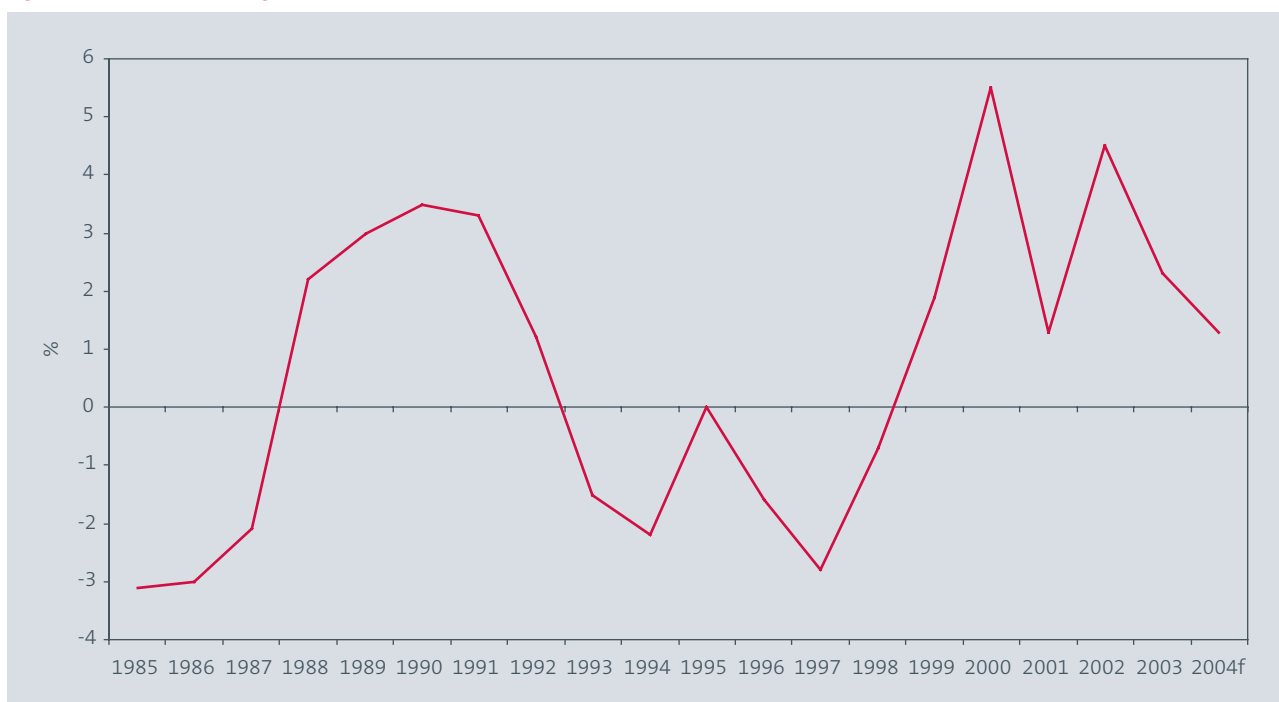
There was an upswing in the late 1980s and early 1990s, although it was of relatively modest proportions with regard to housing investment. So, with demand rising faster than supply, real prices shot up by over 40% from a trough in 1985 to a peak in 1992. That price boom was then brought to a halt by general economic difficulties. However, when the economy started to grow again in the mid-1990s, the housing market did not immediately follow. It was held down by a number of factors. On the supply side, a vacancy overhang and the difficulties people had in selling homes contributed to a continuing softening of prices. On the demand side, the higher cost of housing following the early dramatic increase in prices created affordability problems. Moreover, consumers were reluctant to buy dwellings when it looked likely that prices might continue to fall.

Mortgage interest rates, furthermore, persisted at relatively high levels for longer than in many other EU countries, as the monetary authorities tried to reduce inflation ready for entry to the euro. As late as 1997, mortgage interest rates were over 10%.

The latest revival spread until a general price upturn in 1999. Prices have been increasing ever since. Prices, however, have not seen the spectacular increases of some other EU countries, described elsewhere in this Review, partly because house price growth has been concentrated in the more dynamic cities and regions, and so looks less at a national level. House prices in high demand locations have been substantial. Central city apartments in Rome and Milan, for example, are only exceeded in price in the EU by those in Paris and London.⁷

Housing output has expanded in recent years as a result of improved demand conditions. Yet, the supply response has been moderate. It is far less than would be expected with the strength of current demand, and suggests some supply-side constraints. There is, consequently, a limited supply of housing available for sale on the market – in particular of high-quality accommodation, where demand has been strongest. New housebuilding is estimated to represent around 15% of the housing market nationally but only 5% in the major cities, where demand pressures have been greatest.⁸

Figure 14.3: Annual % change in real residential investment, 1985-2004



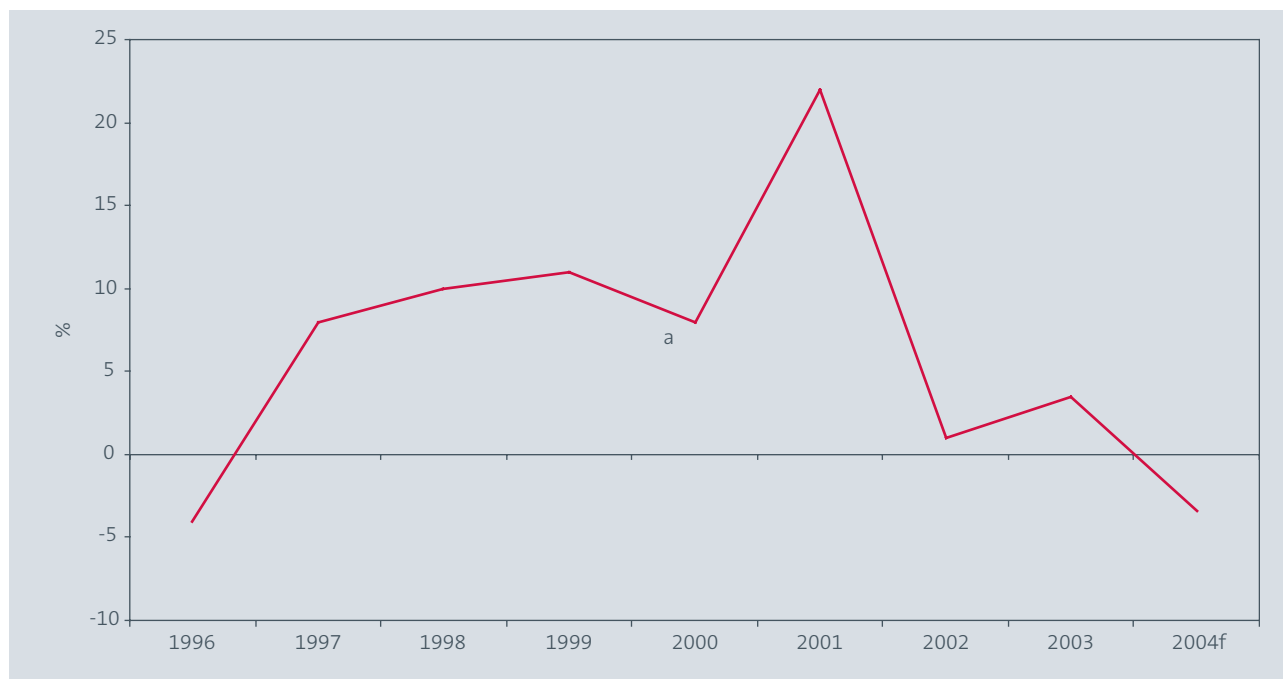
Source: OECD

⁶ It is gross because the data do not subtract demolitions and disrepair.

⁷ Scenari Immobiliari Forecast Report 2004.

⁸ Scenari Immobiliari Forecast Report 2005.

Figure 14.4: House sales 1996-2002, annual % change



Source: Ministry of Internal Affairs

Market turnover accelerated rapidly from 1998. According to official data, it rose by almost a third between 1998 and 2000, but expansion has slowed since 2002 and was forecast to fall slightly in 2004 overall (Figure 14.4).

Several cyclical factors, as well as the trend switch towards homeownership discussed earlier, have helped to generate strong housing market recovery. Initially favourable economic conditions, easy credit availability and falling interest rates are the most obvious. The earlier housing market downturn itself was a significant influence. During that downturn, many household moves were frustrated by the depressed market conditions. So, as the market bounced back, many more households were able to realise their long-held housing aspirations. Financial and housing aspects have therefore enabled the housing market to continue to grow whilst the rest of the economy has stagnated.

New demand for housing is mainly driven by the search for better housing conditions in the same urban area, so most new building is located in areas on the fringes of already built-up areas. Yet, new building investment has become smaller compared to maintenance and renovation. Investment in residential renovation and improvement is the most important market in the construction sector. Renovations have also showed the strongest growth since 1998, thanks to tax incentives for renovations introduced by the government to boost construction expenditure. Renovation has also been encouraged by the trend amongst certain affluent and younger households to live closer to city centres in attractive and historic neighbourhoods. The differences between the performance of the new and renovation markets therefore, in part, reflect a shift in consumer preferences.

Macroeconomic influences

The country's economic performance was outpaced by many other EU countries in the 1990s. GDP growth started to improve significantly in 2000, reaching 3%, but this acceleration did not last long because of global slowdown. Growth moderated in 2001 as a result, and has been virtually non-existent since then. Higher world trade in 2004 was offset by higher than average inflation, which is eroding the country's competitiveness.

Unemployment, although still relatively high at 9%, has been decreasing in the past few years, albeit at a very slow pace. The economic downswing has not helped job creation, but moderate job growth is occurring. There are wide regional variations, however, with the unemployment rate ranging from less than 3% in areas like the north-east, to over 20% in the deep south. One reason for the slow decline of unemployment has been a weak record of employment expansion. The overall level of involvement in the labour market is still relatively low – total employment as a share of the working age population stood at only 56% in 2002 (see Factfile).

Employment growth is often a notable stimulus to the housing market, particularly if it involves substantial inter-regional or city moves by the newly employed. The weak employment situation has therefore been a drag on the housing market and will probably remain so, especially in areas where jobs are traditionally limited in supply. Furthermore, if labour force participation rates rise – as they probably will in future years – this will further stimulate the homeownership market, as it has done in a number of EU countries over the past decade.

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

Mortgage market influences

The mortgage market is not as sophisticated or as developed as that in many other European countries. Outstanding mortgages were only 11% of GDP in 2002, although this was up from 5% in 1990.⁹ Given the stability that Euro Zone membership now offers, the ratio is expected to grow rapidly in the future as the use of residential mortgages expands. At present, Italy is the world's most affluent large country that has such a low level of mortgage activity. The overall ratio of nominal long-term household debt to household disposable income was only 26% in 2001, far less than in any other of the world's major economies.¹⁰ It could be argued that, in the past, high public sector debt crowded out such private sector lending possibilities. The high public sector debt ratio is still a cause for concern, but it no longer crowds out the mortgage market, as interest rates are no longer determined nationally.

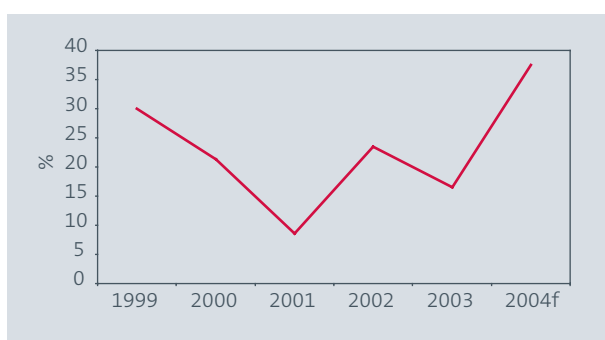
Mortgages are advanced by commercial banks. In recent years, foreign banks from elsewhere in the EU have moved into the Italian market, and they have played an important part in stimulating the mortgage market. They include UK banks, such as the Woolwich (part of the Barclays Bank group), which has set up Banca Woolwich as Italy's first bank specialising in mortgages, and formed links with estate agencies such as Gabetti. Their entry was encouraged by the existence of the Euro Zone. Even non-Euro Zone institutions, such as UK banks, benefit from monetary union when operating in Italy, because it has lowered the exchange rate and other financial risks of operating in a country that once had volatile exchange and inflation rates.

Consumers can choose either fixed or variable mortgage interest rates, or packages that offer a mix of the two. These three options took roughly a third of the market each in 2002, though there is a greater preference for fixed rates in the south of the country than elsewhere. Mortgage products tend to have shorter lending periods than in many other EU countries. Around a quarter in 2002 were of 10 years or less duration, and only a third were over 15 years in duration.¹¹

The mortgage market has grown strongly since 1998 as a result of much lower interest rates and renewed growth in the housing market. The mortgage market grew by 2.5 times in nominal euro terms between 1998 and 2003. Mortgage advances in 2004 are forecast to be up by almost two-fifths on the previous year (Figure 14.5).

One factor holding back mortgage growth is the difficulty banks can have in recovering bad debts.

Figure 14.5: Increase in residential mortgage advances to households 1999-2004



Sources: Central Bank, Scenari Immobiliari

Demographic influences

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

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

The total population is expected to stabilise, and then decrease, over the next ten years. Moreover, the population is ageing. There was a very high birth rate in the 1960s, but there has been a subsequent demographic transformation, which gives Italy the lowest birth rate amongst OECD countries. Life expectancy is also high, and rising. The result of these changes is that the country is experiencing one of the greatest demographic shocks of all advanced nations. People over 65 years old currently equal 10 million – about 18% of population – and the number will grow steadily to reach an estimated 16 million by 2040. By 2050, 31% of the population will be 65 or over.¹² Such a transformation is likely to have profound effects on the housing market.

Both the decline in population and increasing share of the elderly in it are also stronger trends in the northern regions than elsewhere. Household numbers are subsequently expected to increase (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.¹³ However, it is close to the European average in the North but 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.

There is, furthermore, a long tradition of family members living together for longer periods of their life-cycles than is common in many Northern European countries. Italy, for instance, has the highest percentage of 20 year olds still living in the parental home in the EU (96%). This lifestyle often persists through a person's twenties, with 43% of men and 27% of women still living with their parents when they reach thirty. Whereas, at the other end of the family cycle, only 8% of men and 13% of women aged 65 live alone, compared to much higher percentages in Northern European countries.¹⁴ In part, such behaviour is the result of social preferences, but it has also been based on a history of chronic housing shortages. So, it is to be expected that as affluence grows and housing conditions improve then progressively more people will set up independent households, further lowering average household size.

Immigration, at current rates, will only partly offset the natural decline in population. Recent immigrants now represent 2% of total population – so that Italy is still one of the EU countries with a relatively small percentage of resident foreigners.

⁹ Housing Statistics in the EU, 2003. ¹⁰ OECD Economic Outlook, 2003.

¹¹ These data on the mortgage market have been provided by Scenari Immobiliari based on information from the Italian Central Bank.

¹² OECD, Economic Survey: Italy, 2000; EUROSTAT.

¹³ In 2000. Housing Statistics in the EU, 2001, Finnish Ministry of Housing.

¹⁴ Mid-1990s data. 'Household scenarios for the EU, 1995-2025', Statistics Netherlands.

Factfile: Italy

Background

Population (m) 2002	Population Growth % 1980-2001	Fertility Rate* 2002	Years Life Expectancy 2002
57.9	2.3	1.3	78

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

Services output as % of GDP 2000	Employed as % working age population 2002
68	56

* GDP per person employed 2002

Economic

	200	2001	2002	2003	2004f
Real GDP growth %	3.2	1.7	0.4	0.4	0.9
Growth in real private consumption %	2.8	0.8	0.4	1.2	1.0
Inflation – GDP deflator	2.2	2.7	3.1	2.9	2.5
Inflation – consumer prices	2.6	2.3	2.6	2.8	2.2
Unemployment rate %	10.7	9.6	9.1	8.8	8.6

Government

	2000	2001	2002	2003	2004f
Expenditure as % GDP	47	49	48	49	49

Housing market

	2000	2001	2002	2003	2004f
Growth in residential investment	5.5	1.3	4.5	2.3	1.3

Taxes

Owner occupied housing	Capital gains exempt	Imputed rental income
Mortgage interest relief – yes	yes	not taxed

Property taxes as share of all taxes 2002	Property taxes as share of GDP 2002
5%	2%

Housing Statistics in the European Union 2003, Eurostat, OECD, World Bank.

chapter fifteen

Netherlands

Overview

The economy is in the doldrums, with growth at a virtual standstill for the third year running, yet the housing market has still not seen a collapse in prices as feared – though it is now four years since the great Dutch house price boom ground to a halt in 2001 (Figure 15.1). House prices are still rising gently in nominal terms, though when general inflation is taken into account there was a slight drop in 2003, but not in 2004 (Figure 15.2). This experience gives some hope to the other EU housing markets which have seen substantial price rises in recent years that a soft landing is possible.

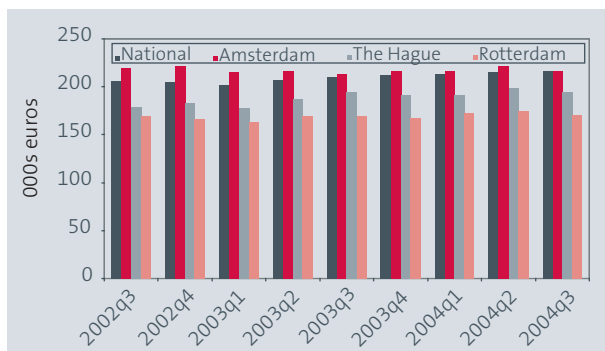
Previously, in the decade up to 2001, the country had experienced some of the greatest increases in real house prices in Europe. There is also significant long-term volatility in the housing market (Figure 15.2).

An interesting feature of the housing market is that transaction levels have stayed high in recent years, and even increased in some of the major cities, even though prices and mortgage advances are well past their respective peaks (Figure 15.3). This has helped to ensure that desperate sellers waiting months for a sale have been in the minority, thereby sustaining price levels.

Low interest rates have been a key factor in sustaining a high level of housing demand, plus continued housing shortages that government planners had hoped would be over. The unforeseen

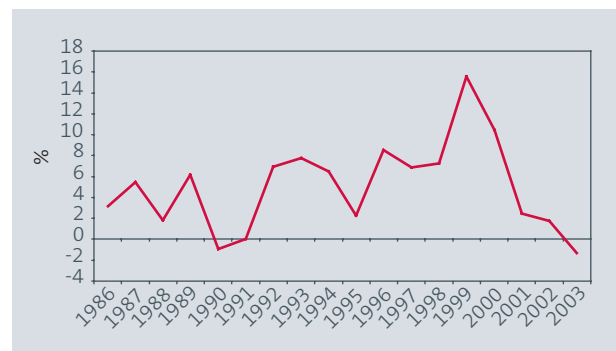
experience of yields in capital markets actually softening during 2004 helped to sustain demand in a country where long-term fixed interest rate mortgages predominate. In addition, housing supply remains extremely tight – with a massive squeeze in housebuilding over the past decade or so – meaning that there is no overhang of unsold buildings, as there have been at the start of previous downturns. This is likely to ensure that the trend of house prices, particularly for good quality, spacious accommodation, remains strongly upwards. As a result, potential sellers are more likely to sit out the current period of soft prices, rather than sell up in expectation of long-term falls in housing values.

Figure 15.1: Recent house price levels



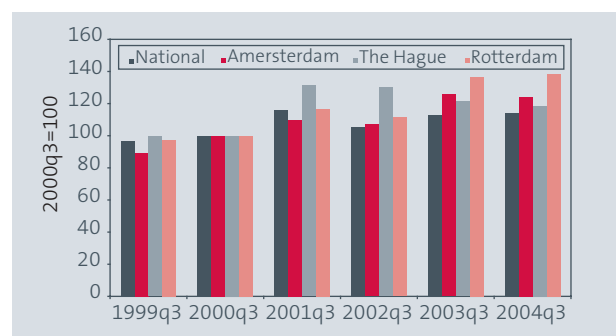
Source: NVM

Figure 15.2: Real house price changes 1986-2003



Source: NVM

Figure 15.3: Housing transactions 1999-2004 (third quarter comparisons)



Source: NVM

It did seem, early in 2003, as though prices were going to fall rapidly – with price declines strongest at the upper end of the market. The spring and summer periods, however, lowered such fears, and renewed interest in house purchase throughout 2003 indicates that the crisis seems to have passed; as long as no unexpected shock derails either the national economy or the housing market specifically. Nonetheless, the Netherlands Central Bank was still highlighting the potential risk to financial institutions of consumer mortgage defaults late in 2004, indicating that the housing market remained in uncertain territory.

The period of sustained housing market expansion up to 2001 had occurred in an economic context that was particularly strong, and during a period when population and household numbers were rising fast. Real economic growth rates from 1995 onwards were some of the best in the EU, and private consumption expanded in tandem. The economy then slowed markedly in 2001, which heralded the peak of the housing boom. Since then economic performance has been one of the worst in the EU, as a burst of inflation eroded competitiveness for a number of years and structural problems further weakened the economy. Other key EU economies have experienced similar events and the Euro has strengthened, and the competitiveness of the Dutch economy has still by no means been fully restored. As a result, both the economy and the housing market are likely to remain slack during 2005.

The housing system

Roughly a third of the housing stock is in the form of multi-family structures and two-thirds are single family dwellings. Of those single family dwellings, two-thirds again are terraced houses. The country has a tradition of dense urban forms, which have been encouraged by longstanding planning practices and the high cost of preparing land for housebuilding.

Longstanding relationships, however, are now changing. For many years now houses have constituted over 75% of new dwellings, and progressively more Dutch households are choosing to become homeowners. The homeownership rate is consequently growing at a rate that is likely to accelerate over the next decade. The heightened demand for space and housing quality is also coming into increasing conflict with a number of cherished public policies in land-use planning and environment protection related to dominant views against urban expansion.

In view of the apparent land constraint, it is perhaps surprising to realise that the average Dutch dwelling is one of the most spacious in Europe. Average useful floor areas are more than ten per cent better than in Belgium, France or the UK, for example. This reflects the traditional policy importance of housing and high density living policies combined with a large quantity of subsidy-driven, high-quality new housing. Housebuilding subsidies are now virtually gone, and it will be interesting to see whether housing and planning policies will be able to steer the market as successfully as some policy statements confidently predict.

The state, at local and national levels, plays an important role in housebuilding as a key land developer. Until the 1990s, it undertook virtually all of the land development function. Although private developers have been more active in land markets in recent years, around two-thirds of residential land is still developed by local authorities, with parcels sold on subsequently to private developers or housing associations. For the other third of land development, local authorities develop sites in partnership with the private sector.¹ Such a scale of public sector initiation of land development is unique in Europe, and gives considerable power over housebuilding to highly interventionist public land-use planning policies.

Owner-occupation and the recent housing market boom

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 homeownership, which now stands at around 54% of the stock – up from 42% in 1980. A number of factors have encouraged this trend, which will be looked at in more detail below. This structural shift in the housing system, in turn, helped to stimulate the market boom of the past decade.

On the policy side, homeownership continues to receive favourable tax treatment. Most significantly, there is full income tax deductibility of mortgage interest, which is a major benefit given the relatively high marginal rates of income tax. In addition, the capital gains from rising house prices are not taxed.² These breaks are partly offset by an annual imputed rental income tax on assessed values.

The tax on assessed values was altered in the 2005 Tax plan. The imputed rental value for owner-occupiers (known by the acronym, EWF) will in future be adjusted on the basis of the average movement in rent levels. The capital value of dwellings for assessment purposes is based on the Valuation of Immovable Property Act (known by the acronym, WOZ), which are periodically revised. From 2005, the assessment is being set at WOZ values on 1 January 2003, while previously it was based on 1 January 1999 values. The higher potential tax take caused by the increase in house prices between those two dates is being partially offset by reducing the EWF tax rate from 0.85% to 0.60%.³

Transaction cost taxes are relatively high. Purchasers of new houses pay 19% VAT, and existing houses are subject to a 6% property transfer tax. A property tax is levied separately on occupancy and ownership, although the new coalition government is pledged to abolish the occupancy component. Overall property taxes, however, are quite small – including non-residential structures, they amount to 2% of GDP.

Politicians have made repeated pledges to sustain the tax benefits of homeownership, despite its fiscal cost and the distorting impact on personal sector asset holdings and housing choices. Given the tightly balanced political situation and the soft housing market, it is unlikely that such pledges will be

¹ H. Priemus and E. Louw 'Changes in Dutch land policy : from monopoly towards competition in the building market', *Environment and Planning B : Planning and Design*, 2003, 30, 369-78.
² OECD Economics Working Paper 2001/29. ³ Ministry of Finance.

relaxed in the near future – although discussion is now appearing about the distortionary consequences. Economists and the Netherlands Central Bank, for example, have suggested that it would be better to reduce or abolish mortgage interest tax relief (MITR).

The tax reform of 2001, by lowering the highest marginal rate of tax from 60% to 52%, somewhat reduced the gain at the upper end. Tax relief on second homes was also abolished, along with tax relief for interest payments on general household credit.⁴ Furthermore, since 2001, when households increase their mortgages as part of a process of equity withdrawal, they have to prove that the money will be used for home improvement purposes to qualify for MITR. This latter measure may deter households from periodically borrowing for general consumption purposes on the value of their homes, yet it has the adverse effect of encouraging households to take out higher mortgage loans at the time they move in order to qualify for tax relief.

Tax breaks have undoubtedly been capitalised into house prices and, thus, helped to stimulate the long housing boom. The favourable tax position of homeownership has also had an impact on encouraging suburbanisation and population decentralisation in a country where environmental concerns feature prominently. Any sudden improvement in tax neutrality, however, would send house prices into freefall. Reform, if it comes, will therefore probably be a long and gradual process, and does not look a near prospect.

Another important policy factor affecting the housing system in recent years has been the beginning of a reversal of the previous strategy of providing subsidised social housing for large numbers of households, coming from a wide range of social groups and income levels. General subsidies have now been withdrawn, and some of the more affluent previous social housing tenants have responded to the new fiscal situation by becoming homeowners.

The reduction in social housebuilding and renovation subsidies has been huge, with a fall from 18.1 million euros in 1995 to 0.4 million euros in 2002. This has been slightly offset by an increase in consumption subsidies given on a means-tested basis, which rose from 0.9 to 1.5 million euros over the same period. Nevertheless, public expenditure on housing in 2002 was only a tenth of what it was in 1995. These data, of course, exclude tax breaks, such as MITR.

Social housing as a share of all dwellings reached a peak of 38% in 1998 – an EU record. Since then it has declined somewhat, to 34%, though this is still by far the largest share for social housing in the EU. The growth of the social sector up to the mid-1990s was accompanied by a sharp fall in private renting, which now houses only about 10% of the population, compared to 24% in 1980.⁵

The high demand for homeownership from the 1990s was caused by several interlinked factors. In part, it reflected demographic developments; while economic growth increased

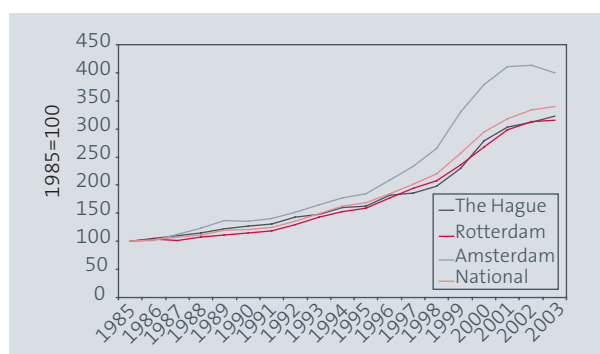
real disposable incomes and, until 2002, led to a decline in unemployment alongside a rapid expansion of jobs. Interest rates fell from their early 1990s highs and the mortgage market was subject to much greater competition as lenders have fought to gain larger market shares. Generous lending terms are now offered, with mortgages typically greater than the value of a property – to cover such factors as transaction costs. From the mid-1990s, furthermore, borrowing-to-income ratios have been based on all incomes in a household, rather than that of a single family member only.

Memories also faded of the long decline in real house prices from the mid-1970s to the mid-1980s, during which time they fell by around 15% in real terms. During that earlier period, negative equity was high and there was a near seizing up of market transactions in many localities for a long period of time. In contrast, the long rise in house prices in the 1990s encouraged more and more households to jump on the owner-occupied bandwagon in the oft-realised hope of capital gains from house purchase.

House price data indicate that the house price boom was greatest in Amsterdam. This can be seen in Figure 15.4, which shows house price indices from 1985 to 2002 for the country as a whole, and for the three major cities of Amsterdam, Rotterdam and The Hague. In fact, prices in Amsterdam seemed to have accelerated away from those in the rest of the country during the upswing; whilst those in some of the other cities trailed behind. By 2003, however, the Amsterdam market was one of the softest, and prices have converged slightly as a result. Turnover, as noted earlier, has kept up in the major cities and has even increased markedly in some cities, such as Rotterdam (see Figure 15.3).

A final aspect of the housing market boom relates to planning policy. This switched in the mid-1990s to one that severely restricted suburban growth by sharply constraining land supply in suburban areas. This reduced housing supply at a time when demand was growing rapidly – encouraging further price rises. This policy is now being eased slightly, so land supply policy has been perversely counter-cyclical.

Figure 15.4 City and national house prices compared 1985-2003



Source: NVM

⁴ OECD Country Report, Netherlands, 2001.

⁵ Housing Statistics in the European Union 2003.

There is a silver lining to the apparent planning cloud, because the constraints on supply mean that there is now less of a supply overhang on the market than there would have been under a more liberal land supply regime. Over the medium-term, however, less responsive supply not only means higher housing costs but also greater cyclical price volatility, as there is less supply around to satisfy demand increases.

Despite the growth of homeownership, its national share is still low compared to most other EU countries, reflecting the historical importance of social housing. The policy document 'What people want, where people live', outlining future housing policy, passed through Parliament with broad political consensus on its aims in 2001, and, despite several changes of government since then, will probably form the basis of policy for several years to come.

One of the prime aims of the new focus of housing policy is to increase owner-occupation to 65%, the EU average, by 2010. Even though almost 80% of new houses are now built for owner-occupation, such a major shift of 12% of households into homeownership in a relatively short space of time implies a significant absolute reduction in rental housing. This is estimated to require the transfer of 700,000 existing rental dwellings into homeownership, half a million of them owned by housing associations – around a fifth of their housing stock of 2.4 million dwellings in 2003 – with future transfers from local authorities and the private sector. Whether this goal will actually be achieved is debatable.⁶ The medium-term prognosis for owner-occupied housing is more subdued than it was during the boom years. If this is the case, housing policy targets may be overtaken by events.

A new owner-occupation grant scheme, the Home Ownership Promotion Act, was introduced in 2001 to enable people on low incomes to buy their own home. Its stipulations mean that it is most likely to be used for the sale of social housing to sitting tenants.

The repositioning of social housing

Rental housing is dominated by social housing providers. Housing corporations are private non-profit institutions, whose sole stated aim is that of providing good and affordable housing. 36% of their dwellings are in the low-rent category (almost 60% in Amsterdam and Rotterdam); 58% affordable; and 6% high rent.⁷

Policy change is the main driving force behind the transformation of the social rented sector. In a grand gesture in 1995, the government abolished its once substantial subsidy and financial arrangements with social housing institutions through a 'grossing and balancing' agreement. Under it, housing associations repaid all their outstanding public loans and, in compensation, received a lump sum amounting to the

estimated value of all government subsidy obligations. To balance their books and finance new building and stock improvements, social housing organisations now have to rely more directly on rental income or property sales.

As housing corporations are private bodies, it has been difficult for central government to order them to dispose of the better parts of their stock to sitting tenants at large discounts – as occurred in the UK with council house sales. The transfer of the existing social stock to another tenure is consequently not a simple matter. In fact, in 2001, the 16,000 sales (6,000 to sitting tenants) and 9,000 demolitions were together surpassed by the 19,000 purchases and the 12,000 newly built social dwellings.⁸ Therefore, it is unclear at present whether the social sector is actually shrinking.

Change is still likely to occur because of the country's policy and institutional framework of trying to find consensus – the 'Polder model'. Social housing institutions can build for sale and, hence, with public urban renewal subsidies will have incentives not only to upgrade the quality of their existing stock, but also to demolish and build new dwellings for homeowners. Housing associations are reported to have significant plans for transforming and shrinking their stocks in such ways, although recent government pronouncements have emphasised that social housing institutions should focus on their affordable renting role.

Adjustment to their newly perceived role in the housing system will probably take many years to work itself through the social sector. As better-off tenants shift towards homeownership, they may face higher vacancy rates in future, and resulting financial pressures. The only option then, under present arrangements, is for associations to sell off the better parts of their portfolios to balance their books. This might end up being the route by which some social housing is converted into owner-occupation.

The movement of middle income groups out of the tenure into owner-occupied residential districts is resulting in greater spatial segregation of low-income households, particularly among ethnic minority groups. The big cities, like Amsterdam, have large shares of their housing stock in the social sector, so the threat of significantly increased polarisation in the social structure of these urban areas is high.

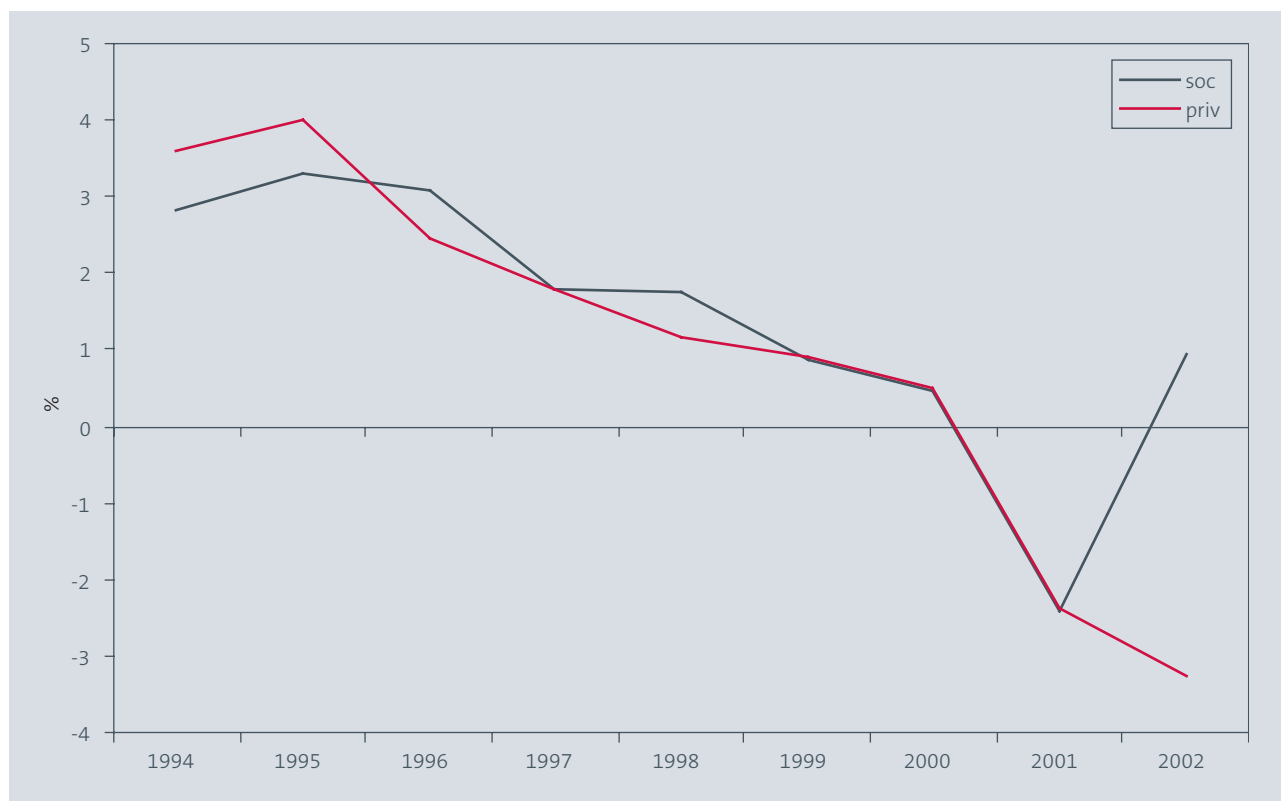
In an attempt to avoid such social spatial segregation, a controversial policy of 'gentrification' has been introduced as part of urban renewal programmes. It has led to measures aimed at increasing the supply of more expensive owner-occupied housing in the attractive localities currently dominated by social housing. As this programme is directed at areas already filled with housing, it involves the demolition, upgrading, or selling off of rented dwellings.

⁶ See, for example, the discussion in A. Ouwehand 'Dutch housing policy for the next decade' European Journal of Housing Policy, 2002.

⁷ Ministry of Housing, Spatial Planning and Environment, www.vrom.nl.

⁸ CBS Webmagazine.

Figure 15.5: Annual real rent changes 1994-2002



Source: Housing Statistics in the EU 2003

Rent controls

With the exception of the up-market sector, 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 it can be passed onto spouses, children and others. Rents bear no relation to market contexts, 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 all rents can only be raised annually by a maximum amount decreed each year by the government. The impact of such intense rent controls can be seen in the changes in real rents shown in Figure 15.5.

Despite the boom in house prices, real rent increases have been limited and declining since the mid-1990s. Real rents even fell in 2001, because unanticipated inflation outran the permissible rises of that year. Social housing institutions managed to reverse some of the decline in rents in 2002, but private landlords experienced further real losses.

The Housing Ministry negotiates annual rents rises with landlords' associations. In 2004, citing the current economic situation, 0.5% was trimmed off of the increase social housing institutions had wanted, restricting it to 2.9%, and the depreciation allowance element in calculating maximum

chargeable rents for particular types of accommodation was abolished. Moreover, landlords agreed to make a 30 million euro contribution to the rental costs of 1 million recipients of housing allowances.⁹

Investing in private rental housing is generally not a profitable exercise outside of the small upper market 'free' segment (5% of the sector), unless it involves capital gains from sales of properties. At the same time, there is a growing need for more rental accommodation, particularly for new households and lower income groups. The number of people moving up the housing ladder annually has also declined by around a quarter, from around 410,000 to 320,000 households, creating a logjam in the lower end of the market.

In recognition of the need for more rental housing, the government is proposing to allow more rapid increases in rents and to ease current rent controls somewhat. This is as much an attempt to persuade large-scale landlords, most of which are non-profit, to achieve short-term government housing goals, as it is a move towards a more market-oriented rental sector. Private landlords will be permitted to raise rents by 1.5 to 3% above the rate of inflation annually between 2005 and 2009, and social landlords by somewhat smaller amounts. Part of the deal struck with landlords' organisations is that more rental properties will be built as a result. If the dwellings are not

⁹ Ministry of Housing, Spatial Planning and the Environment.

forthcoming, the permitted rent increases will be lowered in later years; conversely if they are built, rents might be further liberalised after a review in 2008 (though at least one national election will take place between now and then). In addition, greater account will be taken of regional variations in housing market conditions in rent-setting from 2006, with a full conversion of rent setting to WOZ-based assessment values by 2010.

One final aspect of current rental policy is to slightly extend the free market by lowering the current maximum rental limit beneath which rent controls apply. At present, only rents of 597.54 euros are outside of the controls, and the proposal is to lower it to 550 euros. The government aims to increase the free market component to a quarter of the whole rental sector, or about a tenth of the stock overall.

The continued decline of private rental housing

Private rental housing is in long-term decline in the face of rent controls and subsidies to social housing institutions. At present, less than 10% of households live in the tenure. A much higher role for private renting traditionally existed in the four main cities, but the 1990s decline of private rented housing was particularly spectacular in those localities. Sales shifted the rental stock into owner-occupation, or to the social housing sector for demolition or renovation. In Amsterdam, for example, 52% of households were private renters as late as 1990; yet, by 1998, the percentage was down to 29%. Most of the switch was to social housing, which rose from 41% to 57% of all Amsterdam dwellings.

There are two institutional types of private landlord, broadly dividing the market into two segments: a small landlord sector of individuals and small firms, and a large landlord sector owned predominantly by institutional investors.

Housing in the first segment usually consists of lower quality, moderate rent, small, pre-war dwellings in inner-city areas. Properties are owned as a result of inheritance or speculative purchase. Landlord strategies are to sell dwellings on to owner-occupiers or social housing institutions for renovation when market conditions are ripe. Poorly maintained, this sector is likely to continue to decline.

Institutionally owned rental housing is in marked contrast to the small landlord sector. Most of it has been built over the past thirty years, predominantly in good city locations. The units are generally spacious, well-equipped and maintained, and the rents are high and, thus, outside of the strictest controls. This sector is popular among mobile, affluent households, because by renting they avoid the high transactions costs of ownership. It is also popular among the elderly, partly for locational preference reasons, and because it enables them to realise equity previously locked up in a home.

Over the long-term, however, this sector cannot compete with the tax breaks offered to owner-occupiers. This induces sales, when conditions in the market permit. Investors are in the habit of selling off their properties after 15 or 20 years, when loans start to expire. So, in the future, the sector will probably continue to play only a modest role, although a widening of the free market sector could see a revival, as has occurred in other European countries.

Housebuilding

Private sector housebuilding peaked quite early in 1998 and since then has been generally declining, despite the continued increase in house prices (Figure 15.6). Overall residential investment volumes have been more volatile, but have generally stayed higher because of the additional contribution of improvement and renovation expenditure. Yet, they still fell sharply in 2001, and continued to fall for the next two years, but, according to the Planning Bureau, are expected to grow in 2004 and 2005 (Figure 15.7). Nevertheless, net housing stock rose by 10% between 1995 and 2004, though some of this will be accounted for by subdivisions rather than new build.

New social housebuilding is around 12% of completions nowadays. There is also some building of luxury free market private rental dwellings, especially in prestige downtown and renovation areas. The bulk of new building, however, is for owner-occupation.

The decline in housebuilding well before the market peaked suggests that planning constraints on land supply had marked effects. For instance, housing completions declined notably in the period 1999-2001 at a time when house prices were rising rapidly – a seemingly contradictory market response.

Figure 15.6: Housing completions 1995-2002



Source: Netherlands Statistics

Figure 15.7: Private residential investment annual change 1990-2005



f = forecast

Source: CPB

An interesting feature of housebuilding in recent years has been rising construction costs, which have increased at well above the rate of inflation. Furthermore, construction completion times have lengthened considerably – caused by a mix of planning delays, extended building periods, and the new emphasis on urban renewal. Only a fifth of dwellings were completed within a year of being granted a permit in 2002, and the construction time was more than two years for 35% of new homes; whereas this was only the case for 5% of dwellings in 1995. This indicates that the responsiveness of supply to extra demand has declined significantly over the past decade, and is likely to remain so in the future. The government is introducing measures to try and speed up construction times and the processing of planning applications.

Macroeconomic influences

During the 1990s, the economy was one of the strongest in Europe, with low inflation and steady growth. Between 1990 and 2000, economic growth averaged almost 4% a year and it accelerated in the second half of the 1990s. This impressive performance led to higher disposable incomes. Nominal disposable income rose at over 6% a year on average between the period 1990 to 2000, while yearly inflation averaged only 2%. Households, therefore, experienced significant increases in purchasing power during the 1990s. This was particularly true for two-earner households, which were one of the main sources of growing housing demand during the boom years.

Inflation, however, picked up from 2000, and reached over 5% in 2001. Since then it has abated but has severely affected competitiveness. The economy, therefore, was badly hit by the slowdown in the world economy, and the upturn in the world economy has so far only had a limited effect. Economic growth was below zero for 2003 and is expected to be only around 1% in 2004, and 1.5% in 2005 – well below the economy's full-employment potential of 2%. Consumer confidence picked up from its lows in 2003, but by late summer 2004 was starting to fall again. Unsurprisingly, unemployment has risen sharply and is expected to reach 550,000 – a two-thirds increase in only 3 years.

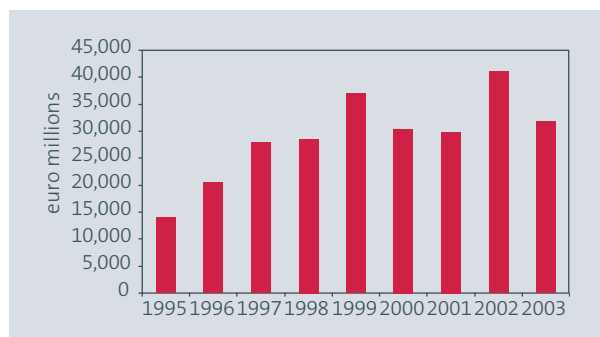
The economy has experienced a deeper recession than in the early 'nineties, when the housing market languished. In particular the market sector has a hard time. Recovery is expected to be led by foreign trade, but exporters are suffering major losses of market share due to many years of eroding price competitiveness. On the domestic front, private consumption is being hit by rising pension premiums and a higher tax burden and near zero wage increases in the private sector are expected in 2005. Cuts in government expenditure have also occurred in order to minimise the deficit, forecast to be 2.9% in 2004.¹⁰

With such a gloomy economic situation, unsurprisingly, house prices are expected to be stagnant in 2005. The high level of mortgage debt, at 105% of GDP, is also of concern. Equity withdrawal from the housing market added about 1% to national income growth in 1999 and 2000, and then trimmed it by -0.5% in 2001 and 2002 as house price rises slowed.¹¹ The precarious state of the housing market is one of the major threats to an economic upturn – though, as noted earlier, concerns about the state of the housing market late in 2004 were still more of a worry than a reality.

Mortgage market influences

The mortgage market has boomed over the past decade in tandem with the owner-occupied market, with outstanding mortgages rising over fivefold between 1991 and 2004. A much faster growth in the value than in the number of outstanding mortgages can be attributed to rising house prices, more generous mortgage terms and the strong demand for higher quality housing. In addition, a substantial amount has been lent to finance second homes purchased in the Netherlands and elsewhere in Europe, to refinance existing fixed interest loans at lower mortgage rates and to withdraw housing equity.

Figure 15.8: Net demand for mortgage loans by households on capital market * 1995-2003



* includes mortgage-backed securities

Source: Netherlands Central Bank

Interest rates have tightened since 2002, but are still attractive in relation to historic experience. However, falling inflation has pushed real interest rates into the positive zone again since 2003, after a number of years of negative real interest rates.

There are a variety of mortgage lenders. The most important are general banks, such as ABN Amro and ING (including Postbank), followed by special mortgage banks and building funds ('bouwfondsen'), insurance companies and savings banks. In 2001, the banks had a 44% market share, the insurance companies 12% and a variety of other lenders 44%.

Although fixed interest rates with a 5 year review are the most common mortgage product (with over 95% of the market), consumers have a wide range of types to choose from. They often obtain mortgage packages, financed with a mix of first and second mortgages, and containing various potential combinations of payback terms and fixed and variable interest rates. Large percentage advances have been common.

The desire of each large mortgage provider to increase market share has led to this more varied product range, and to tighter lending margins and less strict lending criteria. Mortgage terms have eased considerably. The biggest change was when two-incomes were brought into the affordability equation in the mid-1990s, meaning that professional couples in particular could suddenly borrow much larger sums. The participation of women in the labour force has grown substantially from the low levels of the 1970s – so that there are now far more two income families than a decade or so ago.

¹⁰ Central Planning Bureau. ¹¹ DNB Quarterly Bulletin, June, 2004.

A National Mortgage Guarantee ('Nationale Hypotheek Garantie') was set up by the government in the mid-1990s to encourage lower-income homeownership. Such homebuyers may insure their risk of default by paying a small insurance premium (0.15 percent of the mortgage loan) when taking out a mortgage, and receive a discount on their lending rate in return (of 0.2 - 0.5%) because they then pose no default risk to the lender. About a third of mortgages are guaranteed in this way.

Demographic influences

The country is experiencing three major demographic trends. First, average annual population growth is decreasing. Second, the number of persons per household is falling. Third, the population is ageing.

One of the most notable demographic factors of the past 20 years has been the large increase in household numbers. They grew from 5.1m to 6.8m between 1980 and 2000. Over the same time period, the number of one-person households doubled, from 1.1 to 2.3m. A third of the 7 million Dutch households are now single-person; a third are multi-person households without children; and a final third contain children. The dramatic rise in one-person households has had an important effect on the housing market, although the rate of increase tapered off after 1999.

Table 15.1: Population growth and age structure 1990-2050

	total population millions	% shares of total population 0-19	by age 20-64	group 65+
1990	14.9	26	61	13
2001	16	24	62	14
Forecasts				
2010	16.9	24	61	15
2030	17.9	22	56	22
2050	18	23	56	22

Source: Netherlands Statistics

The overall population grew by 1.1m between 1990 and 2001 – a rise of 7%. Population growth, in contrast, is now very low – rising in 2004 at the lowest rate for over a hundred years. Immigration has been a significant political issue in recent elections. Net immigration was running at 0.4% of the population in 2001. Since then, it has fallen sharply as entry criteria have been tightened, was virtually zero by 2003, and emigration actually surpassed immigration in 2004. If zero or negative net immigration remains a policy goal, population forecasts will have to be revised heavily downward.

The most recent overall population forecasts in 2004 give widely ranging outcomes for population size by 2050, ranging from a slight fall to 15 million to a 25% rise to over 20 million, depending on the trajectory of the economy and the welfare state.¹²

An ageing population is likely to begin to have a significant effect on the demographic structure from 2010 onwards, which will have significant 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 (Table 15.1). 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. The recent reduction in immigration is likely to worsen the ratio of economically active to economically dependent, because immigrants are far younger than the average age of the resident population. Ageing will alter demand within the housing stock, particularly lowering it for family housing, which in the most recent boom has been at a premium.

The general forecast for housebuilding is that numbers need to be above over 100,000 a year in order to meet current and expect demand. This is over a third to more than current levels, and is a far cry from the hope that the housing shortage would be overcome by the early 2000s, as believed by policymakers until recently. The 2005 Budget Statement stated that 420 thousand homes will have to be built in the Netherlands between 2005 and 2009. So, once again, the pressure is on to find suitable land on which to build these homes.

¹² Netherlands Statistics.

Factfile: Netherlands

Background

Population (m) 2002	Population Growth % 1980-2001	Fertility Rate* 2002	Years Life Expectancy 2002
16.1	13	1.7	78

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

Services output as % of GDP 2000 Employed as % working age population 2002 GDP per head EU average = 100 2003

70	64	112
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* GDP per person employed 2002

Economic

	200	2001	2002	2003	2004f
Real GDP growth %	3.5	1.2	0.2	-0.7	0.9
Growth in real private consumption %	3.6	1.4	0.8	-1.2	0.4
Inflation – GDP deflator	3.9	5.4	3.4	2.8	1.3
Inflation – consumer prices	4.7	3.1	2.0	1.5	1.0
Unemployment rate %	5.5	5.1	5.2	5.0	4.8

Government

	2000	2001	2002	2003	2004f
Expenditure as % GDP	45	46	48	49	48

Housing market

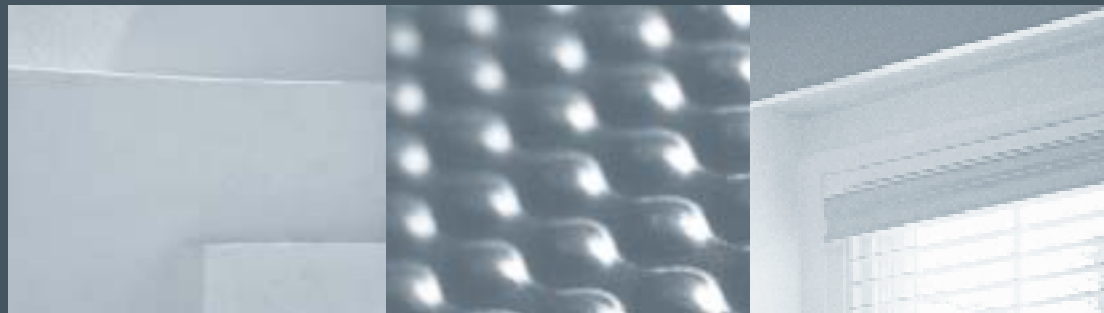
	2000	2001	2002	2003	2004f
Growth in residential investment	-0.3	0.8	-3.7	-1.8	2.1

Taxes

Owner occupied housing	Capital gains exempt	Imputed rental income
Mortgage interest relief – yes	yes	taxed

Property taxes as share of all taxes 2002	Property taxes as share of GDP 2002
5%	2%

Housing Statistics in the European Union 2003, Eurostat, OECD, World Bank.



chapter sixteen

Poland

Overview

The housing system, like the rest of the economy, has undergone a considerable series of changes since the 1980s. After an initial transition period, most contemporary market features have developed since the mid-1990s. Private ownership now predominates, but markets are still fledglings. Although the use of mortgages has started to expand rapidly in recent years, they began from a very low base and borrowers have suffered a severe exchange rate shock. Transactions are also relatively small in number compared to mature housing markets, while much informality and quasi-legality surrounds many housing exchanges. Housebuilding also continues to be predominantly owner-organised for direct consumption, though a development industry has been growing strongly in recent years.

The sharp slowdown in the economy in 2001 and 2002 badly affected the housing market. The re-emergence of general growth in 2003 and 2004 then fed into housing demand. The medium-term prospects of the housing market continue to depend on the state of the economy and inflation.

The housing system

National income per head is less than half of the EU25 average, so it is to be expected that housing conditions are significantly lower than in Western Europe, as are other indicators of average living standards. Housing provision was a key element of the centrally-planned economy and, so, has been significantly affected by the transition from a state-dominated social system to a market one; by the 'shock' therapy that accompanied that transition; through the sometimes uncomfortable juxtaposition of previous and new housing and financial institutions; and by economic and social problems: notably high levels of unemployment, strong inflation until the last three years, and a continuing relatively large public deficit.

The growth of owner-occupation

The transformation of the structure of housing tenures since the 1980s has ostensibly not been so great as in some other previously centrally-planned economies, for a mixture of political and practical reasons associated with the institutional

framework of property ownership. By 2003, 55% of dwellings were owned by private individuals, almost entirely as owner-occupiers, yet this seems a fairly limited change from the 48% in 1988. The second largest tenure is co-operative, then successively local authority, state, firms and a small other category – the latter includes the new non-profit social housing institutions, most of which are municipal subsidiaries (Polish acronym TBS, of which more below) (Table 16.1).

Table 16.1: Housing tenures, 2002

Per cent

Owner-occupied	Co-operative	Municipality	State	Enterprises	Other
55	28	12	2	2	1

Source: Housing Ministry

The apparent relative stability of tenure shares belies the fact that privatisation has been taking place through the sale of individual flats in building structures owned by municipalities, employers and co-operatives. The discounts offered are typically 80% of estimated market value or higher, so that tenants have a strong incentive to switch in situations where ownership offers lower monthly outgoings than renting. By 2001, 22% of the municipal and employer housing, and 67% of co-operative dwellings had been privatised.¹ The privatisation process, thus, has differed from other Central and Eastern European countries in that ownership of the building frame and common services remains with the original institution, rather than, as in Hungary, being passed over to the households living in the structure.

Overall, consequently, if the different types of property rights corresponding to owner-occupation in the generally understood sense of the word are added together, the owner-occupation rate rises to 76%; which is not so dissimilar from experience in the other Central and Eastern European countries. Private renting is extremely small, at less than 1% of the stock, although informal arrangements and lodgers must be more common.

¹ Housing Developments in European Countries, 2003, Department of the Environment, Dublin.

Most sales to tenants in co-operatives have been of tradeable rights-of-occupancy, similar to those in Scandinavia, though there have been some outright sales on a condominium basis with the co-operative retaining administrative functions. So, in one block of flats there can be three different types of property relation: tenant, right-of-occupancy and condominium.

Local government only originates from 1991, so its experience of administering housing is limited. Their stocks are based on decentralisations of previous state housing. Housing for them is heavily loss-making, so that they face the need to find alternative sources of finance for it, which is problematic. Such pressures, in general, mean that they are keen to sell off of as much housing as they expediently can. Such housing is geographically concentrated, so that in some localities municipal tenants can form important voting blocs in municipal elections.

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

To date, there have been few conflicts between tenants and the two types of owner over repair costs to the buildings in which flats exist, in contrast to some other new EU member states. This is partly because the building structure is still owned by a third party (i.e. the co-operative or municipality) and also because all three groups tend to be lower income households, and so prefer the minimum necessary expenditure. It is unclear, however, how major renovations can take place to such structures, given the incomes and mixed incentives of occupants, and it may well need public subsidy to overcome the logjam.

Housing shortages

There are currently around 12 million dwellings and a crude shortage of about another 1.5 million, concentrated in the economically dynamic cities. Furthermore, the population is ageing from its relatively young current profile, so household numbers will continue to rise over the course of the next decade, adding further demand pressures.

Population pressures, which have been strong, are forecast to abate. The population, in fact, is expected roughly to stabilise until 2020 and then fall quite substantially, by over 1 million, in the subsequent decades, because of a low birth rate and limited net immigration. The population will also age, so that 30% of people will be 65 or older by 2050.

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

A symptom of housing shortages is found in the average number of people per dwelling, which is relatively high, at 2.8.

Dwellings are also quite small. The average useable floor area is 67m², compared to around 90 in the old EU15. New dwellings, however, are significantly larger than old ones so that this space deficiency should slowly decline over time.

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

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

Investment backlogs

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

Renovation is not a cheap process. It may often be less expensive than demolition and new building, but still frequently requires investments equivalent to half or more of the cost of a new home. Consequently, improvements to the existing stock would put an impossible strain on the financial and investment capacities of the economy if most were tackled immediately.

Given the scale of current housing shortages, moreover, there is little chance that new building will lead to significant replacement of the existing stock in the near future. Replacement is inevitably a slow process. This can be illustrated by a crude analogy of estimating how long it would take to replace the whole of the housing stock at typical current housebuilding levels. In Poland's case, 120 years would be needed to replace the existing stock, even if all of new homes were simply used as substitutes for existing dwellings. This illustrates that poor quality housing is going to remain a problem for many years to come.

² Housing Developments in European Countries, 2003, Department of the Environment, Dublin.

³ Housing Developments in European Countries, 2003, Department of the Environment, Dublin.

Barriers to change

Another barrier to housing change is the legacy of past borrowings, with loans from the 1980s or earlier still having to be repaid, even though the housing may be inappropriate or of low quality. Inflation has eroded the real value of the domestic currency dominated debt. Even so, proposals for change have to take into account such debt overhang, which might rule out preferred options.

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

Another situation concerns the new planning regime. It has been recently introduced into major cities like Warsaw, making the old plans redundant, as they no longer have any legal status. However, new plans have not been formulated for most areas of cities so far (only 13% of Warsaw has new plans, for instance). This means that all development technically is frozen until the new plans are drawn up and ratified. Therefore, at present, in many localities no land-use change can legally proceed without special dispensation, which takes time and involves substantial transaction costs for developers at a time of pressing housing shortages.

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

Such frictions clearly limit the flexibility of organisations and distort incentive structures away from the desired rationalities. This limits the options of governments, municipalities, existing housing institutions and private individuals in relation to their housing decisions and, hence, the allocation of resources. Regulatory uncertainty and delay, for example, are likely to inhibit housing investment.

Policy-making itself may send out inappropriate signals and lead to failure to achieve objectives. The main policy emphases are decentralisation and market-orientation. Even so, actual changes frequently are not the results of transparent, well-articulated, public debates, but rather of political exigency and pressure group lobbying.⁴ In part, this political context arises from the low level of public interest in housing policy – it is not an item high on the political agenda.

An example of confused political outcomes relates to the reform of rents across the whole range of non-profit landlords. They were supposed to move from the mid-1990s towards more realistic levels, which would have led both to a more efficient use of space and provided higher incomes to housing

institutions, enabling them to spend considerably more money on improving poor existing housing conditions, and removing the need for continued municipal subsidy of loss-making organisations. Laws were duly passed that enabled rents to rise toward a maximum annual level of 3% of replacement costs for municipal and co-operative housing, and 4% for the new dwellings provided by TBS. However, political pressures, especially in the recessionary years between 2000 and 2003, have meant co-operative and municipal rents remain low, and far below those levels; whereas TBS rents have, on occasion, overshot their ceiling.⁵

A whole variety of central government subsidies to housing have been pared away over the past decade, as the responsibility for housing provision has passed to private initiative and local authorities. Apart from housing-related tax reliefs, by 2004 the only remaining large, long-term, central government subsidies related to payment guarantees to the housing savings schemes and payments for social housing from the National Housing Fund. In 1995, central government housing subsidies had represented 1% of GDP, yet they were only a tenth of that level by 2004. This figure, however, does not represent the full extent of the state's fiscal stance with respect to housing, because it does not take account of taxes foregone and local government expenditure.

Low income housing initiatives

The National Housing Fund (the acronym KFM in Polish) is a subsidiary of the state-owned bank, Bank Gospodarstwa Krajowego. It provides subsidies on long-term mortgages that enable housing cooperatives and social housing associations (Polish acronym TBS) to build dwellings for low income households, in a programme that started in the mid-1990s. This has led to the construction of an average of 8,500 dwellings annually in recent years. The mortgage offered is index-linked at half the commercial rate of interest and can cover up to 70% of a project's value. 10% is also written off the debt when a project is successfully completed. Rents are then supposed to cover the rest of the loan cost, plus administration and repairs. The remaining 30% of the construction cost is usually raised in the form of an in-kind contribution of a plot by the local municipality and financial contributions by third parties, usually prospective tenants' families.

Individual households in all tenures can apply for means-tested housing allowances, which are capped at 70% of total housing costs no matter the level of income. They used to be operated via municipalities with subsidies and standards laid down by central government. Between 1995 and 2003 the cost of these central government expenditures more than doubled and, in 2003, 850,000 households were in receipt of them.⁶

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

⁴ Large Housing Estates in Poland, Węclawowicz, Kozłowski and Bajek, RESTATE, Utrecht University, 2003.

⁵ Muzioł-Węclawowicz & Oracz 'Rents in Polish Social Housing', ENHR 2004.

⁶ Ministry of Finance.

Taxation and property registration

The interest costs of housing loans can be deducted from income tax assessments. In addition, part of the costs of housing renovation and modernisation can be offset against income taxes for the expenditures made by both owners and tenants.⁷

Caps were imposed in 2002 on interest rates based on maximum assessed dwelling values at the time of acquisition, which lowered both the exchequer burden and the bias of the subsidy towards better-off persons buying the most expensive homes. The maximum tax permissible interest rate deductions are now calculated on the value at the time of acquisition of a notional mortgage for a 70m² dwelling based on a 100% loan-to-value ratio. That dwelling for tax purposes is valued at the state-declared dwelling price per m² for the year of purchase, which was 2117 PLN for the 3q 2003, or 455 euros per m² approximately: i.e. the maximum interest charge to be offset against tax for a dwelling bought between 3q 2003 and 3q 2004 is the current mortgage interest rate x (70 x 2117) PLN.

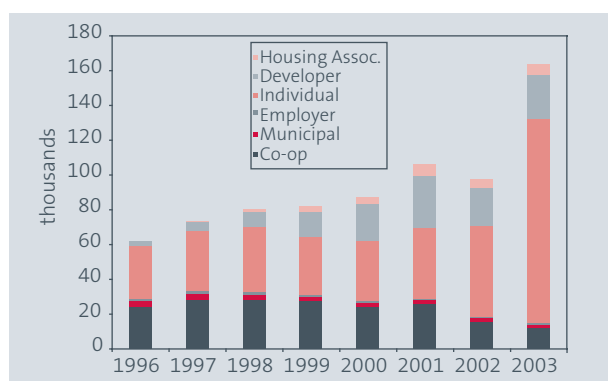
Poland's membership of the EU has altered the incidence of VAT with respect to housing. Until 2007, the reduced rate of 7% will continue to apply to housing-related construction activity (new build, renovation, etc), but construction materials from May, 2004 now are subject to a 22% VAT rate. This higher rate will be extended to all housing construction after 2007, except for housing provided as part of a social policy.

One of the difficulties of housing and mortgage transactions is the time it takes to register them with regional courts, which can extend for many months. Electronic systems are being introduced to speed up the process dramatically. Unfortunately, they currently are only being implemented in about a 100 of the more than 300 courts that deal with land and mortgage registrations, so that delays in many parts of the country will remain for some time to come. The new land registration system is expected to be fully introduced by 2009.

Housebuilding

Housing output averaged around 100 thousand units annually in the first half of the 1990s, but then collapsed to only 60 thousand in 1996, before recovering again in recent years (Figure 16.1).

Figure 16.1: Housing output 1996-2003



Source: Central Statistical Office

The 2003 housebuilding figure was severely distorted by the announced introduction from 2004 of fines for occupying a dwelling without notifying the authorities of the completion of works. This meant that owners of undeclared dwellings rushed to register them in that year, so that the data give an exaggerated picture of true output, whereas levels in earlier years were correspondingly under-recorded. Most new housebuilding is now for the private sector: 97%, for example, in 2002.

Private developers have grown in importance as housebuilders since the late 1990s. For example, in the first 8 months of 2004, around 20% of new building was undertaken by private developers, 60% by individuals, 10% by co-operatives and 7% by other organisations.

Much of the co-operatives' declining levels of output is actually for the private market. In fact, they were the main institutional provider of new private housing in the first half of the 1990s. Sales present a useful source of income for them. Co-operatives have a problem with development, in that they cannot hold reserves and have limited possibility of borrowing on the open market to finance construction, rather than the special loans of KFM. So, they have to have to rely entirely on 'owner' member deposits in order for a project to start.

Developers have increased their market share at the expense of co-operatives, because of their superior financial capabilities and products. A trade body for them, the Association of Polish Developers, was set up in 2003, partly to counter the adverse publicity caused by several owners of dubious enterprises running off with client deposits.

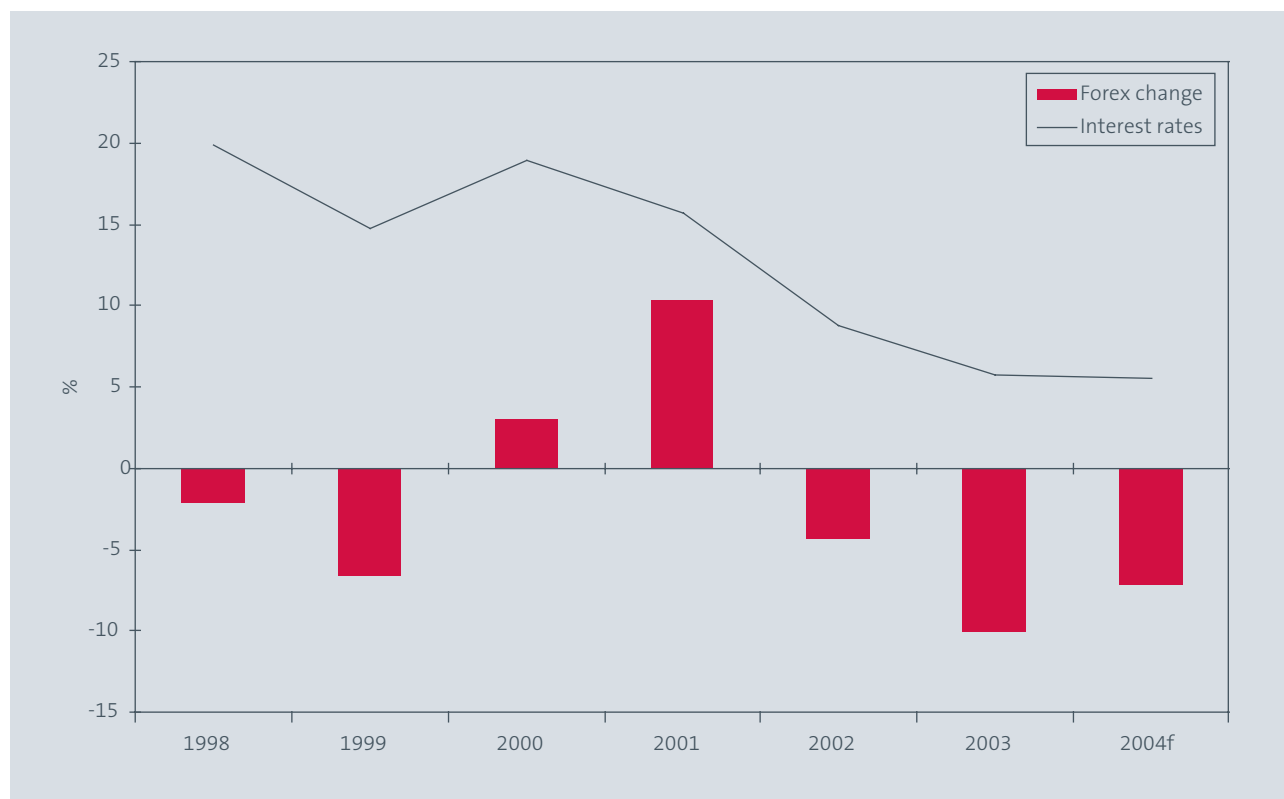
Most new housing developments are blocks of flats rather than houses. They are popular with consumers because they are cheaper and less easy to break into, as security is a frequent worry. Projects are concentrated in Warsaw, where shortages and incomes are the greatest. Many are located in the suburbs, with cheap land and relatively good accessibility to keep costs down. To reduce the land cost element, purchasers are even willing to live in localities with poor reputations as long as efforts are made to keep new schemes secure. This has led to some quite large 'residents only' schemes being built in the midst of rundown, high unemployment, tenanted estates. The years of central planning, of course, meant that the scarcity and desirability of locations had little impact on residential location patterns. As market forces increasingly redefine urban geographies, so substantial spatial changes are likely to occur.

The two main developers in Warsaw, with 40% of the market, are local companies, but other European firms have entered as well, such as the Swedish firm, Skanska, Bouygues from France, and several developers with a UK capital base. Several overseas developers initially pitched their products into a luxury sector that is too expensive for the local market. Others have been more successful in viable middle and upper market ranges. Bouygues, for example, currently has 500 units underway, having sold out its initial schemes. It sells units unfinished inside to make them more affordable for potential purchasers.

It is now commonplace for Polish building workers to work in other parts of the EU, especially the UK, which has imposed no transitional limits on labour mobility from the new member states. This has not tended to create significant labour availability problems in Polish construction, because their place has generally been taken by workers from the Ukraine and Russia.

⁷ Ministry of Finance.

Figure 16.2: Interest rate and the exchange rate 1998-2004



Note: Short-term interest rates and the annual percent change in the effective exchange rate.

Source: OECD

Macroeconomic influences

Growth in the years up to 2001 was high, but then fell sharply to only 1% in 2001, and was not much better in 2002. This obviously affected the new housing market and pinched the growth in housebuilding that had been taking place. By 2003, however, the economy was growing again, and expansion was likely to be back at earlier strong levels in 2004. The housing market looks like it may have picked up with the economy.

The turbulence of the 1990s created two legacies: high unemployment and inflation. Unemployment is running at almost a fifth of the workforce. The country also has the lowest share of people of working age in employment in the EU, at only 51%. There are consequently far less earners and multiple-earners in families capable of paying housing costs. Social security payments are limited, so that widespread poverty exists with large numbers of households concentrated in un-privatised apartment blocks who can afford to pay little or nothing for

their housing, in the absence of housing allowances. New households also face severe housing affordability difficulties. A recent survey showed that up to 60% of families could not afford to buy an apartment in a country where renting options are now very limited for new entrants and movers.⁸

Inflation was in double figures for over a decade until 2000, and remained high up to 2001 (Figure 16.2). In 2001, the monetary authorities raised and kept interest rates high until 2003, in order to squeeze out inflation and reverse the decline in the trade balance. This and deteriorating international trade helped to generate the economic slowdown.

An effective devaluation over three years of around 20% in the Polish zloty (Figure 16.2) had by 2004 made the economy more competitive on world markets. Growth prospects now look reasonable, but the risk of renewed inflation remains, especially as the government deficit has grown to almost 6% of GDP.

⁸ Large Housing Estates in Poland, Węclawowicz, Kozłowski and Bajek, RESTATE, Utrecht University, 2003.

Mortgage market influences

Mortgages are generally offered by commercial banks, issuing variable loans at short-term interest rates plus a spread. The state has also encouraged the development of a mortgage bank system that raises funds on capital markets for lending to consumers on a long-term fixed interest basis. To date, it represents a small fragment of the mortgage market, but is forecast to grow strongly as economic and financial conditions stabilise.

Overall, the mortgage market remains small but is growing fast. It is estimated that mortgage finance is currently used in about a quarter of all transactions.⁹ Typical due diligence data are still scant because of the limited history of competitive lending. In addition, the strength of the lenders remains to be seen. One national bank completely dominates the market, PKO BP, yet competition is growing, and the strength of mortgage lending institutions in the face of major unexpected shocks is yet to be tested. It is, perhaps, unsurprising that in such an environment spreads still remain high.

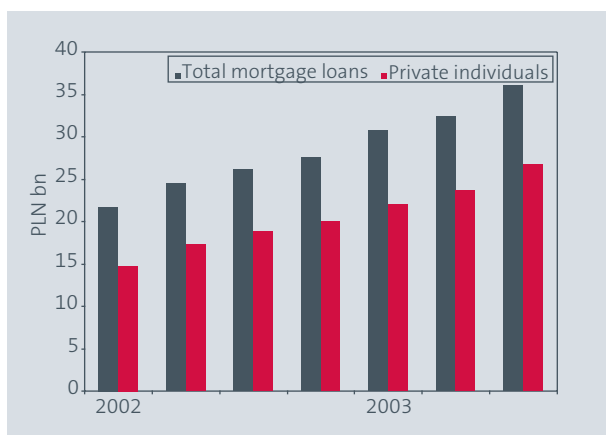
The profile of interest rates until recently has militated against mortgages in general, and fixed rate ones in particular. In 1997 and 1998, nominal mortgage interest rates were 25%, and were still in double figures into the 2000s. Such huge rates were a disincentive to borrowing, although indexation is widespread. They were caused by high general interest rates and the large spreads required by financial intermediaries on mortgages. Greater competition in the mortgage market and falling general interest rates have seen interest rates fall dramatically, so that they were 7% by 2004, providing a substantial stimulus to the mortgage market. Since 2002, mortgage loans have grown rapidly (Figure 16.3).

To avoid high domestic interest rates, many consumers in recent years have taken out foreign currency dominated mortgages. They still experience the relatively high spreads charged in the financial system, but enjoy lower international interest rate environments. Unfortunately, as household earnings are usually denominated in Polish currency, they face an exchange rate risk. With the 20% or so devaluation of the Polish zloty in recent years, existing mortgage holders have faced sharp rises in the zloty value of their mortgage repayments.

The largest banking group, PKO BP, lent 60% of the value of all mortgage loans in 2000 but is facing increasing competition from new entrants. In 1997, mortgage bonds and associated banks were introduced to bring German-style Pfandbriefe to Poland. Four mortgage banks currently exist, run either by domestic, German or Danish parent groups. To date, the significance of these mortgage banks has been small, despite loan guarantees by government. In 2003, they held loans equivalent to about 6% of the outstanding loans of the banking sector.

In addition, there is also a housing savings scheme similar to that of the Bausparkassen in Germany. Low interest rates on savings are matched by low lending rates on loans in a 'mutual-support' type of way. State tax credits are also in place. However, the expected flood of higher income groups to such schemes has not materialised, and they remain relatively minor players in the financial system.

Figure 16.3: Mortgage lending 2002-03



Source: Polish Central Bank

⁹ Ministry of Finance.

Factfile: Poland

Background

Population (m) 2002	Population Growth % 1980-2001	Fertility Rate* 2002	Years Life Expectancy 2002
38.2	-0.04	1.3	74

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

Services output as % of GDP 2000	Employed as % working age population 2002
66	51

* GDP per person employed 2002

Economic

	2000	2001	2002	2003	2004f
Real GDP growth %	4.0	1.0	1.4	3.7	4.7
Growth in real private consumption %	2.8	2.0	3.4	3.1	3.7
Inflation – GDP deflator	6.7	4.0	1.2	0.7	1.2
Inflation – consumer prices	10.1	5.5	1.9	0.8	1.8
Unemployment rate %	16.1	18.2	19.9	19.6	19.7

Government

	2000	2001	2002	2003	2004f
Expenditure as % GDP	45	45	46	46	47

Housing market

	2000	2001	2002	2003	2004f
Growth in residential investment	18.9	15.7	8.8	5.7	5.5

Housing Statistics in the European Union 2003, Eurostat, OECD, World Bank.

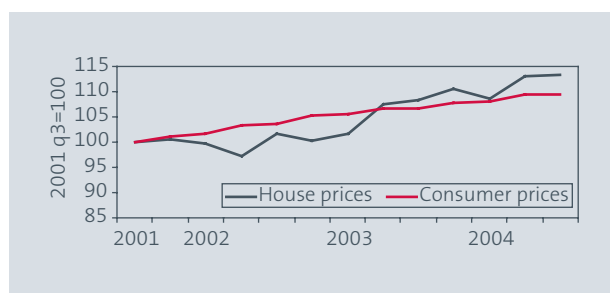
chapter seventeen

Portugal

Overview

The housing market has been out of synchronisation with other Southern European ones in recent years, stagnating while others boomed. There was strong growth in the late 1990s and early 2000s, but this was followed by a sharp downturn in 2001 and 2002. Vacancy rates rose and prices levelled off.¹ Since 2003, however, the housing market seems to have been leading the economy out of recession with rises in prices – up by 10% in 2003 but a more moderate 7% forecast for 2004. The prognosis is also good for 2005. This unique cycle is primarily due to the divergence between the country's rate of economic growth and that in the rest of Europe, with recent renewed activity in the housing market aided by low mortgage interest rates and growing consumer confidence.

Figure 17.1: House and consumer prices, 2001q3-2004q3



Source: INE

The housing system

Tenures, housing policy and taxation

Over three-quarters of households are homeowners, and this proportion has grown significantly over the past 20 years (Table 17.1). At the same time, the share of the private rented sector has fallen by almost a half. Owner-occupation, in fact, spreads right through the social levels, including low income households (around a fifth of the population is classified as living in a low income household).

Table 17.1: Tenure shares, 1981-2001

	1981	1991	2001
Owner- occupied	57	65	76
Rented	39	28	21
Other	5	8	3

Source: Census, INE

A sharp decline in the rate of inflation during the 1990s added stimulus to owner-occupied housing demand, because it enabled significant growth in the mortgage market. Bank competition and low interest rates increased the role of mortgages in stimulating demand.

Private renting accounts for most non-owner occupied housing. There is little tradition of social housing, so that it is only around 4% of the current stock and 6% of newly completed dwellings, and unevenly available throughout the country. Moreover, there has been a programme of sales to sitting tenants, with the aim of reducing management costs and freeing up revenue for new building, so that between 1991 and 2001 the social housing stock fell by 17%.² The National Housing Institute (INH is the Portuguese acronym) owned the largest amount of social housing, but reform in 2002 led to the transfer of its 20,000 housing stock to other bodies, with priority given to municipalities.

Rental controls have been in place for many years. There have been three important dates over the past 30 years in the legislation.

1. Following the 1974 revolution rents were frozen throughout the country.
2. In 1986, new contracts had rents adjusted annually by an official rate broadly linked to inflation. Rents on contracts existing from before 1979 were increased significantly in order to catch up with intervening inflation.
3. From 1990, new contracts were left to the free market.

¹ The house price index is a new one starting in 2001, based on bank valuations for mortgage purposes.

² Housing Developments in European Countries 2003, Department of the Environment, Dublin, 2004.

Roughly 60% of tenancies were still on pre-1990 contracts at the time of the 2001 census. Their rents were only 55 euros on average, compared to 220 euros for the post-1990 lettings. So, tenants of the pre-1990 contracts have little incentive to move, especially lower income ones with no prospect of upgrading their accommodation.

The low rents on the older rental contracts have meant that landlords have had limited incentives to maintain or repair dwellings, so that dilapidation of these properties is high, especially in older, historic areas. In such cases, landlords have found it is worthwhile abandoning properties rather than renting them out. They may hope that dilapidation will become so bad that the property has to be demolished and the plot can be sold.

Controls have thus contributed to a segment of the housing stock being of poor quality – around 6% of the stock. Various government funded renovation programmes have to date had only limited success in improving the quality of the rental stock – though this issue is becoming an increasing focus of policy aims.

In reaction to problems of disrepair, special redevelopment and modernisation funds have been offered by government, and landlords have utilised them. The results are visible in many historic areas. Additional legislation to accelerate urban rehabilitation and redevelopment was enacted in 2004, and this REABILITA Programme was allocated a budget of 55 million euros for the first year of implementation. Therefore, rehabilitation has become a better opportunity for real estate and housing investors.

Rent control and security of tenure have also restricted the option of a 'return to the city' common in the historic districts of many European cities. Instead, higher housing aspirations can only be met by moving to new developments in the suburbs. Subsidised new housing, therefore, has been substituting for adequate repair and modernisation in the unsubsidised, unprofitable, older parts of the stock. This probably represents a significant misallocation of resources. The dilapidation of attractive historic areas, in addition, also acts as a wider constraint in a country with a large tourist element in general economic activity.

In 2004, the government announced plans for further decontrol of the pre-1990 contracts. Decontrols were to be gradually introduced and substantial exceptions are going to be made for older and lower income tenants. The dissolution of Parliament and the February 2005 elections have brought this policy into doubt.

State subsidies take four principal forms. There are grants for the construction of social housing; credits to encourage renovation in the private rental sector; loan subsidies so that low income and younger households can purchase owner-occupied

dwellings, or landlords can provide them with low cost rental housing; and mortgage cost deductions from income tax (both amortisation and interest costs). The latter, however, are capped at the small sum of 575 euros a year. Savings accounts for housing are also eligible for tax relief up to a level of 2,302 euros a year. These funds can be used for new house purchase, or improvements or repairs to existing dwellings. Because of their tax efficiency, they are popular savings vehicles.

Subsidies to rental housing are falling – by 10% between 1998 and 2002 – while they were growing in respect of owner-occupation by a similar proportion and, by 2002, the latter represented 80% of fiscal subventions to housing.³ Loan credits were curtailed after 2000 following concerns over the misuse of funds by borrowers.

Altogether state housing subsidies and tax breaks account for around 2% of total government expenditure. They have been falling somewhat in real terms in recent years. The decline reflects the cyclical behaviour of the housing market and conscious policy aimed at reducing the budget deficit. In 2004, the Finance Ministry suggested that all housing tax breaks were an inappropriate use of public resources, especially as housing shortages and interest rates were much reduced in comparison to the past.

There is a sales property tax of 0 to 6%, depending on property value (maximum is paid on properties worth over half a million euros) and an annual property tax of 0.2-0.5% of dwelling values,⁴ which is the main source of revenue for municipalities. All dwellings now have to have a compulsory 'identity' card, listing attributes of the dwelling, which provides information for use in property valuations for tax purposes, amongst other items.

Other transaction costs of house sales are associated with legal and sales agent fees. The former are around 0.5% of value, and the latter have fallen noticeably in recent years, from 5% to 1-2%, as a result of greater competition. There is also a small property registry fee.

Households tend not to move frequently once they have settled into a dwelling, so that the second hand market is noticeably less active than in some Northern European countries. The youthfulness of the stock and rent controls further contribute to the limited levels of transactions in the existing stock.

Traditionally, dwellings were handed down through the generations, though this is less common now, as children are more likely to move to other areas and cities in the modern economy. When families or family members move from rural areas to urban ones, the old country dwelling may well stay in the family as a second home; otherwise it might join the mass of vacant dwellings unlikely to be occupied again.

³ Housing Developments in European Countries 2003, Department of the Environment, Dublin, 2004.

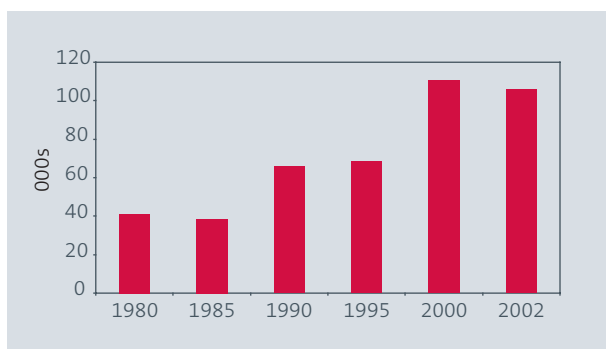
⁴ This rises to 5% for off-shore owners.

Housebuilding and the housing stock

The past two decades have seen a substantial growth in housing output, driven by demographics and rising living standards. Housebuilding rates in recent years are running at 2.5 times the levels of twenty years ago (Figure 17.2). This has added significantly to the housing stock, which has risen by almost half in 20 years, while the population has only grown by 4%. Building has been concentrated in the home ownership sector, with less than 2% of new building estimated to be available to rent. The country now has one of the youngest stocks of housing in the EU, with 44% of it built since 1980. This reflects the scale of the investment into improving housing standards in recent decades, and the extent of the transformation of urban areas that has taken place in parallel with such high levels of building.

Around 8% of national income is now spent on residential investment, and the country has the second highest level of house building per capita, after Ireland, in the old EU15. This, plus tightened legalisation, has led to a marked reduction in the number of informal dwellings, once concentrated around the fringes of Lisbon and Porto, of which there were over 500,000 as recently as the 1980s.

Figure 17.2: Housebuilding 1980-2002

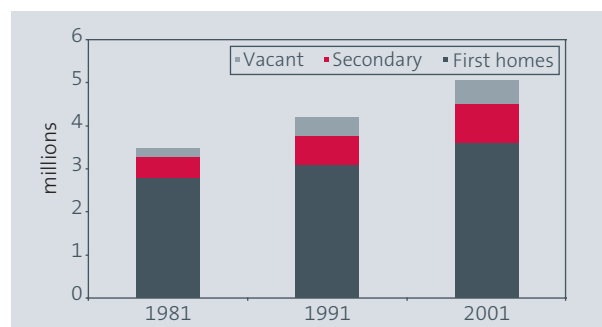


Source: Housing Statistics in the EU 2003

Following high levels of housebuilding for some years, the housing stock is now over 5 million dwellings (Figure 17.3), giving a crude dwellings-to-population ratio that is one of the highest in Europe. The ratio of first residences to population is not so great, however, because of the high number of second homes and vacant dwellings, which means that only slightly more than 70% of the stock is used as primary dwellings.

There are around a million second homes, representing 18% of the stock. Portuguese households in virtually all income levels have a high propensity to own second homes for similar motives to those in first residence ownership. The investment motive is heightened by the ability to rent out dwellings to holidaymakers. In addition, many second homes are owned by other EU nationals from Germany, Ireland, the Netherlands and the UK, in particular.⁵ A high proportion of the stock is also vacant, almost 11% (Figure 17.3), and the absolute number of vacancies has grown significantly over the decades; rising by almost a quarter between 1991 and 2001. Though some of these vacancies are due to transaction and cyclical factors, many are attributable

Figure 17.3: The housing stock – primary, secondary and vacant



Source: INE

to population movements from rural to urban areas. Other vacancies are due to rent controls, as they encourage owners to leave properties vacant and allow them to deteriorate, so that they can eventually be demolished, even in conservation areas, because of their state of dilapidation. The recent proposed reform of the rent control system in 2004 was to have raised taxes on vacant buildings and given greater powers to public bodies to expropriate such dwellings as hoped-for deterrents to such practices. Altogether, around 60% of vacant dwellings (about 330,000 units) have actually been withdrawn from the market. Such structures in reality therefore represent past housing rather than effective existing stock.

Average household size is relatively high, at 2.8 persons per household, a characteristic common in other Southern European countries, such as Spain, Italy and Greece. Partly, this relatively high percentage is due to the low proportion of single person households, at 17%, which is about half that in N.W. Europe. Children also tend to leave home at a late age on average, which is again a characteristic of Southern European housing systems.⁶

The average size of new dwellings is small, at 83 square metres of useful space for both existing and new dwellings. This reflects the generally lower standards of housing compared to Northern Europe and, probably, the inclusion of secondary dwellings in the data. Though small, dwellings tend to have a relatively large number of rooms – 4.7 on average – reflecting the traditional extended family way of life.

Around 45% of dwellings are flats as opposed to houses, though this share is significantly less than in Spain, where over 60% of dwellings are flats.⁷ Apartment living, nevertheless, is the most common urban form, particularly in the larger towns and cities. Flat ownership is of a condominium status, and owners are required to contribute monthly to funds for repairs and improvements to structures, so that generally such buildings are in a good condition. There is a tendency to outsource maintenance and administration to property services companies.

Housebuilding is undertaken in a variety of forms. Construction of traditional single-family dwellings would generally be organised by owners or their agents. Nowadays, however, the building process is more likely to be organised by a developer. New house purchasers typically have to put down a 10-30% deposit before building work commences. This is a significant burden for them and exposes buyers to developer default or delay risk.

⁵ See Chapter 2. ⁶ Census data. See also Barlow et al Housing and Welfare in Southern Europe, Blackwell, Oxford, 2004. ⁷ Housing Statistics in the EU 2003.

Municipalities in general are pro-building and, so, represent far less of a constraint to new housing building than is common in northern countries. The positive attitude to urban development also arises because of the incentives of property taxation. As they are the main source of municipal revenues, local government income increases with more housebuilding. This means that better facilities can be offered to all local households and local politicians are more likely to be re-elected as a result. Consequently, existing inhabitants, outside of protected historic districts, tend to be more relaxed about additional building in their locality than are some of their Northern European counterparts.

Developers, nonetheless, still complain about the structure of the planning system, and not all development is locally popular. There are a variety of bodies at central, regional and local levels that have to give permission for new development, and they may have conflicting views or generate significant delays. Delay is especially identified as problematic with larger schemes.

Although no adequate house price index exists at either the national or regional levels, the price indicators that exist suggest that price evolution over the past decade has been far more moderate than in many other countries, including neighbouring Spain.

Limited fluctuations around the apparent price trend are partly due to the strong drivers of unmet demand and the housing growth needed to meet it in recent decades; government subsidies; the tradition of low levels of second hand sales, and with them a limited impact of existing housing equity on demand; and the stimulus to new building caused by the recent development of a mortgage market. In this sense, the Portuguese housing market is still an immature one. In the future, as it develops additional characteristics common in more established housing systems, such as widespread second-hand sales, house price cycles may become increasingly marked.

Even though prices may not have fluctuated much, variations in housing demand have had far more impact on fluctuations in housing output. For example, in the late 1990s housing boom, output rose from under 80,000 units a year in 1995 to almost 120,000 in 1999 – a 50% increase in only 4 years. The next four years saw output fall again, to around 80,000 by 2004. The prognosis for the future is that output is likely to level out rather than reach the levels of the late 1990s peak again.

This price and output behaviour reflects the apparent high price elasticity of housing supply. When demand grows output rises, moderating price increases, and then building falls again as demand pressures ease in quick adjustment processes to the new reduced level of demand. Semi-built projects, which are put on hold during the downswing, then provide additional quick sources of supply when the market picks up again. If the elasticity of supply continues to remain high, the country is unlikely to experience the price volatility of other EU countries with poorer supply responses.

The current market supply structure enables, and is aided by, price-sticky developer strategies. As demand moderates, they resist cutting prices but rather halt building and delay new

projects. The cushion of up-front deposits from prospective purchasers means that those developers in downturns are under less pressure from lenders to build out and sell at distressed prices than is the case in the highly-g geared development context common in the mature markets of some other EU countries.

Macroeconomic influences

The economy boomed in late 1990s, and the sheer scale of the housing boom then must have contributed significantly to excess aggregate demand. Inflation and the public sector deficit rose in tandem, threatening accession to the euro. In 2001, a slowdown started that turned into full recession by the summer of 2002, and growth remained negative throughout 2003. This helped to puncture a potential inflationary bubble at the cost of depressed consumer confidence and a rise in unemployment. The downturn in the housing market, while other ones in the EU boomed, thus, had its roots in the economic cycle.

There has been a gradual recovery during 2004 but the economy is not expected to pick up until 2005, and the scale of that upturn will depend on the level of economic activity in the countries with which Portugal trades and the competitiveness of exports, which crucially depends on the future path of inflation.

Over the longer-term, there is still a great deal of economic catch-up to take place in relation to the rest of the EU, including neighbouring Spain. For most of the decade prior to the 2001 downturn, economic growth was as good as that of Spain, though from a lower economic base, but growth has lagged behind since then. With reforms, including those in the housing market, and a reining in of public expenditure, the growth trajectory of the next decade could be far better than that of the past few years, which is good news for the housing market. Housing investment as a share of economic activity, nevertheless, is likely to decline from the high levels seen in the decade prior to 2002.

Unfortunately, a cloud remains over the next few years because the fiscal balance is likely still to trouble the economy. The European Commission and the OECD in autumn 2004 were forecasting that the Portuguese fiscal deficit would be the largest as a proportion of GDP of all of the Euro Zone countries in both 2005 and 2006. The pressure will consequently be on to find means of reducing that deficit. The remaining housing subsidies are obvious targets.

Further liberalisation of the private rental sector may be necessary beyond the current reforms, which might well turn out to be rather timid in practice. A better functioning rental housing market would have significant impacts on housing investment in localities where it is needed and on labour mobility, a key factor in continued economic growth and flexibility in the face of potential economic shocks.

The interrelationship between the housing market and long-term economic growth, consequently, is not simply one-way. A well-functioning housing system pays dividends to the economy, as well as vice versa.

Mortgage market influences

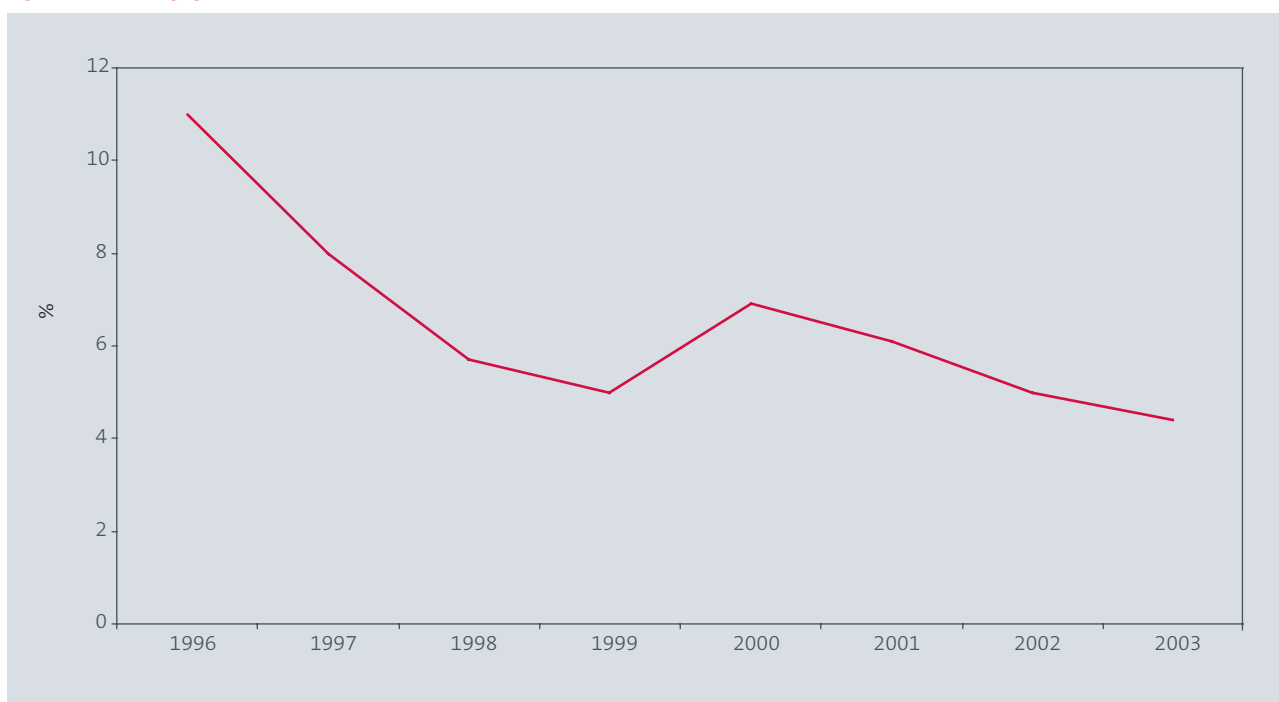
In recent years, borrowing has grown considerably. The scale of the boom in mortgage finance in the late 1990s and early 2000s can be seen by examining the ratio of mortgage debt to national income. By 2002, the mortgage debt to GDP ratio was 50%, and it had risen from just 22% of GDP in only 6 years.⁸ This dramatic shift in consumer housing indebtedness sensibly helped many consumers to spread their housing costs over longer time periods. By doing so, the mortgage market generated a shift effect in housing demand, which provided a key stimulus to the housebuilding boom of the late 1990s.

One reason for the growth in mortgage debt was the switch in interest rate regime from a high nominal interest one – rates in the 1970s and 1980s were generally over 20% – to a low interest rate, one typical of the Euro Zone today. The decline in interest rates, however, has not been entirely smooth. Interest repayment costs, for example, in 2000 and 2001 rose sharply above previously levels, helping to trigger the slowdown in housing market activity (Figure 17.4).

Subsequent interest rate developments in the Euro Zone have benefited housing demand. For most of 2004, housing loan interest rates were hovering around 3.8% – historic lows – which implied a 20% reduction in interest repayment costs compared to the early months of 2003. Mortgage demand has grown rapidly in periods of falling interest rates, but to nothing like the extent of that seen in most of the currently booming housing market countries of the EU. Outstanding mortgages were 5% higher than in the previous year in September 2004, and almost 30% up on 2001.⁹

The sensitivity of the housing market to mortgage interest rates, nevertheless, may have a downside in that any future increase in interest rates may, once again, slow down the market significantly, especially as households are becoming less shielded from the full effects of rising housing market borrowing costs as tax breaks diminish. Yet the prospect of higher interest rates seems a long way off currently, given the renewed slowdown in the euro-economy in the second half of 2004, and the interrelated appreciation of the euro against the weak dollar and the Asian currencies pegged to it.

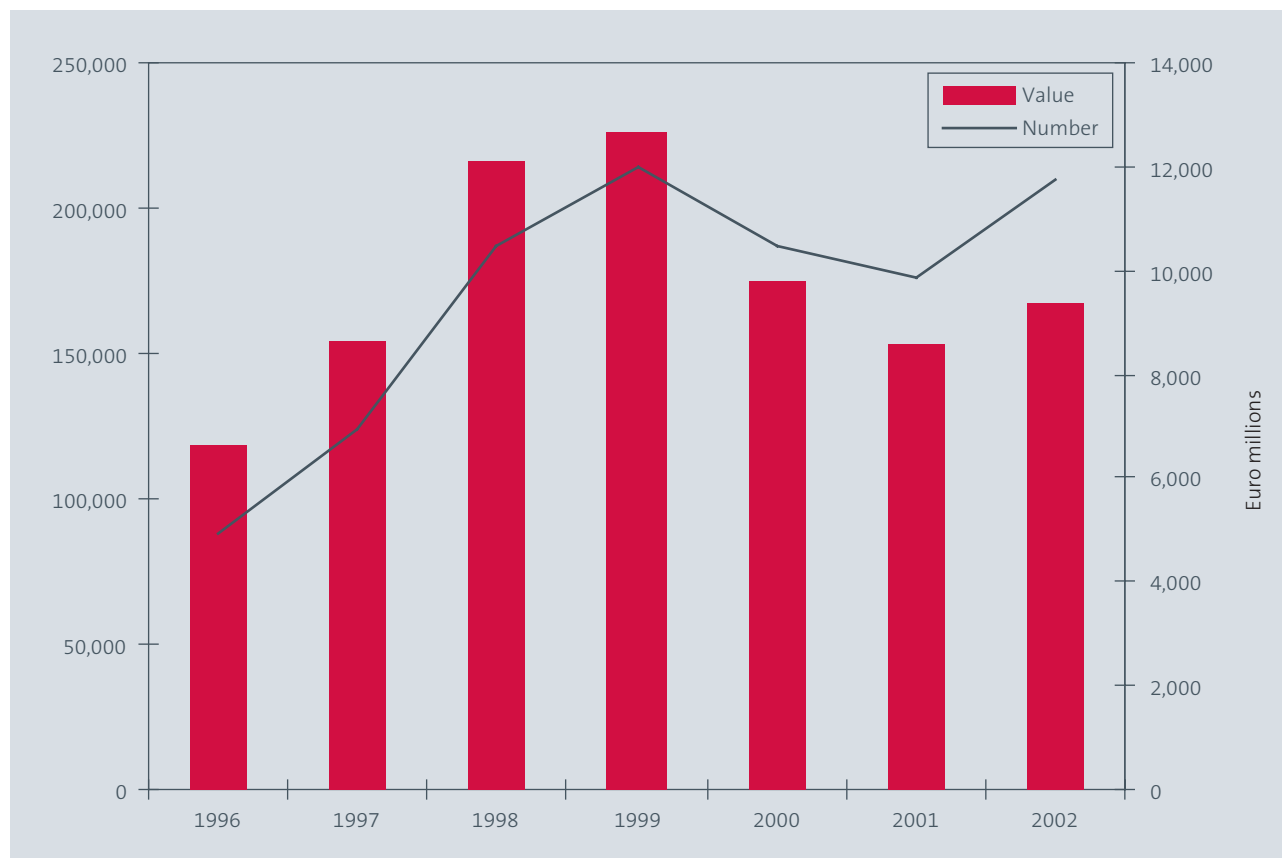
Figure 17.4: Mortgage interest rates 1996-2002



Source: Bank of Portugal

⁸ Housing Statistics in the EU 2003.
⁹ Bank of Portugal.

Figure 17.5: Mortgage market activity 1996-2002



Source: Housing Developments in European Countries 2003

Variable interest rates predominate, with 70% of mortgages of that type issued in 2002, for instance.¹⁰ The reference interest rate for mortgages is generally the one year Euribor rate. Borrowers are charged it plus a spread to enable the financial intermediary offering the mortgage to earn a risk-adjusted return. Interest rate adjustments are made on a quarterly or four monthly basis. There is also a 0.8% stamp duty on new loans. Defaults have been low for many years, encouraging lenders to improve their lending terms.

A previous epoch of high inflation may have been the main cause of the slow evolution of the mortgage market, but even so the history of the financial sector has contributed as well. In 1974, all banks were nationalised and their strategies were henceforth focused on financing the burgeoning public sector, and specialist mortgage lenders faced little competition. So, the country and the housing market missed out for many years on financial innovations taking place elsewhere in the world. By the mid-1980s, there was some relaxation of state control, and bank privatisations began in the early 1990s. The largest bank, Caixa Geral de Depósitos, still remains state-owned, but innovations

and a greater consumer focus have now spread throughout the financial sector.

Two organisations dominate the consumer loans market, including mortgage finance, with a combined market share of around 80%. One is Caixa Geral de Depósitos, and the other is now private, Millenium BCP. A number of Spanish banks have entered the Portuguese market in recent years, recognising the opportunities offered by the relatively undeveloped financial market in contrast to the maturation of the Spanish one. BSHB and BBVA, two major Spanish banks, have taken over pre-existing Portuguese institutions as launching bases for further expansion. The result has been a positive influx of competition.

Mortgage lenders compete in price terms by advertising the size of the spread they offer over the reference interest rate. Non-price competition, as elsewhere, takes place in terms of the flexibility of applicant screening criteria, plus service factors aimed at improving the housing transaction process for clients. One bank, for example, recognises the difficulty of transactions in the second-hand housing market, and offers an advantageous bridging loan facility as an option for its mortgage clients.

¹⁰ BBVA interview, Lisbon.

Demographic influences

Demographic influences on housing demand are in a process of significant change. The years of relatively rapid population growth may now be over (Table 17.2), and they will be replaced in terms of housing demand by an increase in household numbers, which implies smaller family sizes and more single person households. Such a shift indicates that future housing demand will be driven by rising standards of living above all else. The outcome will be a shift from quantity to quality and a more targeted focus in new housing demand on specific types of household and market sectors.

Estimates of future population levels and age distributions are notoriously difficult to make and are subject to continuous review, so that the 1998 projections presented in Table 17.2 may now be becoming outdated. What they demonstrated is the relative lack of importance of the ageing problem. The demographic time bomb is likely to explode far away from Portugal. Concern has been expressed about the growth in the share of the population over 50 in the next 15 years, yet the scale of the issue relative to countries such as Germany and Italy is actually quite small.

Table 17.2: Population and age distribution forecasts

	2000	2010	2020
Population m.	10	10.2	10.1
Shares %:			
0-14	17	17	16
15-24	14	11	12
25-49	37	37	34
50-64	17	19	20
>65	15	16	18

Source: PNEDES 1998

Factfile: Portugal

Background

Population (m) 2002	Population Growth % 1980-2001	Fertility Rate* 2002	Years Life Expectancy 2002
10.2	0.1	1.5	76

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

Services output as % of GDP 2000	Employed as % working age population 2002
66	71

* GDP per person employed 2002

Economic

	200	2001	2002	2003	2004f
Real GDP growth %	3.4	1.8	0.5	-1.3	0.8
Growth in real private consumption %	2.8	2.0	3.4	3.1	3.7
Inflation – GDP deflator	3.5	4.4	4.7	2.3	2.2
Inflation – consumer prices	2.8	4.4	3.7	3.3	2.0
Unemployment rate %	4.0	4.1	5.1	6.4	6.6

Government

	2000	2001	2002	2003	2004f
Expenditure as % GDP	45	46	46	48	47

Taxes

Owner occupied housing	Capital gains exempt	Imputed rental income
Mortgage interest relief – small	no	not taxed
VAT on new dwellings	Taxes on sales	
no	yes	

Housing Statistics in the European Union 2003, Eurostat, OECD, World Bank.

chapter eighteen

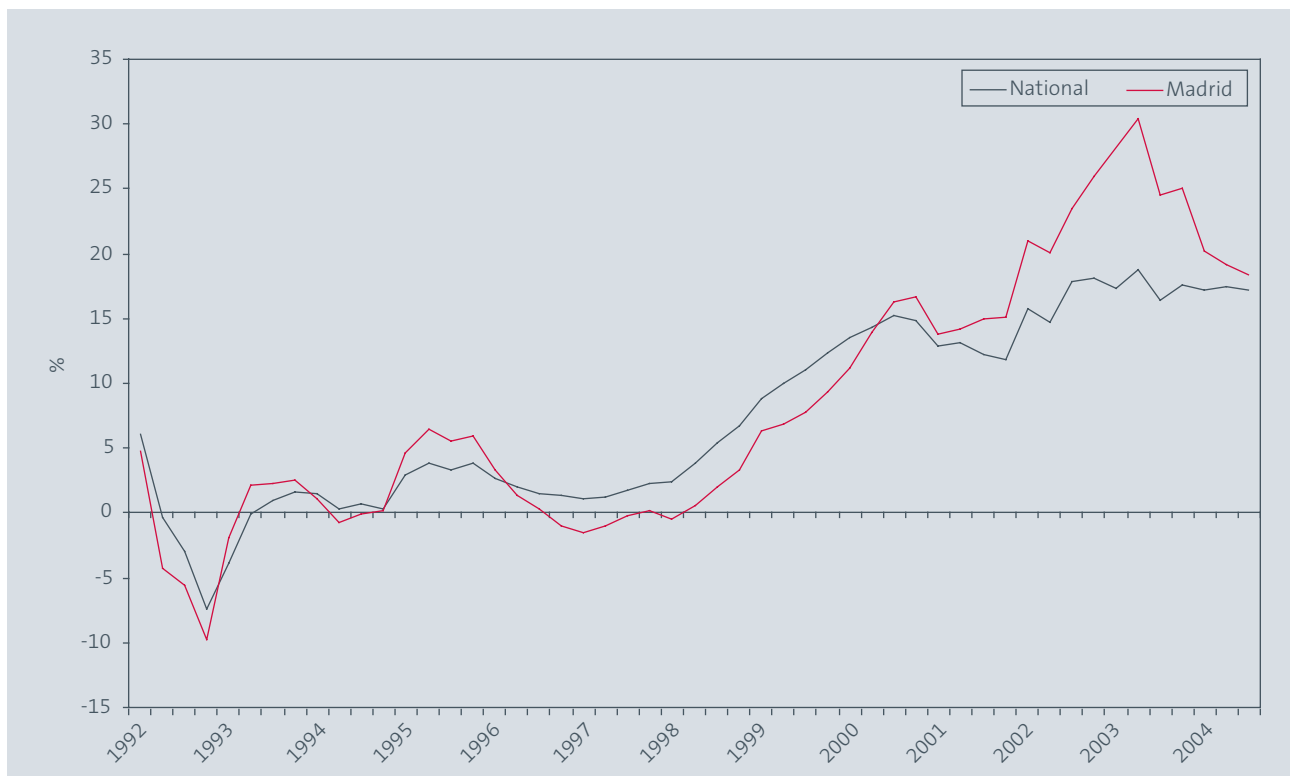
Spain

Overview

The housing boom, though predicted to slow down rapidly in 2004, actually continued to power along during the first 9 months of 2004. Prices were still rising by 17% nationally and 18% in Madrid, on an annualised basis, in the third quarter of 2004 (Figure 18.1). The national figure was little different from what it had been since the middle of 2002; in Madrid, however, the acceleration of prices did slow down from the extraordinary levels of the previous year.

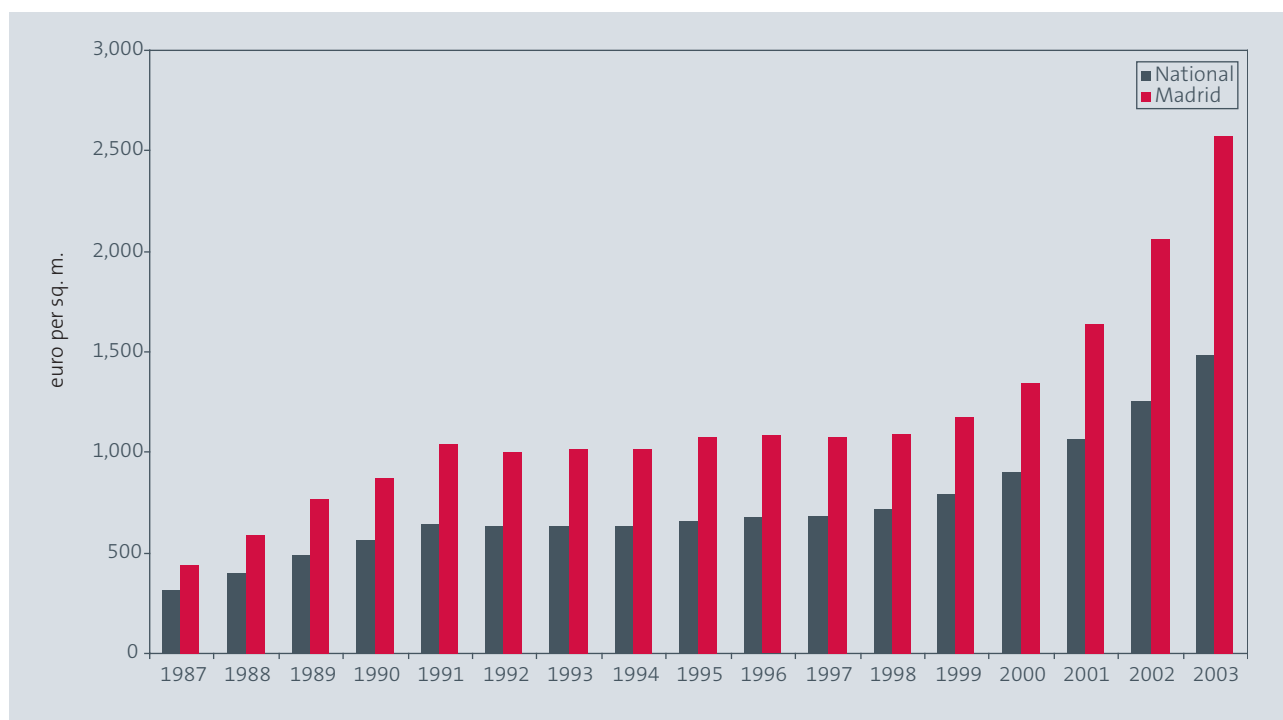
The Spanish boom now well surpasses those of other EU countries, such as in France, Ireland and the UK, and may be setting a world record. Mortgage markets and housebuilding rates gave further indication of the heated nature of the housing market, though there was some slowing down of housing starts in 2004 – suggesting that developers were beginning to anticipate retrenchment.

Figure 18.1: Annual house price change, 1992q1-2004q3



Source: Housing Ministry

Figure 18.2: House prices 1987 - 2003



Much of the increase in house prices in recent years can be linked to the long-term rise in living standards, but the Spanish Central Bank, amongst others, is of the opinion that some degree of downward price adjustment may be in the offing. House price to income ratios have risen from 3.4 in 2000 to 5.5 in 2004, with initial purchase costs now taking more than 45% of an average salary.¹

A prime driver of current demand is substantial expected capital gains in an environment of cheap and easy borrowing – the classic formula for a price bubble. Moreover, much equity withdrawal, as in Ireland, is being ploughed back into the housing market via contributions to children's house purchase and the buying of second homes. The weight of demand, therefore, is overwhelming in the face of very tight supply in the major urban areas, forcing up prices year-on-year. Yet, each year of rapidly rising house prices in such a context suggests a greater likelihood of a sharp correction at some time in the future. Nonetheless, there is little evidence of a major downturn just around the corner because of the low interest rate environment.

One key factor in stimulating the housing market boom has been the marked fall in the real mortgage interest rate, which is now one of the lowest in Europe. Mortgage costs in real terms fell both because of declining nominal rates and because of

rising inflation between 1999 and 2002. In 2003, the real rate was only around 1%, following falls in nominal mortgage interest rates from 5.4% in 2002 to 4.01% in Spring, 2003.² Real mortgage interest rates have probably reached a trough in their cycle. When they rise, this will help to dampen housing demand.

One widely held view is that the current house price boom is part of the 'catch-up' of Spanish economy and housing market with those of the most advanced countries in the EU, combined with the current profiles of demography and mobility. On this thesis, house prices are inevitably rising from their historic levels (Figure 18.2). While there may be some element of truth in such a thesis, it is difficult to understand how any level of acceleration of house prices, no matter how high, can be justified on such a basis. The nearest comparison probably is Ireland, and it is not particularly supportive of the catch-up view. House prices in Spain in recent years have been growing at a faster rate than occurred in Ireland even when it was regularly achieving double digit real economic growth rates in the late 1990s. In contrast, growth in Spain in recent years has been quite modest, at around 2.5%, though better than the euro area as a whole, and the economy is by no means the most dynamic in the EU – yet housing market 'catch-up' should be driven by the economy if it is to be sustainable.

¹ BBVA estimates

² Rates on mortgages fixed for 3 years or more. ECB data.

The housing system

Housing conditions still remain some of the most crowded in the EU, with 3.3 people on average per dwelling. The number of rooms per dwelling, however, is quite high by average EU standards, yet rooms tend to be small as the useful floor area of dwellings is towards the bottom of the EU rankings.

In part, this cramped lifestyle reflects cultural factors. Often several generations of families live together in dense urban accommodation. 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 already own one.

44% of men and 30% of women aged 30 were still living in the parental home in the mid-1990s, the highest proportion in the EU; while only 5% of 65 year olds lived alone, the lowest in the EU (in contrast to over 20% of 65 year olds living alone in Denmark).³ The high cost of urban housing encourages such practices; as does, for lower income households, the relatively high unemployment rate and the associated low share of the working age population in employment – only 60% in 2002 (See Factfile).

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 37% of the stock.⁴ 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.⁵

Owner- occupation and second homes

Most housing is owner-occupied. Homeownership is the one of the highest in the EU, at 83% in 1999.⁶ Tax breaks for homeownership are generous, which has helped to discourage private renting and fuelled the current owner-occupied housing boom.

Some newly built owner-occupied housing is given subsidies in the form of reduced interest on loans, via means testing schemes, known as 'Vivienda de Protección Oficial de Promoción Vivada', or VPO for short. VPO housing subsidies now help to finance about 50,000 units a year, in contrast to much higher rates in earlier decades. The new Socialist government aims to increase substantially the number of VPO-funded homes as part of its drive to make housing more affordable and available to lower income groups. Even in the so-called unsubsidised market, purchasers enjoy significant tax breaks – including mortgage interest tax relief and no taxes on capital gains.

14% of the stock was second homes in 2001 – and the share will have grown since then – and, of the overall stock of 19 million dwellings, a high proportion are vacant – 15% in 1998 – often because they are either extremely rundown or in the more remote locations that are losing population to the growth areas. Almost 30% of existing dwellings, consequently, are not in the main prime residence market and a third of new homes are purchased as second dwellings or as investments.

Secondary homes tend to be located on the Mediterranean coast, in the Balearic and Canary Islands, and in the internal rural areas of the country. The secondary home market operates independently of the primary one, and is influenced both by domestic economic conditions and the economic situation in countries such as Germany, the Netherlands and the UK, because many purchasers are foreign nationals. A substantial amount of new building is for second or retirement residences, distorting considerably the apparent supply situation in the primary residence market at the national level (see below).

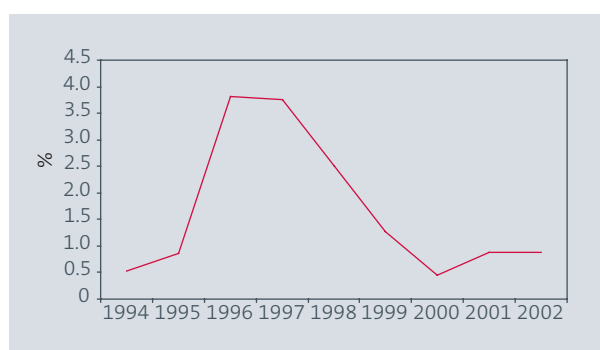
Renting

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 dwellings classified as social. Public sector and non-profit provided social housing of the type common in many other EU countries, therefore, 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, pro-ownership subsidies and tax-reliefs, and consumer preferences. Rent increases have been limited in recent years after some growth from 1996 to 1998, despite the scale of current general housing shortages (Figure 18.3). Returns are consequently generally low with the exception of windfall capital gains from sales of vacant properties to homeowners.

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 on new tenancies were liberalised in 1985 – though leases still run for a minimum of five years and landlords face legal difficulties over non-payment of rents. Tenancies taken out prior to 1985 still have security of tenure and low rents, which makes this a low return, poorly maintained sector. There are only limited rent allowances for low income families, which constrains their ability to operate in the liberalised sector, and this holds back the demand for renting.

Figure 18.3: Real rent increases 1994-2002



Note: Same series applies to both private and social renting.

Source: Housing Statistics in the EU 2003

³ Household scenarios for the EU, 1995-2025; M. Alders and D. Manting, Statistics Netherlands working paper in population.

⁴ Housing Statistics in the EU 2003. ⁵ Housing Statistics in the EU 2003. ⁶ Housing Statistics in the EU 2003.

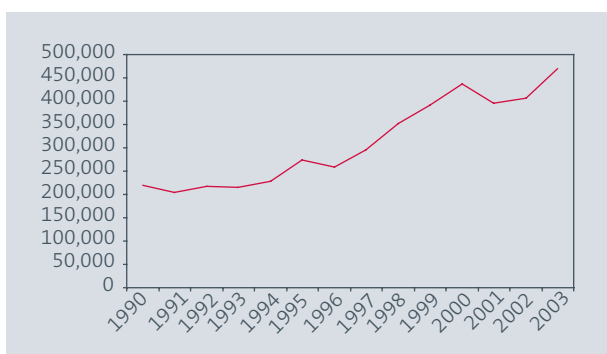
Rising house prices have also encouraged households to switch from renting into homeownership to take advantage of the expected capital gains. In so far as price rises slow in the future, renting may consequently become more attractive, but it will still be discouraged by the tax advantages of homeownership.⁷

The new 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. How it plans to achieve this is unclear. One potential programme being worked up is to build social housing on 6 million square metres of identified land, using a public sector organisation, SEPES, that traditionally has been concerned with industry. However, housebuilding only gradually has an impact on the housing stock, because the latter is so large relative to annual housing output. Without substantial transfer of owner occupied-housing into the rental sector, consequently, it is difficult to see how to double the relative size of the rental sector in the near future, and such a transfer seems unlikely.

Housebuilding

Growth in housebuilding has been variable since the mid-1990s and it is also highly seasonal, with sharp peaks occurring in the summer months. With the surge in house prices after 1998, output did initially rise rapidly but it peaked in 2000, dipped in 2002 and then rose again somewhat from 2002. Furthermore, much of the new output is destined for the second and investment home markets, and shortages are highest in the places of greatest demand, the major cities. Around 55% of housing output in 2004 took place in the tourist coastal areas, whereas only 9% occurred in the big cities.⁸

Figure 18.4: Housing starts 1990-2003



Source: Housing Ministry

It is widely argued that policy-induced land supply restrictions in the major urban areas are major causes of the sharp rises in house prices.⁹ Several pieces of legislation were introduced in the early 1990s with the aim of modernising the planning and land supply process. Unfortunately, they still contained features that hold back residential land supply.

Land is made available in the planning system via designating the whole country into zones of urban, developable and protected land. In the decentralised political structure, there is no central co-ordination of land-use planning, so planning

policies vary widely between regions and municipalities. Despite this variability, local government generally responds to the land release incentives, or their lack, that local government finance and the planning system give them.

An important element in local government decision-making processes over residential land availability is the fact that real estate is the major source of municipal income, especially in the current boom conditions, when land and property prices are extremely high. As part of the process of winning permission to build on new land sites, developers have to give 10% (originally 15%) of the site to the local municipality. The municipality may use the allocated land for subsidised VPO housing and urban facilities, or it can resell it on the development market. Taxes on land sales also accrue to local governments. As most local public income comes from such land transactions and other property value-based local taxes, municipalities have an incentive to restrict land supply in order to encourage high local land and property prices and maximise their tax take.

Macroeconomic influences

Economic growth has been stronger than the EU norm since 1995. It averaged an impressive 4% a year between 1998 and 2000 for what is, after all, one of the larger countries in the EU with 10 times the population, for example, of Ireland. The slowdown in the world economy since 2001 has pushed down the rate of growth, but it is still high by general EU standards. Real consumption growth has remained strong as well (see Factfile).

There has been a long epoch of growth and change since joining the EU. Markets have been liberalised; industry has been modernised; EU funds and government investments have helped to improve the country's infrastructure; and foreign investment has played a key role. In this process of growth, the economy has become more open. Real per capita incomes are catching up with levels in the most advanced countries of the EU, which has stimulated the consumption of durable goods, including housing.

Job creation has been strong, especially since 1999, and the extra employment rapidly translates into additional household formation and demand for housing. Yet unemployment is still high, at 11% – although it has fallen considerably from a 24% peak in 1994 – and the economic activity rate amongst the working age population, at 60%, is still low compared to many other European economies. Labour market restrictions, including job protection legislation, are said to contribute to the high unemployment rate. The price indexation of many wage contracts also means that inflationary pressures are rapidly transmitted through the labour market. Inflation was falling throughout most of the 1990s, but it rose in 2000 to 3.5% and has fluctuated between 3.5% and 4% for the economy as a whole since then, although consumer prices are expected to drop below 2.5% inflation in 2004. The relatively high rate of inflation means that real interest rates on loans are extremely low and have been negative in a number of years, helping to stimulate mortgage demand and house price inflation.

⁷ OECD Country Report Spain, 2003. ⁸ BBVA. ⁹ See, for example, OECD Country Report Spain 2001

The share of public expenditure in national income is around 40%, having fallen slightly in recent years. The government's budget is also broadly in balance. Housing demand has also been stimulated by high levels of public infrastructure investment, which have facilitated urban expansion in the major cities and opened up new areas for second homes. Housing subsidies and tax income reductions were reduced as part of a reform of general tax policy in 1999. The principal effect was to limit tax breaks to first homes, thereby excluding second homes from their previously generous tax breaks. Cash grants are given to low income buyers, but administrative delays mean that they are received very late, which puts some such households in difficult liquidity positions.

The new government intends to extend further housing subsidies towards lower income groups, in attempts to improve affordability and accessibility for them without cutting back on tax breaks elsewhere, so the fiscal stance towards housing is likely to become even more generous than in the recent past. The policy of extending demand and supply subsidies for specific groups may have the unfortunate effect of stimulating aggregate housing demand further during a housing boom and, in so far as it succeeds, of crowding out supply in unsubsidised sectors of the market. The overall consequence may be to give a positive push to house prices with little positive impact on affordability. If the government wishes to direct housing policy effort towards specific income groups, it may be wiser to rein in current tax breaks and target them. Moreover, waiting to stimulate demand until the current boom burns itself out may be advisable to avoid further destabilising a market that is already showing signs of marked disequilibrium. Housing shortages cannot be solved rapidly, and hoped-for quick fixes targeted at politically sensitive groups can easily backfire and worsen housing affordability, as Irish governments discovered a few years ago.

Mortgage markets

The liberalised mortgage market has played a significant role in the expansion of housing over the past decade. Mortgages are mainly advanced by banks, with savings banks taking around a 60% share and commercial banks somewhat over 35%. The standard mortgage product has a rate that is variable on an annual basis, with around three-quarters issued on such terms.¹⁰

Mortgages have traditionally played only a small part in the housing market, so that the volume of outstanding mortgage debt has started from a low base, in common with other Southern EU countries. In 1990, outstanding residential mortgage debt was only 14% of GDP; growth since then, however, has more than doubled that share. (It stood at 38% in 2002).¹¹ Because of the high level of homeownership, most of this housing debt is held by households. The overall household debt ratio – in which housing debt is the most rapidly growing

item – rose from 50% of gross household disposable income in Spring 1998 to 83% by the end of 2002.¹² Household indebtedness, therefore, caught up with the EU average level in the space of a few years, though it is still way below levels in the UK and USA. Lower interest rates, however, have meant that the cost of financing that debt has fallen, and incomes are also rising. As a result, the ability of households to repay their debts as measured by the debt burden, the ratio of loan repayments to disposable incomes, has remained constant over the past few years.¹³

The volume of mortgage advances took off along with the housing market in 1997, since when growth has been robust. In 1996, monthly mortgage transactions were running at around 30,000, and by 2004 they were nudging 100,000 a month – and the increase in house prices meant that the value of loans rose at an even faster rate. By September, 2004, Spanish Mortgage Association data showed outstanding residential mortgages at 550 billion euros, over a fifth higher than a year earlier.

Borrowing for housing is a large part of general consumer lending, reaching 73% in 2002, with over €250 billion in new loans and securitised funds. How much of this was refinancing to take advantage of higher house prices and equity withdrawal is unclear. Given the predominance of annually variable interest rates, nevertheless, the phenomenon of large-scale refinancing of fixed rate loans is absent.

Competition between lenders is strong and there has been little credit rationing beyond normal lending credit-worthiness criteria, except in the years between 1991 to 1993 when banks experienced a high level of mortgage defaults. At the end of the 1990s, mortgage lenders began to offer more favourable terms, in the form of extended loan terms of 25 to 30 years and increased loan to house value ratios. They also started to extend mortgages to up to 100% of dwelling value. In Autumn 2004, the Finance Minister announced that borrowers would be able to switch their loans from one lender to another without having to pay fees for doing so, in a move aimed at intensifying competition in the existing mortgage market. This is likely to put pressure on the dominance of savings banks, as commercial banks will be more able to compete for their existing customers.

New, easier terms on mortgage lending, a high average mortgage to income ratio, and the current level of house prices all indicate that the sheer magnitude of the recent boom has now exposed mortgage lenders to greater risk than was the case earlier in the housing market cycle, although current defaults are extremely low. Housing wealth, net of mortgage obligations, is still rising. Mortgage exposure risks, therefore, are more associated with particular individuals and parts of lender portfolios, rather than being a major concern. Given the current performance of the economy and favourable interest rates, a situation of large-scale defaults similar to that in 1992 is still unlikely.

¹⁰ Housing Statistics in the EU 2003.

¹¹ Housing Statistics in the EU 2003.

¹² Bank of Spain.

¹³ Bank of Spain Financial Stability Report 2003.

Demographic influences

The reduction in the birth rate and the ageing of the population are having significant effects. Demographic data and population forecasts show that there was something of a surge in population from 1997 to 2001. Household numbers, for example, rose by 7% between 1997 and 2000, but the rate of increase is now tailing off. This rise, it should be noted, corresponded with the current upswing in the housing market, and forecasts suggest that demographic factors will put less pressure on local housing markets in the near future. Furthermore, the population is expected to stagnate until 2010, and decline from then on – although immigration may reverse some of the slowdown.

The birth rate is now the lowest in the EU, alongside that of Italy. The average number of children per woman is only 1.3, whereas it was one of the highest until the early 1980s. This further suggests that household formation will see a significant fall in the near future, as fewer children born since 1980 will translate into less house purchasers 20 to 30 years later. Part of this dramatic change arises from the greater role of women in the labour market and in higher education, both of which encourage later childbirth. Yet other important factors have been the high unemployment rate and the much greater insecurity of employment, particularly amongst young men. This has delayed the age of marriage for many, while already married and co-habiting couples have put off having children. Unless there is a dramatic change in births, the population will start to age rapidly over the coming decades.

Such demographic factors will gradually alter demand for particular house types as current age cohorts move through the stages of their housing life cycles. Moreover, with less children around, the decline in average household sizes will speed up. Over the next decade, the number of people aged between 20 and 39 years old will continue to grow, however, and household numbers are likely to increase substantially as the tradition of multi-generational living in the same household weakens. So, any potential demographic time-bombs for the housing market may be some way off and are more likely to have gradual effects, especially if labour market participation rates continue to rise towards those of the more economically advanced parts of the EU.

Regional migration flows are substantial, and the areas experiencing the greatest increase in household numbers are predominantly those with the fastest economic expansion. Increasing immigration from abroad is creating housing problems in such areas, because understandably they are the places where migrants wish to live but face affordability problems on their low incomes.

Factfile: Spain

Background

Population (m) 2002	Population Growth % 1980-2001	Fertility Rate* 2002	Years Life Expectancy 2002
41.1	9	1.3	78

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

Services output as % of GDP 2000	Employed as % working age population 2002
66	60

* GDP per person employed 2002

Economic

	200	2001	2002	2003	2004f
Real GDP growth %	4.2	2.8	2.0	2.4	2.9
Growth in real private consumption %	4.0	2.8	2.6	3.0	3.3
Inflation – GDP deflator	3.5	4.2	4.4	4.2	3.5
Inflation – consumer prices	3.5	2.8	3.6	3.1	2.3
Unemployment rate %	11.0	10.5	11.4	11.3	10.9

Government

	2000	2001	2002	2003	2004f
Expenditure as % GDP	40	40	40	40	39

Housing market

	2000	2001	2002	2003	2004f
Growth in residential investment	7.4	0.9	3.9	5.4	5.5

Taxes

Owner occupied housing	Capital gains exempt	Imputed rental income
Mortgage interest relief – yes, with exceptions	yes	not taxed

Property taxes as share of all taxes 2002	Property taxes as share of GDP 2002
7%	2%

Housing Statistics in the European Union 2003, Eurostat, OECD, World Bank.

chapter nineteen

Sweden

Overview

The housing market exhibited renewed price vigour in the Spring and Summer of 2004, with prices rising at 8% (Figure 19.1). The strength of the economy in the last few years combined with low interest rates have been the main drivers of extra housing demand. Nevertheless, price behaviour has been more volatile in recent years than during the strong growth period from 1997 to 2001. There has been a notable downward shift in price growth in Stockholm since the heady double-digit price rises of a few years ago. Then, the capital led the country in house price growth; now, it tends to trail.

On the negative side, construction and land price inflation are raising the cost of house purchase. Higher house prices and a lack of new rental supply, furthermore, are creating problems of housing affordability in the boom regions in a similar way seen in many other growth regions in the EU.

The country has long been famous for its interventionist housing policies and high housing standards. 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, these subsidies were almost entirely withdrawn and housing policy was given far less government attention. The housing ministry was even symbolically abolished.

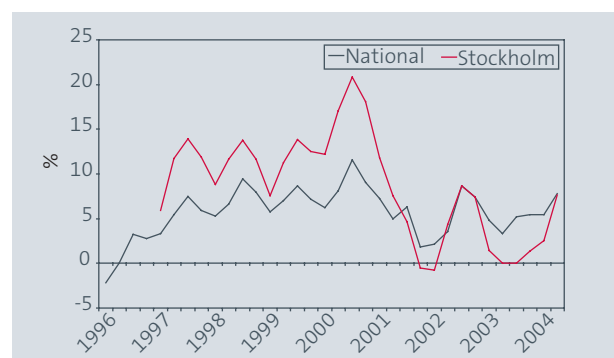
The scale of the decline in housing subsidies has been huge: from SEK 33,000 million in 1993 to only SEK 1,400 million in 2002. Policy emphasis, instead, has been placed on unsubsidised initiatives, which means that homeownership in its broadest sense has grown significantly.

Even so, it is far from clear that government has abandoned the driving seat in housing provision. The 'hands-off' rhetoric of the early 1990s after some disastrous policy mistakes turned out to be short-lived. Although responsibility for housing was devolved to municipalities, the absence of a housing ministry did not last long. A housing division within the Ministry of Finance was set up in the 1990s to liaise with the municipalities, and housing now resides in the new Environment and Community Development Ministry set up in November, 2004.

Central government now seems to be hoping for policy options that are cheaper on state funding than past ones, and also more consumer and economic-growth friendly. The housing market is surrounded and structured by a series of state constraints, incentives and policy initiatives, so that housing provision in Sweden is still one of the most overtly state-managed systems in the world. Whether this has led to a better housing situation with positive social, economic and other benefits compared to other less-regulated countries of a similar standard of living, is a matter of debate. Housing standards are certainly high, so the issues more concern cost and flexibility. The most important economic housing policy issues relate to fiscal matters, tenure arrangements, land supply and rent regulation.

Since the 1980s, the housing situation has been transformed by the expansion of homeownership in the context of newly liberalised mortgage finance. Along with that change came a marked house price cycle. There was a major housing depression in the early 1990s, following a house price boom in the late 1980s. The unprecedented scale of the early 1990s slump came as a shock to policy makers, financial institutions and consumers alike. The collapse of the bubble saw house prices fall to their mid-1980s levels again, and the market languished from 1993 to 1996. From 1997, the market boomed again, initially with real price rises of a broadly similar magnitude to those of the late 1980s. Economic problems brought price rises to a halt in the second half of 2001, but since the summer of 2002 they have revived nationally.

Figure 19.1: House price changes quarterly 1996-2004q2*



* Single-family dwellings

Source: Swedish Statistics

Housing system

Sweden has the smallest average household size in the EU, at 2.1 persons per dwelling. This is partly due to the very high number of single person households, which at 41% is the highest in the EU, compared for example to 29% in the UK. Even so, the average number of rooms per dwelling is good, at 4.3, and the overall quality of the housing stock high – reflecting the years of very high housing investment up to the 1990s.¹

Single-family owner-occupied dwellings are exclusively found in one or two family houses, which represent 45% of the housing stock, while most rented and co-operative dwellings are apartments. In general, one and two-family houses are more spacious than apartment dwellings. A typical owner-occupied house consists of five rooms, kitchen excluded, while an average flat consists of three rooms. Hence, owner-occupied housing is predominantly inhabited by families with children, while rented and co-operative dwellings contain a higher proportion of childless households.

Housing investment in the 1990s slumped with the market crisis and the sharp reduction in state support. Since 1995, it languished at between 1 to 2% of GDP – far lower than the EU average of 5 to 6%.² As a result, in the second half of the 1990s marked shortages began to appear in the growth regions. In 2001, 20% of municipalities where 45% of the population lived were reporting housing shortages.³ Housing costs are also relatively high nowadays. On average, households in the rental sectors, for example, spend almost 30% of their disposable income on rents.⁴ Nonetheless, the range of housing costs across households and tenures is very uneven, with many dwellings in growth areas having rents that are well below market levels for reasons that are explained below.

The housing system is quite complex. There are four tenures: single-family owner-occupied, owner co-operatives, and private and public rental. 38% of all dwellings are single-family owner-occupied, 16% are in the co-operative sector (which are owner occupied on a specific basis, see below) and 46% are rented – almost half of which are in the private sector.⁵

Statistics on tenure shares in Sweden vary between data sources, but it does seem as though owner-occupation is growing.⁶ This is not surprising, as the subsidies towards rental housing have fallen markedly; interest rates movements and mortgage market competition have made mortgages more available and affordable; and growing affluence is raising the housing quality and space demands of many households, which cannot be adequately met in the rental sectors. Yet, the very low housebuilding rate is undoubtedly frustrating the growth of owner-occupation, and helps to explain the significant trend rise in house prices.

The proportion of single-family homeownership has grown somewhat since the early 1980s, when it stood at around 35% of all dwellings. Owner co-operatives have grown rapidly in importance, so that this sector has been the main source of expansion in owner-occupation over the past two decades.

Owner-occupation

Almost 55% of the housing stock is flats in multi-storey buildings, one of the highest shares in Europe, with the rest in single- or two-family units. Strictly speaking, homeownership is limited to the single-family 'outright ownership' sector, but the owner co-operative flat sector confers substantial tradable property rights on participating households. The purchase of such dwellings has been substantial. Over 70,000 of them were bought both in 2002 and 2003, and they are playing a particularly important part in slowly increasing the role of owner-occupation in the housing stocks of the major cities of Stockholm, Gothenburg and Malmö, where renting predominates. Around half of all new purchases of owner co-operative dwellings are in these big three cities.

Co-operatives are in many respects similar to condominiums, though their characteristics differ in certain important ways from arrangements in other countries. From a legal perspective, co-operative associations own the apartment structures but households can sell their 'right to occupy' them on the open market once it has been bought from the co-operative at its set-up. Until 2004, it was impossible under Swedish law to own an individual apartment outright, so co-operatives are a legal, alternative form of ownership that have now become an important institutional part of the housing scene.

Co-operatives generally own only one estate or apartment building. This means that a new one is generally formed for a new build project, or when an existing rental property is upgraded and converted to co-operative status. In either case, the new association takes out a mortgage for most of the cost, with a lesser part financed through contributions from co-operative members in exchange for a tradable right to occupy a specific dwelling. These contributions may be self-financed or funded by personal mortgages, provided under similar conditions to mortgages on single family houses, though they incur slightly higher interest rates to cover the somewhat greater default risk.

Housing co-operative members are charged monthly fees to cover the costs of the mortgage taken by the association, and maintenance and repair costs. The right of occupancy asset traded in the market for co-operative dwellings includes an obligation to pay the monthly fees associated with the dwelling. Traded prices consequently depend not only on the market value of the dwelling as such, but also on how well the association is managed, the charges they impose and the default risk of other co-operative members.

Individual members can claim tax allowances corresponding to 30% of interest payments on the mortgages they take out personally. Some allowances are also given for the mortgages held by the co-operatives, but generally they are much smaller in scale. As in the single family house sector, imputed rent is taxed on the basis of the assessed value of the property. In practice, the tax rate is far from uniform, because the relationship between assessed value and market value varies greatly.

¹ Housing Statistics in the EU, 2003 ² Housing Statistics in the EU, 2003. ³ Regular National Report on Housing Developments in European Countries 2004. ⁴ Housing Division of Ministry of Finance. ⁵ Regular National Report on Housing Developments in European Countries 2004. ⁶ Partly, this is because there has been no Census since 1990.

In general for owner-occupiers, mortgage interest can be deducted from tax allowances corresponding to 30% of gross expenditure at the purchaser's marginal rate of tax. Offsetting this is a tax on the annual 'imputed' rent implied by the capital value of the property. The capital value, in fact, is an 'assessed value' roughly equivalent to 75% of the market value.

Developments over property taxation were triggered by the fact that the freeze on tax assessment values on houses since 1997, ended in 2001. As prices were rising, the tax imposition on homeowners was likely to grow significantly, and governments responded by lowering the tax rate. This was first done in January 2000, when the tax rate on multi-dwelling buildings was lowered from 1.3 to 1.2 percent. Further reductions in 2001 cut the rate on houses from 1.5% to 1%, and on apartment buildings to 0.5%. The overall property tax take is quite low – less than 1% of GDP after these measures. Part of the reason why it is so low is that there is no local property tax. In another tax adjustment, the exempted amount in the wealth tax was increased to SEK 1m for single persons, and to SEK 1.5m for married persons or partners with children.⁷

There have been proposals to abolish both mortgage interest tax relief and the imputed rent tax altogether, with the idea that the pain of no tax relief is offset by the gain of no property tax, making the move more politically acceptable. So far, however, the changes have been limited to confining the rate of tax relief on mortgage interest to a 30% tax rate. A further 15% tax is imposed on capital gains that arose during the course of ownership – charged at the time of sale, net of certain expenditures. Payment of the tax can be delayed until the subsequent sale, however, if the owner buys a dwelling with a price at least as high as that of the one sold. There is also a 'fee' charged by the state for registering a new acquisition, amounting to 1.5% of the transaction price, which is generally regarded as a tax.

A VAT tax of 25% is charged on new housing. However, some downward adjustment to this rate has occurred in recent years in areas of high demand as a means of encouraging new building of specific housing types (affordable accommodation, student housing, etc.). New housing is also exempt from property taxation for five years.

Rental housing

Social housing is predominantly owned by municipal housing companies (MHC), independent non-profit housing organisations owned by local authorities. Anybody can apply to live in a social rented dwelling, because traditionally the means-tested criteria that are common elsewhere in the EU do not apply. Strong long-term policy emphasis has been put on equality of access and avoidance of spatial differentiation by income or social group. Recently in areas of high housing demand, however, MHCs have been operating screening policies that weed out potentially high cost tenants by refusing lettings to those with records of poor rental payment or eviction.

Rents are set in aggregate, in order to ensure that MHCs do not make a profit from their housing stock. The patterns of relative

rents for individual flats reflect quality differences. Rents, therefore, are largely historic cost based and reflect the age composition of the social housing stock.

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 and private landlords organisations, in the social and private sectors respectively. The overall costs of MHCs essentially set the average rent level. This has the unfortunate side-effect of limiting the incentives MHCs have to be efficient, because they always know that local rents will be set to cover their costs. Negotiations then determine rents for the different dwelling types and locations within stock. Private rents in the negotiation process are compared to social ones, which leads to rent conformity across tenures.

This rent-setting structure means that rents in attractive central urban locations are often well below market clearing levels. As housing shortages have grown in the major cities, this has encouraged intricate rationing procedures to deal with excess demand and black-market transactions. Such procedures greatly raise search costs for prospective renters. As tenants can sub-let, shortages mean that sitting tenants can enjoy substantial windfalls by re-letting.

The cost-based rents of the social sector are low, as the stock was mainly built before the mid-1970s and most debt on it is now paid off. Such rent levels do not encourage efficient use of the stock. Existing tenants have little incentive to move with such attractive rents and, because the criteria for entry to the tenure has been very broad in the past, people from a wide variety of social strata can end up with substantial gains, whose social cost is questionable. Queues to enter the tenure are long in areas of high demand.

The private rental sector is also quite large – roughly the same size as the social sector – though it has declined significantly over the past two decades, due to the limited profitability offered with the dominant role of the MHCs in rent-setting. Rents are ostensibly freely negotiated but, as noted above, they are set in the context of average local rents, which are generally determined in the social sector. This means that they are usually way below free market levels.

There has been a gradual tendency for rents in nominal terms to rise, because costs are increasing as a result of the removal of subsidies, the limited incentives MHCs have to lower their costs, and in response to general price inflation. As Figure 19.2 shows, there was a surge in rents in the mid-1990s. (The data in this figure apply to both the social and private sectors because of the harmonisation dynamics explained above). In real terms, however, since 1998 rents have been falling, making investment in rental housing increasingly unprofitable. This has undoubtedly helped to constrain housebuilding rates, as rental housing represents two-fifths of the stock and state building subsidies now only exist for specific types of dwellings targeted to particular social groups, especially the elderly and students.

What rent changes there have been, moreover, are cost rather than demand based and so the spatial variations of rents bear

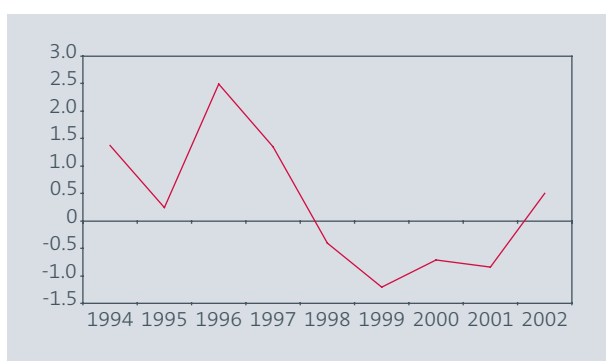
⁷ Ministry of Finance.

little relation to market realities. In the more remote or economically weak regions, rent levels are closer to market ones, but they are substantially lower in areas such as the Stockholm region.

The government has become concerned about the adverse effects of current rental policies on the incentive to build new dwellings or improve and subdivide existing ones. As a result, they have set up a commission with the task of recommending changes within the current framework to improve the situation, though it is difficult to see what they can recommend – apart from the reintroduction of significant new build subsidies in one form or another – without moving towards substantial market-oriented reforms.

There have been transfers of social housing to private housing companies and sales to tenants for conversion to co-operatives in recent years. For example, around 30,000 units were sold by MHCs during 2000-1, mainly in the Stockholm Region.⁸ These were at cost, which gives substantial windfalls to tenants.

Figure 19.2: Real rent changes, 1994-2002



Source: Housing Statistics in the EU 2003

The inability of MHCs to make profits or to transfer sales receipts to municipalities' accounts means that there is limited incentive for large-scale social housing sales. More recently, central government has put caps on transfer numbers in locations where they are likely to affect the subsequent determination of MHC average rents in areas of high demand. As the local MHC housing stock forms the criteria on which to judge local rents, any significant alteration to that through the transfer of some of the better parts of it to the private sector will alter the profiles used in estimating comparative cost-based rents. It is feasible, therefore, for MHC dwelling sales to lead to a raising of all rents in a locality, under the rent-setting rules, to the potential detriment of existing local tenants and incumbent politicians. The 'law' of unintended consequences, therefore, makes even mild reforms of the current tenure structure hard to achieve.

Vacancies in the social housing sector rose sharply in the 1990s, reflecting both over-investment in peripheral regions during the 1980s and the subsequent movement of population away from these regions to the major urban centres. In 2001, 22,000 units of a roughly 870,000-strong social housing stock were vacant, almost 3%. Vacancies ranged from 0.1% in Stockholm to 7.6% in Jämtlands.⁹ The country is thus divided into rental housing

scarcity and glut regions. 40% of municipalities face surpluses: though only a fifth of the population live in such areas, whereas three-fifths live in areas of shortage.

High vacancies have encouraged MHCs in the outlying regions to demolish some dwellings in an attempt to reduce their cost bases. Altogether, 16,300 dwellings were knocked down in the five years up to 2003. A National Board for Municipal Housing Support was set up in 2002 to restructure MHC's finances when they are suffering from high vacancy rates – effectively by subsidising demolitions – in order to avoid MHC bankruptcies and not disturb the rent profiles of specific localities.

Low-income households may receive allowances in part-payment of their rent. Such allowances represent just under a third of direct government subsidies to housing – though these have been falling over time as well. Assistance is mainly provided for families with children and for young people, and around 330,000 households were in receipt of allowances in 2001. Expenditure on allowances has fallen sharply since its peak in 1994, partly because of the comparatively low levels of rents in an era of rising economic prosperity. As elsewhere, such means-tested allowances generate significant implicit tax rates on such households when their incomes rise and allowances are withdrawn.

Little attempt is being focused on market allocation mechanisms, via variations in price, to deal with housing gluts and shortages. So, in scarcity areas, existing tenants have little incentive to economise on accommodation, while thousands of households cannot find homes. In this sense, housing policy has not moved that far from the state 'identify and command' political philosophy dominant from the 1950s to the 1980s. Instead, the agents chosen to implement government aims have switched from being solely MHCs to a more diffuse group now encompassing private investors and homeowners as well. They require far less state funding and may be more effective in specific circumstances.

Housing supply

As noted earlier, the housing system is designed on the basis of all-embracing administrative principles rather than to be responsive or flexible. In the current context of high demand at specific locations, there is particular difficulty with rising costs and extensive delays on the housing supply side. Moreover, such problems can no longer be fixed by the lubricant of large state subsidies.

Housing construction costs are high, at around 30% above the EU average, according to the OECD (though they are higher still in Germany and Denmark).¹⁰ The OECD attributes high housebuilding costs to market structures that evolved in the era of high housing subsidies, low levels of construction imports, and heavy regulations – all of which limited competition and innovation. To these, the government has recently added 'grey market' labour (i.e. outside of the regulatory and tax codes). This is somewhat paradoxical because it is supposed to be significantly cheaper than direct employment through the avoidance of taxation and union-negotiated wage rates.

⁸ Housing Division of Ministry of Finance. ⁹ Swedish Statistics. ¹⁰ OECD Economic Survey: Sweden, 1999.

Other potential causes have less pessimistic implications for construction costs. In particular, there have been increases in the size and quality of recently-built accommodation in comparison to that of a decade or so ago, and construction cost indices are not adjusted over time for improvements in the quality and complexity of what is built.

Yet the high cost of building – in a country which once prided itself on its innovative construction techniques and high quality labour training – has become a major political issue. Building costs have been identified by the government as the prime cause of low residential investment rates, though whether they are a symptom or a cause remains to be evaluated. A government commission is currently labouring over how to lower them.

Supply responsiveness is also limited because of land constraints. Land shortages occur for NIMBY reasons and because of the structure of local authority finance. Little local taxation is derived from property. So, municipalities have a financial incentive to discourage housebuilding in their localities, as extra housing imposes costs on local infrastructure provision and services with no direct increase in revenues. They have large upfront costs, with little prospect of a payback for many years to come. This problem also arises in countries, like the UK and several other EU states, which rely on central government grants to finance the majority of local expenditure. The allocation formulae under such systems are based on predominately population-based local 'need' criteria and, so, generate similar long pay-back lags.

There is a land shortage for new housing in the boom regions. Traditionally, land prices have been low, and land costs were only a small proportion of total house building costs. In recent years, however, land prices have started to rise significantly, which is causing some concern. As a result, delays in the planning process – which have a familiar ring to housing providers in countries such as Ireland, Spain and the UK – have gone up the political agenda. The government has responded by setting up yet another commission to investigate planning delays.

The spate of commissions shows how politically and economically important housing provision has become in recent years, after a decade or more of low priority. Whether the various recommendations to come will make up a coherent whole is debateable. Whatever else, the newly located Housing Ministry will have much to read and ponder about over the next year or so.

Supply-side delays can spring up for ostensibly unexpected reasons. For example, the owner co-operative form of housebuilding is the fastest-growing tenure, as noted earlier. This means that it should be an important source of new supply, either through new building or the renovation of existing structures. However, the process of setting up a co-operative is slow and cumbersome, so that the tenure is an inflexible means of getting new housing on stream. This may account for why the output of owner co-operative flats actually fell from 76,000 in 2002 to 71,000 in 2003, even though their (quality-unadjusted)

average prices rose by 13% between the two years – twice as fast as that of traditional houses.¹¹ As noted earlier, this type of housing is the prime source of new owner-occupation and, at least until 2004, it was the only effective way of providing new flats in the private sector. This dismal supply record contrasts with many other countries where private-sector inner-city apartment construction has been one of the more buoyant housebuilding sectors in recent years.

Rental housebuilding is low, as noted earlier, because production subsidies are no longer significant in the social sector, and because rent levels in the private sector are far too low to make new building or extensive renovation profitable options. With limited new building, both private and social renting will continue to decline in relative importance within the housing stock. This means that owner-occupation now has to absorb most fluctuations in housing demand.

Recent housing market developments

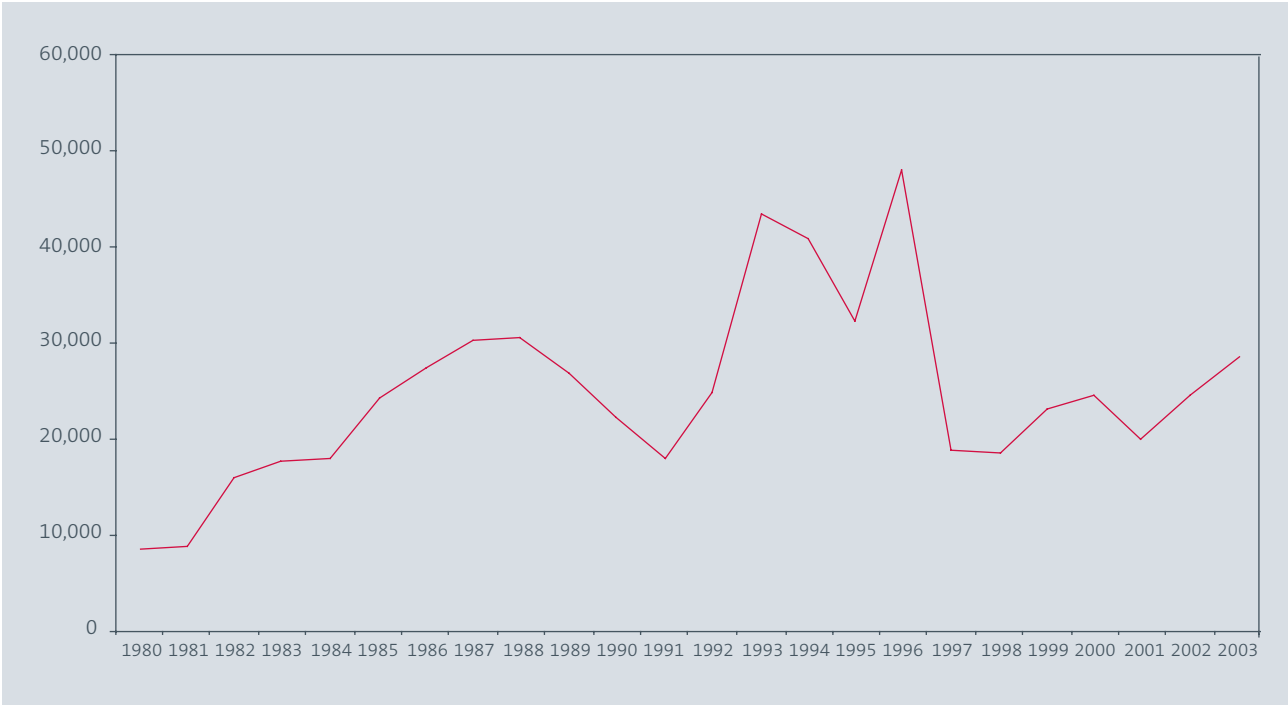
The real house price data illustrate the see-saw fortunes of the housing market over the past 17 years – with a sharp boom that peaked in 1988, followed by a rapid decline in prices back to below their previous trough level by 1993. After that, there was a gradual recovery up to 1997, followed by a renewed price upturn, which stopped in 2001, with prices picking up again during the first half of 2002.

There has been a close relationship between house prices, housebuilding rates and the number of vacant dwellings over the past twenty years. During upswings, house prices rise as the vacancy rate falls and this induces more housebuilding, while the reverse happens in downswings. The late 1990s upswing, however, started alongside a historically high vacancy rate. This was caused by the sheer scale of the previous boom and differences in performance between regional housing markets, which meant that available vacant housing was not necessarily in areas where demand was growing.

New housing supply was slow in responding to improved market conditions in the early stages of the latest upturn, but it began to rise from 1999. New units built had grown by three-quarters by 2003 from their trough five years earlier. Even so, the 2003 housebuilding figure was still less than 30% of output in 1992, illustrating the scale of the collapse of new building in the mid-1990s, and the extremely low supply base from which current housing shortages derive. Overall new residential investment, moreover, has grown far slower than housebuilding figures alone would suggest, because improvement expenditure has remained flat; whereas, in 1998, it was running at the same level as new building. In part, this is accounted for by the surge in conversions during the 1990s – aided by state grants to help the building sector (Figure 19.3). The sharp decline in the number of conversions since the mid-1990s probably reflects the unprofitable nature of rental housing investment and the lags involved in setting up owner co-operatives, noted above. There has been an upturn in renovations since 2002, but they are still well below the mid-1990s levels.

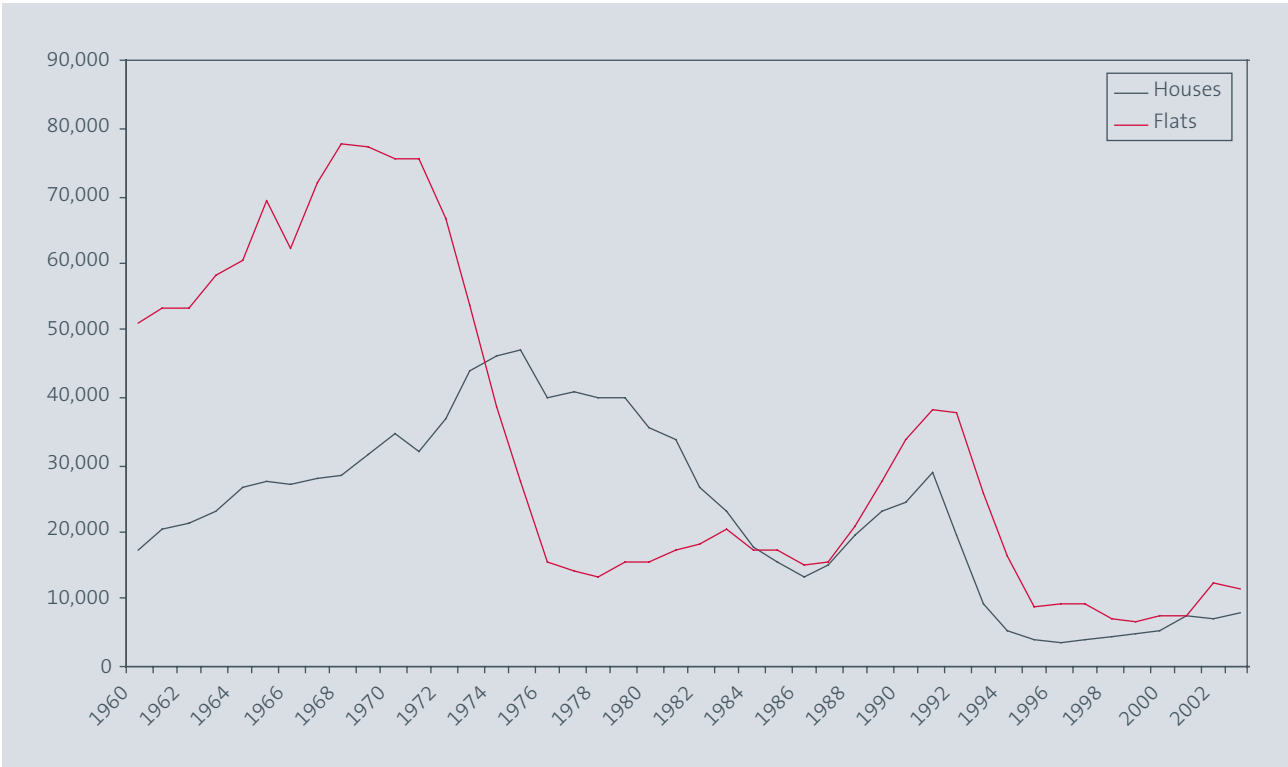
¹¹ Swedish Statistics.

Figure 19.3: Dwelling renovations, 1980-2003



Note: Conversions in multi-dwelling structures

Figure 19.4: Housing completions 1960-2003



Source: Swedish Statistics

The battle of built forms between flats and houses from the 1950s to the 1980s ended in a virtual draw by the mid-1990s, and the ratio between the two has remained fairly constant since then (Figure 19.4). The actual number of dwellings in each multi-family unit is, of course, far higher than in a single family structure and, so, they involve far less buildings overall to produce an equivalent number of dwellings.

In part, the continued building of apartments reflects the expansion of owner co-operatives and the concentration of demand in the major city regions. It is a response to higher house and land prices and to land-use planning policies promoting higher housing densities, because it is believed that such densities are more environmentally sustainable.

The current market situation varies considerably across the country, reflecting differences in economic activity. In the three metropolitan regions of Stockholm, Gothenburg and Malmö, and in several university cities, house prices rose the fastest during most of the upswing. Other regions are experiencing less demand pressure, especially in the North, and have seen much smaller house price rises. The combination of the recent economic boom and varying housing histories have created growing regional disparities in housing market conditions.

Macroeconomic influences

Between 1998 and 2000 the economy enjoyed boom conditions for a number of years at a scale not experienced since the 1960s, with growth averaging over 4% a year, driven by productivity gains, particularly in new technology industries. In the Stockholm Region, 10% of the workforce was engaged in high-tech service industries at the peak of the world IT boom – the highest level in Europe.¹² The 1990s housing market upturn and its spatial concentration consequently had strong economic foundations.

Unsurprisingly, given the emphasis on IT industries, the economy was then badly affected initially by the collapse of the dot.com, and the housing market was caught in the aftershock. However, the economy recovered quickly, with household spending initially taking the lead after tax cuts in 2002, which clearly spilled over into greater housing market activity. The economy has gradually been expanding since 2002, with growth now at around 2%. Even so, there is still some slack in the economy, as indicated by the rising rate of unemployment and very low inflation.

The pattern of housing market change has consequently been stronger than that of general consumption, presumably because of the favourable path of interest rates, as the Central Bank has adjusted monetary conditions to the weaker economic situation. Low inflation and an unemployment rate nudging 6% encouraged the Riksbank to cut interest rates further, by 0.75% in two steps early in 2004.

Over recent years, job creation has been high in the booming regions, and unemployment fell rapidly from 11% in 1997 to 4% in 2002, but it has drifted upwards since then. This low employment level is significant, as the country has one of the highest shares of employed people in the working age population, at 73%. 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 59% of GDP (see Factfile). Associated with such state involvement are high taxes, a variety of tax deductions and a sensitivity of consumption and investment patterns to them. Tax reforms in the early 1990s restricted tax deductions to lower tax bands, which dampened – though by no means removed – the impact of tax breaks on the housing market. Further reforms announced in the 2003 Budget had a similar effect.

Both the IMF and OECD in their respective country surveys have strongly criticised the consequences of housing market rigidities – particularly rent-setting and allocation policies – on the economy as a whole. This is because they hamper labour mobility, intensifying inflationary pressures by exacerbating labour market shortages in the boom areas, and limit the possibilities of microeconomic industrial restructuring and unemployment reduction.

Mortgage market influences

Traditionally, single family owner-occupied housing was generally financed through long-term mortgages, with interest rates fixed on a five year basis. More recently, shorter or variable interest rates have been introduced, and they have become popular in an era of falling nominal interest rates, with 61% of the market in 2002.¹³ Homeowners often take out a packaged mix of mortgage products with different term-structures.

Mortgages are provided by Housing Credit Institutions (HCIs), a type of mortgage bank, and commercial banks. HCIs finance themselves by issuing bonds and other instruments on the capital markets. These are predominantly purchased by the domestic institutions that manage financial assets, such as insurance companies, pension funds and banks. A small sector of 'building societies' also exists, which are unlike either the British ones or the Austrian/German Bausparkassen. Instead, they consist of a variety of specialist lenders. At the end of 2000, HCIs accounted for just under 85% of outstanding lending for housing, and banks lent the other 15%.¹⁴ Most HCIs are owned by commercial banks in a similar way to Germany, but two are state-owned, with a joint market share of 14%. The two largest HCIs have about 30% each of total HCI business.¹⁵ There are five major HCIs.

Competition has been intense since liberalisation in the 1980s. Mortgage defaults were high between 1991 and 1993, and lending criteria were made more strict. Arrears are now at a very

¹² Barclays Bank, London. <http://www.corporate.barclays.co.uk>

¹³ Housing Statistics in the EU, 2003.

¹⁴ National Housing Credit Guarantee Board.

¹⁵ The financial market in 2001, Swedish Central Bank.

low level and, since the mid-1990s upturn, lending conditions have softened as institutions compete for mortgage business. The length of the mortgages on offer, for example, now extends for up to 40 years, up from 30 years in the mid-1990s. To increase loan security, however, downpayment terms have tightened. Variable mortgage interest rates are normally based on prevailing money market rates. There is some guaranteeing of mortgage loans by a self-financing system run by a state institution, the National Housing Credit Guarantee Board.¹⁶

Figure 19.5 shows the growth in loans to households by HCIs, quarterly from 1999 to 2004. The data highlight that housing lending has been brisk, with the rate of increase rising noticeably over the five year period, though it is still moderate in terms of a number of other European countries, and outstanding mortgage debt represented 48% of GDP in 2002.¹⁷

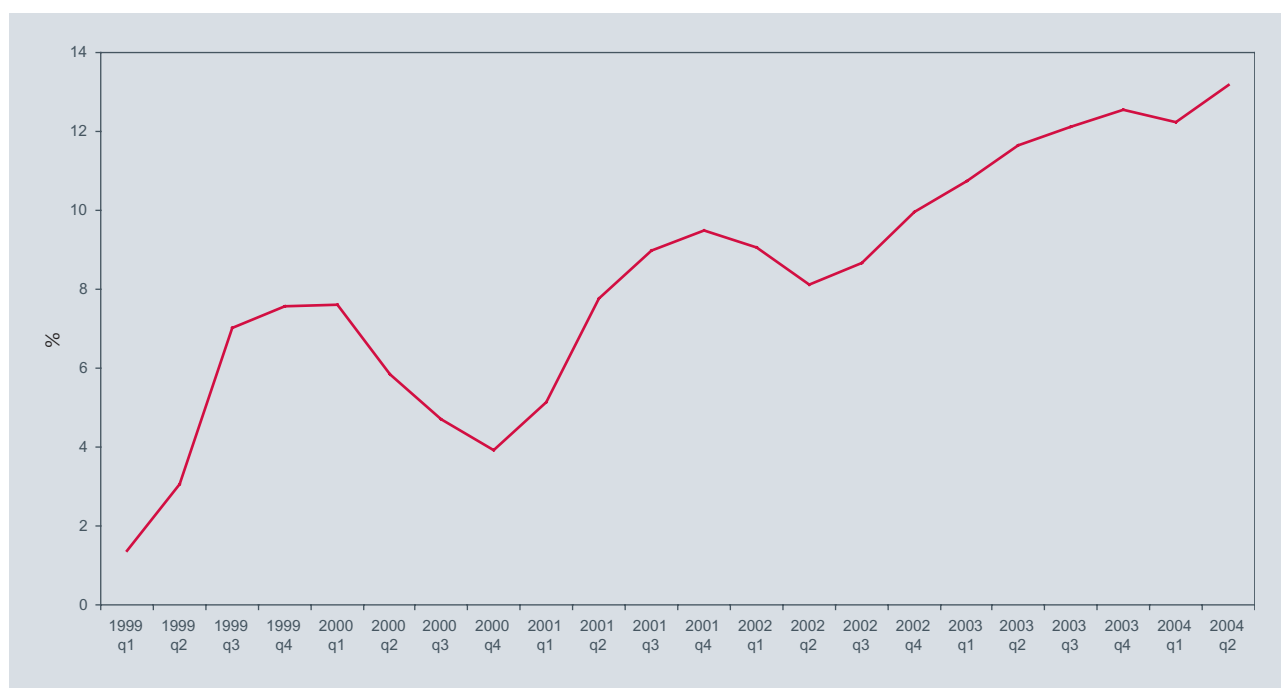
Recourse to flexible interest mortgages and the five year renegotiation clause in fixed interest contracts mean that there has been limited churning caused by households refinancing their mortgage debt. There also does not seem to have been a large amount of equity withdrawal, as there has been in some other European countries.

Demographic influences

Household formation is low, with the birth rate down to 1.6 per woman of childbearing age, but there are large regional variations. Immigration is also low. The current population of around 9 million is only expected to grow by around 3% by 2010, and increase slowly after that. The share of the population over 65, moreover, is only expected to increase by 5% by 2050, so that ageing problems are less than elsewhere in Europe. As so many households already consist of one or two people, household numbers are not expected to rise much either.

The biggest demographic impact on the housing market is migration from economically declining areas to the booming ones. Most population growth is scattered across the south of the country with declines in the north and, even within the south, population is moving towards a limited number of regional centres and the Greater Stockholm area. Research has shown that there is a clear positive correlation between the rate of inward migration to a local area and the rate of change in house prices. The level of vacant socially rented dwellings is also far lower in the growth areas, and local incomes are higher.

Figure 19.5: Growth in loans to households by housing credit institutions 1999 q1-2004 q2



Source: Swedish Statistics

¹⁶ www.bkn.se.
¹⁷ Housing Statistics in the EU, 2003.

Factfile: Sweden

Background

Population (m) 2002	Population Growth % 1980-2001	Fertility Rate* 2002	Years Life Expectancy 2002
8.9	7	1.6	80

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

Services output as % of GDP 2000	Employed as % working age population 2002
71	73

* GDP per person employed 2002

Economic

	200	2001	2002	2003	2004f
Real GDP growth %	4.3	0.9	2.1	1.6	2.5
Growth in real private consumption %	5.0	0.4	1.4	2.0	2.5
Inflation – GDP deflator	1.3	2.3	1.4	2.3	1.4
Inflation – consumer prices	0.9	2.4	2.2	1.9	0.5
Unemployment rate %	5.6	4.9	4.9	5.6	

Government

	2000	2001	2002	2003	2004f
Expenditure as % GDP	57	57	58	58	58

Housing market

	2000	2001	2002	2003	2004f
Growth in residential investment	10.0	4.2	5.7	4.9	6.6

Taxes

Owner occupied housing	Capital gains exempt	Imputed rental income
Mortgage interest relief – yes	no	taxed

Property taxes as share of all taxes 2002	Property taxes as share of GDP 2002
3%	2%

Housing Statistics in the European Union 2003, Eurostat, OECD, World Bank.



chapter twenty

Switzerland

Overview

The upswing in the housing market continued during 2004, although price rises were more moderate than earlier in 2002 and 2003. Rents had firmed slightly by 2004 3q for properties recently advertised compared to the year previously, while the surge in flat prices seemed to have abated. All three main housing markets – flat-renting and buying and single-family house purchase -experienced around 2% increases in prices. This is moderate by the standards of several other European countries, but exists in a general context of very low general price inflation. It also represents a lower rate of growth than in the previous 18 months, which may indicate that extra supply is now restraining price pressures. As elsewhere, strong demand has helped to sustain the housing market – encouraged by an economy that is now growing at a noticeably faster rate than the Euro Zone, and falling interest rates. Interest rates, however, seemed to have bottomed out in 2004, with slight rises reported in the autumn of 2004.

The housing system

Around 65% of all households rent. The rate of homeownership, nonetheless, is growing: rising from 31% in 1990 to 35% in 2000. There is considerable variation in the homeownership rate between the cantons. Valais has the highest owner-occupation rate, at 61%; whereas the lowest shares are in the major cities, with Zurich (25%), Geneva (15%) and Basle (City) (13%) being the lowest.¹

There is no easy explanation as to why owner-occupation is so low. A significant factor is probably institutional inertia, in that the housing system is subject to only limited pressure for change. The rental market works relatively well. There is general consumer satisfaction, continued investor interest and few relative tax benefits of owner-occupation.² This makes urban owner-occupation primarily a feature of the upper end of the market, with high prices paid for generally good quality homes. There is no tradition of starter homes, whereby households can enter the owner-occupied housing ladder at a relatively young age – condominium ownership of flats is a recent development. Many households consequently achieve greater flexibility and mobility by remaining in the rental sector in localities where the

second-hand owner-occupied market is thin. Homeownership is a less liquid investment than it is in many other countries and, as the 1990s showed, is subject to significant price risk. Finally, around 20% of the population are not Swiss nationals and, until recently, they were unable to own real estate and so had to rent.

Condominium ownership of flats (*propriété par étage*) is a recent phenomenon (except in the Canton of Valais) but it is expanding rapidly. The number of such dwellings doubled between the 1990 and 2000 censuses, and accounted for most of the increase in homeownership. The strong price growth of this housing type in recent years shows the consumer enthusiasm for this ownership form, and suggests that the homeownership rate is continuing to grow.

As the prime housing option, the rental market bears the brunt of fluctuations in housing demand, particularly in the major urban areas, where such changes have been the greatest over the past two decades. House ownership, in contrast, is primarily an option for rural households and higher income urban groups, and so is less affected by fluctuations in household formation and migration.

The ownership structure of the rental market is complex. Over half of rental dwellings (57%) belong to private individuals, typically self-employed; another 22% are owned by real-estate companies, pension funds, life insurance companies and real-estate investment funds. These are the two main types of rental housing. Yet, there is a further 14% which falls into a category broadly associated with the notion of social housing. Social housing, however, is distinct from that normally associated with the European model. There are three types of such providers, with their share of the total rental stock given in brackets: co-operatives (8%), public authorities (3%), and associations and foundations (3%). These 'social' owners may be considered such in the sense of their behaviour, because they do not take advantage of all the leeway allowed by rent regulation. Instead, they are content with a moderate target return on their equity investment, and are prepared to dampen fluctuations in costs in order to stabilise tenants' rental payments. Another definition of social housing would count units built or rented with public support as being social. The law, however, does not enable

¹ Data from 2000 census.

² Thalmann, Philippe, et Philippe Favarger, *Locataire ou Propriétaire? Enjeux et Mythes de l'Accession à la Propriété en Suisse* [Tenant or homeowner? Issues and myths of homeownership in Switzerland], Presses Polytechniques et Universitaires Romandes, Lausanne, 2002.

Figure 20.1: Changes in property prices and rents, 1998 q1 – 2004 q3



Source: Wüest & Partner

restriction of subsidies to a particular type of landlord or category of housing, so a tenure division identifying a social sector is not really applicable. A rough estimate would be that about 6% of all housing units built since 1976 are rented with an element of public subsidy – a small amount in comparison to many other affluent West European countries.

Housing policy has not been centred on direct production subsidies – though housing investment does have a special place in the complex tax arrangements for the personal and corporate sectors. Mortgage interest is tax deductible, as are maintenance costs. Homeowner imputed rental income is taxed, which is perhaps unsurprising with such a large private rental sector. Capital gains are also partly taxed. Overall property taxation is quite high by European standards, at 3% of GDP.

Reforming rent control

A rent control scheme has been in existence for many years. At the time of setting up a rental contract, rents are freely negotiated. Subsequent revisions, however, are controlled by a formula predominantly related to changes in landlords' costs. So, rents for existing tenants over time do not correspond to market rents. There is pressure to change the regulations to the benefit of tenants.³ However, in a referendum in February 2004, Swiss voters rejected the demands of the national tenant's association for a decoupling of the linkage between the mortgage interest rate element of landlords' costs and rent changes. Also rejected was a proposal that rents agreed in tenancy contracts could more than 15% above that of a comparable apartment.

The rent controls are, once again, under debate with the Federal government committed to some sort of reform. Any new measure is likely to take some time to come to fruition, given the nature of the political process, and the scale of the disagreement between influential parties.

³ 'The decoupling of rents from mortgage rates: implications of the rent law reform for monetary policy', P. Stalder, Swiss National Bank Quarterly Bulletin Sept 2003.

Recent market developments

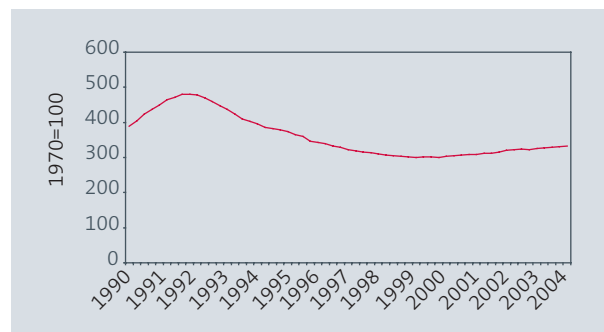
Figures 20.2 and 20.3 show the patterns of rent (at the time of a new contract) and house price changes since 1990. It can be seen that nominal rents and house prices are still below their 1990 levels, because of sustained falls in the market slump from the early to late 1990s, and the relatively moderate increase in prices in the current revival. In contrast, the price of flats has just about caught up with the previous peak.

The 1990s boom-bust cycle it seems was a classic excess supply one. Price rises accelerated in the late 1980s as a result of an unexpected increase in demand. This then led to belated supply responses, which unfortunately resulted in many dwellings coming onto the market after the demand surge had passed. This process is similar in broad terms to those experienced in Austria and Germany during the 1990s.⁴ The vacancy rate was only 0.4% of the total stock in 1990, when the boom was in full swing, but rose to peak at 1.85% in 1998, and then began to decline again to a low of 0.9% in 2003 after the market had picked up again.⁵

The performance of the general economy helped to generate the prolonged crisis of confidence in the housing market. The 1990s market collapse was initially triggered by a surge in interest rates aimed at squeezing out a burst of general price inflation in the early years of the decade. By 1994, annual inflation was down to 1% from its 1991 peak of 6%, but the economy remained at a standstill from 1991 to 1997. Unemployment rates also rose. They were still not particularly high by Western European standards, yet they helped to dent consumer confidence. The country, moreover, already had a very high labour force participation rate during the 1990s – 83% in 1990 – which could not grow much further. In contrast, there was a 5% rise in labour force participation in the Euro Zone as a whole between those dates, which increased housing demand by significantly raising affordability amongst some key household groups. This meant that the growth in two income households, so important in many Euro Zone housing markets, did not help to offset the adverse Swiss macroeconomic environment up to 2002.

The last few years, in contrast, have seen a strong revival in demand, which initially outpaced supply. Reductions in mortgage interest rates since mid-2002 have also helped to hold down rents charged under existing leases.

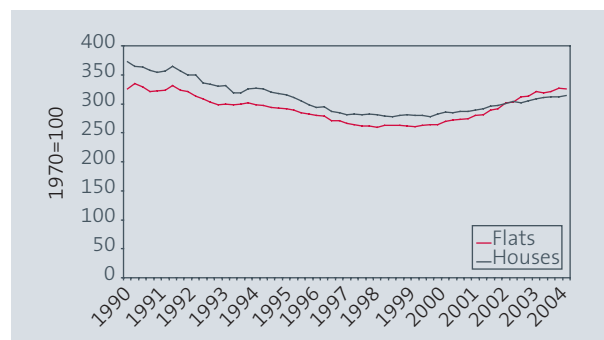
Figure 20.2: Rents* 1990-2004 quarterly



* Based on surveys of asking rents

Source: Wüest & Partner

Figure 20.3: House prices, 1990-2004 quarterly

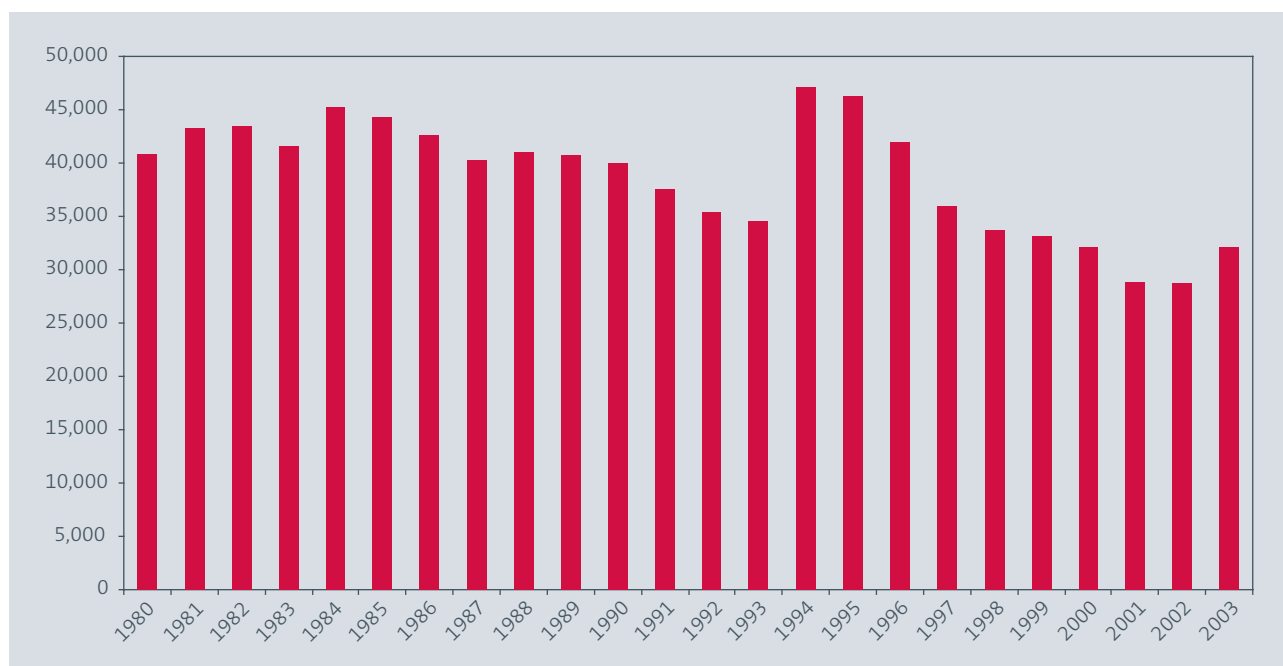


Source: Wüest & Partner

⁴ See Chapters 4 and 9.

⁵ Federal Statistical Office.

Figure 20.4: Housing completions 1980-03



Source: Federal Statistical Office

New building

The volume of construction in the 2000s initially responded weakly to the increases in demand relative to previous upswings. This supply shortage helped to put pressure on prices. Since 2003, however, residential investment seems to be growing strongly. Housing construction investment rose by 17% in 2003, according to the Federal Statistical Office, and has continued to expand in 2004. Yet, after five years of price rises since 2000, house completions are still averaging the lowest for fifty years, at slightly over 32,000 units a year (Figure 20.4). As the vacancy rate is now beginning to rise, residential investment is forecast to slow down during 2005.

There are some contradictory indicators amongst the data. Completions data show a weaker response of supply and permits a more optimistic picture. Permits are traditionally a good leading indicator of future supply. They have risen sharply – up by 54% between 2002 q1 and 2004 q3. In contrast, the growth of completions has been more muted – at only 17% for the same time period – and they were 5% higher than the previous year in 2004 q2. However, quarterly permits data have been behaving oddly since 2002, being notably higher than completions, whereas this widening gap was not visible in early upswings. It is unclear whether this is due to measurement factors or to investors holding off from actual building commitments.

A notable feature of housebuilding has been the fluctuating share of single-family housing within it. There is a more stable demand for houses than for flats, so its share tends to vary counter-cyclically, falling during upturns and rising when the housing market is depressed. This pattern highlights the fact, mentioned earlier, that the apartment sector is the main source of housing for urban households and subject to the greatest variation with changes in demand. However, the data suggest that the demand for houses is still sensitive to the contemporary state of the market. More households have to substitute smaller, apartment accommodation for larger houses as prices rise and, then, are able to afford houses again when prices moderate.

Despite the long-term fluctuations of the housing market, the housing stock grew by 460,000 dwellings between 1990 and 2001, an increase of 15%, and the stock is up by a third since 1980. This long-term growth is substantially higher than in several mature EU countries, with which Switzerland is best compared. By 2001, the housing stock was 3.6 million, which gives a crude ratio of population to housing of 2.0 – one of the best in the world.

Macroeconomic influences

The spurt of economic growth from 1999 to 2001, which had helped to revive the housing market, gave way to economic decline in 2002, as investment and export demand fell. In the second quarter of 2003 the economy was still in recession, with output falling by 1%. The revival of the world economy subsequently led to better prospects, and growth picked up in the second half of the year and continued to accelerate in 2004. As a result, growth is forecast to be near 2% in 2004 and slightly above the long-run growth potential in 2005.

In response to the economic slowdown, the monetary authorities cut interest rates to near zero in succession of cuts from the rate of 3.5% in 2001. For most of 2003 and 2004, the target for the 3-month Libor rate was only 0.25%. This helped to stimulate private consumption and the housing market. The Swiss franc also fell from its 2002 peak against other currencies, in contrast to the rises of earlier years, which has helped to increase exports after several years of falling export demand.

Inflation is very low. Prices actually fell in the first quarter of 2004, will remain very low throughout 2004 and are still expected to be below 1% in 2005.⁶ The upturn in economic prospects late in 2003 significantly lowered a perceived risk of price deflation, which could have had significant implications for the property market.

One reason why inflation remains low is that unemployment has been rising. From its less than 2% trough in 2001, it was nudging 4% early in 2003. Economic revival then stopped any further increases, though unemployment will remain high by Swiss standards for some time. For those in jobs, in contrast, there has been some increase in real earnings. This has more than offset any potentially depressing effects on housing demand of the rise in unemployment.

As one of the world's richest countries, it is hard for Switzerland to sustain the growth rates of countries at lower levels of economic development. Nonetheless, international agencies, like the IMF and OECD, argue that various structural and fiscal reforms could raise growth somewhat.⁷ Even moderate economic growth leads to less pressure on housing demand, so it is likely to be from the supply side and the limited expansion of output that any inflationary pressures in the housing market may arise in the near future.

Mortgage markets

Traditionally, most mortgages have been of the variable rate type. Lenders can alter interest rates every six months with no caps on the change. With lower nominal interest rates in recent years, however, there has been a substantial increase in the use of fixed interest rate mortgages. Over half of recent borrowers have chosen them to take advantage of historically low rates. These fixed-rate mortgages are not long-term ones, as the interest rate is rarely set for more than five years, after which time it is renegotiated. The attractiveness of fixed-rate mortgages clearly depends on the interest rate cycle.

Mortgage interest rates declined from their highs in the early 1990s to 2000. Rates then rose somewhat during 2000 and 2001- to peak at 4.49% in March 2001 – in line with the upward drift of short-term interest rates. They then fell in line with general cuts, to reach 3.19% in October, 2003, where they stayed for most of 2004. The fall in real mortgage interest rates, however, was less because of the declining inflation rate. Rates then rose following the two 0.25% increases by the central bank in June and September, 2004 – but remain at historically low levels in nominal terms.

Mortgage lending is growing, yet has not increased at the scale of some other EU countries, rising by 5.5% on annualised basis by July, 2004 (Table 20.1). However, it is already high, with around 80% of all bank loans secured by a mortgaged, most held by households either as owner-occupiers or housing landlords.

Table 20.1: Growth in mortgage loans by banks 2002-2004

Annual % growth

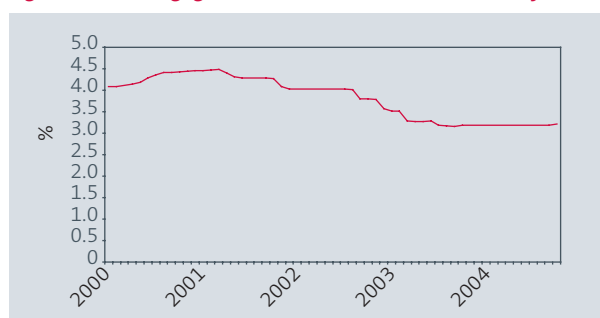
2002	2003	2004 q1	2004 q2	2004 q3
3.9	5.6	5.4	5.4	5.4

Source: Swiss Central Bank

The market for mortgage credits has been repeatedly subject to scrutiny for anti-competitive practices in spite of the large number of credit institutions in existence. Until 1991, bankers would sit together and set minimum mortgage interest rates for each region. That is no longer allowed, and the Federal Bank and Competition Commissions keep an eye on anti-competitive practices.

Mortgage interest rates are subject to much attention from politicians and the public, because the implications of changes in them are felt throughout society. Mortgage indebtedness is very high by EU standards, partly because amortization is very slow with such low general inflation. Rent regulation, as already mentioned, also currently ties rent adjustments to changes in mortgage interest rates. The already high level of indebtedness, the limited potential capital gains in the housing market and a tradition of flexible interest rates taken together probably account for the fact that there has not been major growth in mortgage indebtedness in recent years.

Figure 20.5: Mortgage interest rates* 2000-2004 monthly



* Best quality new mortgages, Cantonal Banks

Source: Swiss Central Bank

⁶ Swiss National Bank Quarterly Bulletin Sept 2003.
⁷ See, for example, Growth in Switzerland: Can Better Performance be Sustained? IMF Working Paper 153, September 2002.

Demographic influences

Population growth is sensitive to the business cycle, as it depends largely on the net migration of workers and their families. Net migration was negative in the economically troubled late 1990s, but it is now positive, at around 20,000 a year. Between the end of 1990 and the end of 2000, the population grew at an average rate of 0.64% per year. It is forecast to rise much more slowly in the future, by 0.2% per year until 2010, and only by 0.08% per year in the following ten years. Depending on future policies with regard to immigration, however, population growth could be stronger than forecast.

Roughly a fifth of the population consists of foreign nationals with a right of permanent residence. There are a large number of foreign residents working for international agencies and other bodies, many of whom will not be in the country for that long. Yet, more than half of the residents with no Swiss passport have been living in Switzerland for over 15 years or were born here.⁸ This level of resident foreign nationals is probably a factor in the scale of the rental sector, because traditionally such households have been unable to buy property and naturalisation is a slow process. Foreign residents have only recently been given the right to purchase property as their prime residence. They are still not allowed to purchase housing for investment or holiday home purposes. Recent bilateral treaties with the European Union, moreover, will facilitate the immigration of skilled Europeans into the country. These changes are expected to increase the demand for owner-occupied housing, particularly near the main business centres.

In spite of the slowdown in population growth, the stock of housing is still growing, at an average rate of 1.3% per year. There are consequently both a demand pull and supply push factors leading to smaller households and more living space per person.

The general ageing of the population certainly works in favour of smaller households. The 65 years + age group is the fastest-growing, with growth of over 10% expected for the next ten years. Its share of total population is expected to grow from around 15% today to about 25% by 2040.⁹ The impact on the housing market will depend on the lifestyles of the elderly in the future. In the short run, ageing implies less demand for rental dwellings and more for owner dwellings, particularly flats. The general shift in the population structure towards the middle-aged (45+ years old) reinforces the trend for larger homes and more living space per person.

Policy and planning factors

The federal government has been working on reforming several policies of relevance to the housing market for a number of years.

1. The taxation of owner-occupied housing: The most likely change is abolition of the tax on imputed rents and, simultaneously, mortgage interest deductibility. There is now widespread consensus on such a measure, and debate currently focuses on whether maintenance costs should remain deductible. Nevertheless, the government does not plan for the reform to be implemented before 2008.
2. Housing aid: Current approaches led to many problems during the 1990s market downturn. The government is working on replacing them with more targeted aid, probably in the form of cheap credit it would directly lend on a means-tested basis. Overall, the federal government wants to cut down housing aid with a view to leaving more responsibility to the cantons.
3. Local housing policies: Several cantonal governments are working on reform of their housing policies and taxation strategies. The underlying philosophy of these changes is that the state should reduce its involvement in housing provision, so that market forces are given more room to operate, and it is hoped that by doing that, inefficiencies will be reduced or removed.

⁸ Federal Statistical Office.

⁹ Federal Statistical Office.

Factfile: Switzerland

Background

Population (m) 2002	Population Growth % 1980-2001	Fertility Rate* 2002	Years Life Expectancy 2002
7.2		1.4	80

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

Services output as % of GDP 2000	Employed as % working age population 2002
68	84

* GDP per person employed 2002

Economic

	200	2001	2002	2003	2004f
Real GDP growth %	3.7	1.0	0.2	1.6	2.5
Growth in real private consumption %	2.5	2.0	0.7	0.8	1.6
Inflation – GDP deflator	0.8	0.6	1.0	1.2	1.2
Inflation – consumer prices	0.6	0.5	1.1	1.1	0.3
Unemployment rate %	5.6	4.9	4.9	5.6	

Housing market

	2000	2001	2002	2003	2004f
Growth in residential investment	-2.7	-4.0	0.5	1.0	1.8

Taxes

Owner occupied housing	Capital gains exempt	Imputed rental income
Mortgage interest relief – yes	partly	taxed

Property taxes as share of all taxes 2002	Property taxes as share of GDP 2002
9%	3%

Housing Statistics in the European Union 2003, Eurostat, OECD, World Bank.

chapter twenty-one

United Kingdom

Overview

The UK housing market, after booming in 2003 and early 2004, seemed to have been brought to a sharp halt in the summer of 2004. The causes were not directly related to the economy, which remained strong, but to a series of interest rate rises in 2004 and the impact on confidence of warnings about the risks of house price falls in the media and by a series of organisations including the OECD, the IMF and, on several occasions, by the Governor of the Bank of England. So far any price falls seem mild and within the bounds of statistical error. The general opinion, however, was that the boom was over, and that 2005 would see moderate price rises or stagnation (Figure 21.1).

Already a number of surveys were reporting house price falls in the autumn of 2004, including the RICS October Housing Market Survey, in which the majority of residential agency members were reporting price falls. To date only Scotland seemed to be immune from the freeze, though it had experienced far lower house price rises than England.

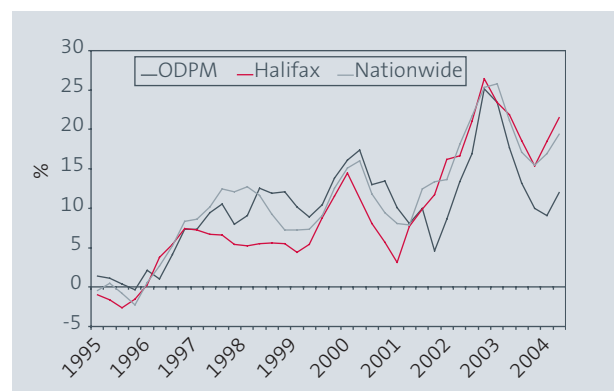
House sales processes take a long time in England, and a great deal of uncertainty surrounds the first phases of offers until the time contracts are 'exchanged' (usually with still at least a month to go before a sale is actually closed), which makes market intelligence confusing as published data are based on different stages of the purchase process. This means housing market information is hard to decipher at potential turning points in market cycles.

Micro-forecasting of the housing market, in any case, is insufficiently accurate over a short time span to be able to come to firm conclusions about the trajectory of house prices in the near future. This is partly because of the short-run volatility of consumer expectations, but also because of the inevitable uncertainty surrounding the trajectory of key factors influencing a housing market, including interest rate levels, inflation and economic growth. The scale of the reported price falls in the UK in 2004 was particularly difficult to interpret because asking prices had forged ahead earlier in 2004. So, it could be argued that a more realistic view of the housing market was that house prices were no longer rising strongly in 2004 compared to 2003 and it will take several months into 2005 to see what the direction of price movements is actually going to be.

The most recent house price boom started nationally in 1997. It had followed several years when real house prices fell by over a quarter from the peak of the previous boom in the late 1980s. The UK housing market has, in fact, been highly volatile for several decades. There was a major boom/slump cycle in the early 1970s and a minor one several years later, followed by a 1980s upswing and subsequent sharp downturn and, then, the most recent upswing, which was also the longest. The scale of price volatility over the long-term has been significantly greater than the average country experience in the EU.¹

An understanding of boom and slump housing market conditions should, by now, be an integral component of the British psyche. On this basis, the recent upswing could be interpreted as temporary collective consumer myopia, with memories of volatility then rekindled as prices weaken. This scenario would imply a crash is on the way because of a shift in sentiment towards pessimism, with prices moving downwards until they achieve equilibrium around the level where the house price-earnings ratio is near its long-run level.

Figure 21.1: Changes in nominal house prices 1995 q1-2004 q2 (three indices compared)



Source: OPDM

¹ M. Ball and M. Grilli Housing markets and economic convergence in the European Union, RICS, London, 1997.

An alternative prediction notes the currently benign state of the economy, and that interest rates are forecast now to be around their likely cyclical peak. While accepting that house prices may be relatively high on a historical basis, it suggests a flattening of prices rather than a crash in them. Part of the reason is that informed households should not only be aware of price volatility, as in the crash scenario, but also of long-run house price trends. Trend price rises have been one of the largest and most consistent in the EU over the past 30 years, and are likely to remain that way.² Prices may currently be above trend yet they are likely to return to it gradually rather than sharply, giving rise to a 'soft landing' scenario, with a forecast price range centre centred on zero but potentially ranging from small falls to moderate rises for several years to come.

In this soft landing scenario, the impact of a potential housing market slowdown presents few major financial risks for anyone who does not need to move within a short timeframe – which includes the vast majority of homeowners. Most owners thinking of moving are likely to hold off selling until the market picks up again and reaches their reservation prices. Only those owner-occupiers under an obligation to sell may face default risks. There might also be some difficulties for some residential investors who have recklessly borrowed, yet mortgage lenders are supposed to have screened out most such potentially high-risk defaulters. Price falls in this scenario are likely to be localised at most. The prospect of a weight of second-hand supply forced onto the market, thereby bringing prices crashing down, is remote according to this view; one held by the majority of market experts. Nonetheless, as the prediction of short-run house prices is a difficult process, some risk of a crash inevitably remains in such forecasts.

Further weight is given to the soft-landing view by three arguments: one relating to the measurement of house prices, another to a possible one-off upwards shift in the trend of house prices, and a third to a potential increase in the trend rate growth of house prices. Nonetheless, each one at best can only explain a part of the large increases in prices that have occurred in recent years.

1. The measurement of prices: The quality of housing is higher than it used to be, especially in terms of internal fittings and standards, so that part of the reason for house price rises is that consumers are now getting more housing services on average for each unit bought. House price indices on this argument exaggerate inflation, as they are not adjusted for quality changes over time.³
2. An upwards shift in the trend of house prices This may have arisen because several factors have increased consumers' general willingness-to-pay for housing services. For example, they may now be prepared to take on more debt because of the apparently improved long-term economic growth prospects of the UK economy compared to a decade ago, or because of a lower risk of periodic inflation-induced sharp rises in interest rates.

3. An increase in the trend growth rate of house prices. This may have risen because supply has become less responsive to increases in demand over time, especially in areas of greatest demand.

On the supply-side, output has failed to respond much to booming house prices in recent years (Figure 21.2). Between the mid-1990s and the present day, private sector housebuilding has increased by only a small amount, and social housebuilding has actually declined by almost 40% since the late 1990s when the New Labour government came to power, so new output remains low by historic standards. Moreover, the new dwellings being built are the smallest in size in the old EU15 (Figure 21.3), so that the improvements in the quality of the stock, noted above, have tended to come about through renovation, modernisation and a higher standard of internal fittings rather than because of the spaciousness of new dwellings.

This poor supply record exists despite the scale of price rises over the past decade and the fact that the country has ostensibly one of the most market-oriented housing systems in Europe, with a high share of owner occupation, a decontrolled private rental sector and a liberalised and highly competitive mortgage market. Such a market perspective, however, does not extend to the key land input to the supply-side, which is strongly regulated by planning and other state controls over greenfield development and urban regeneration.

There is a cyclical bright side to the current lack of supply. With such limited recent housebuilding, there is little chance of an impending supply glut, which further diminishes the chance of significant price falls in the near future.

In the medium-term, the government has committed itself to increasing housing supply substantially in areas of shortage, following the conclusions of a major review published in 2004.⁴ The aim is to tweak, rather than overhaul, the planning system to ensure that local planning authorities in general adopt less restrictive policies with respect to housing development land. Furthermore, specific localities have been designated for substantial housing expansion in regions of high demand. There is evidence of this policy being pursued vigorously, though whether it will survive the pressures of continued political opposition to housebuilding remains to be seen.

There is also a problem of infrastructure shortages holding back residential development. The government has been less forthcoming with proposals on this score, with a few exceptions, because of their cost.

One problem with government supply side policy is that it is coming on stream as the housing market slows down. Fading markets, unsurprisingly, typically depresses supply, so even sustaining housing output levels over the next few years may prove to be a difficult task. It is also hard to keep housing supply issues as a political priority during a soft market, because headline 'affordability' and 'shortage' issues inevitably ameliorate. Yet, given the importance of supply side lags, the issue still needs addressing even in a downswing in order to avoid further sharp price rises in the next upturn.

² Review of Housing Supply: Interim Report, K. Barker, H.M. Treasury, London

³ The quality-adjusted indices that exist are only designed to take approximate account of cross-section relative quality differences between houses.

⁴ Review of Housing Supply: Final Report, K. Barker, H.M. Treasury, London.

Table 21.1: Housing stock and tenure 1951-2001**Great Britain**

	Total housing stock millions	Addition to stock in past decade (m)	% Owner Occupied	% Rented from - Private landlord	Registered social	Local authority
1951	13.7		30	52		19
1961	16.2	2.5	43	31		27
1971	18.8	2.6	50	20		30
1981	20.0	1.2	56	11	2	31
1991	23.0	2.0	66	10	3	22
2000	24.6	1.6	68	10	6	15
2001	24.7	1.7	69	10	7	14

Source:ODPM

The housing system

Most Britons are homeowners, with 69% of households in the tenure (see Table 21.1). The majority of dwellings are also single-family houses. In England in 2000, 82% of households lived in houses, 16% in self-contained flats and 2% in bed-sits and other non- self-contained accommodation.⁵ The housing stock, furthermore, is relatively old in comparison to many other European countries – with 41% built before 1945, another 45% between 1945 and 1984; and only 13% since the mid-1980s. Housing stock growth slowed from the 1970s, although with a minor revival during the boom years of the 1980s after which it decelerated again.

Private renting

As elsewhere in the EU during the twentieth century, the UK experienced a decline of the private rental sector and the growth of homeownership and social housing (Table 21.1). By the early 1990s, the private rental sector was home to only 10% of households, the majority of whom were low income ones.

Rent controls were liberalised in the late 1980s, and there is only limited security of tenure in the most common tenancy contracts. Furthermore, the long-term taxation imbalance between the rental and owner-occupied sectors had also been partly redressed with the abolition of mortgage interest tax relief for owner-occupiers, which was finally phased out in 2000.

Competition and innovation in the mortgage market has also drastically improved the ability of investors to borrow, and the previous large spread between investor and owner-occupier mortgage interest rates has disappeared. Between 1998 and 2004, over 470,000 buy-to-let mortgages had been advanced by lenders, representing around a quarter of the market rental stock. How much of this lending is new lets or remortgaging by existing landlords is unclear. Many landlords still have no borrowings on their properties, despite the gearing and taxation advantages of doing so.⁶

The overall result is that the structure of the privately rented sector has been transformed over the past fifteen years. The composition of rental households has changed away from elderly and low-income households towards more affluent and younger social groups, and several major cities have experienced significant increases in the share of private renting. Private investors have also become significantly more important during a 'buy-to-let' boom, which has affected the level of house prices in some cities, including in the north of England, where renting traditionally was low.

There is some concern that the end of the period of sharp house price inflation will lead to many of these investors selling up, putting downwards pressure on house prices as a whole. However, such fears are probably exaggerated, and any negative impacts, if they occur, are likely to be local ones only. Few landlords seem to be heavily indebted, the transactions costs of quitting the sector rapidly are high, and most investors seem to be in the market for the long-term.⁷ It is too early, however, to see clearly the precise extent to which the recent expansion of private rental housing has contained a strong cyclical element.

Most landlords are private individuals owning a few properties as a secondary source of income. In the mid-1990s, two-thirds of lettings provided landlords with less than a quarter of their income. Not all the new landlords, moreover, take a purely commercial interest in their dwelling purchases but have other motives and, so, are prepared to accept lower returns as a consequence. There is evidence for this in a survey that has suggested that only half of private lettings are regarded as investments, and only a third of landlords look for commercial returns.⁸ These survey data were published in 1998, however, before much of the recent surge in investor interest, so the profile and motives of landlords might have changed since then. However, the 1990s was a period of significant investor interest in housing. By the mid-1990s, deregulation had already led to much extra supply, with more than half the rental stock let for the first time since 1989.

⁵ Survey of English Housing 99/00, ODPM. ⁶ M. Ball The Future of Private Renting in the UK, Social Market Foundation, London, www.smf.co.uk.

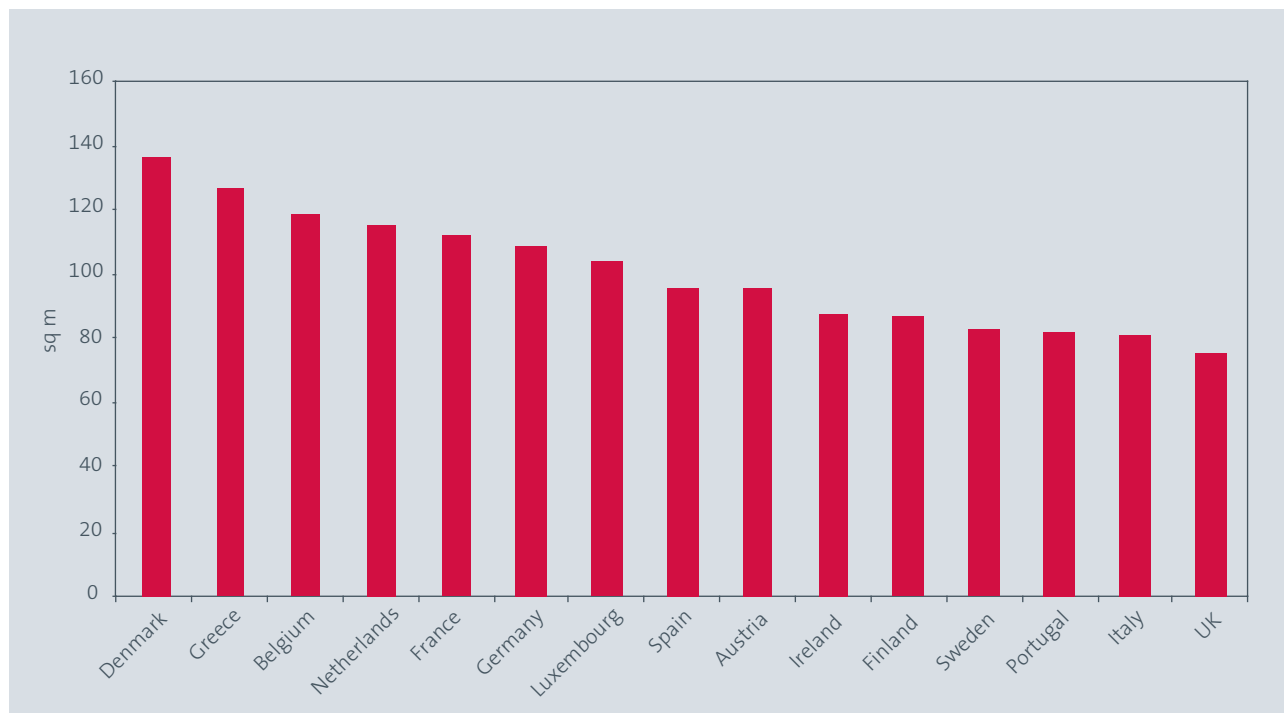
⁷ M. Ball The Future of Private Renting in the UK, Social Market Foundation. ⁸ Joseph Rowntree Foundation (JRF) Findings Housing Research 139, 1995.

Figure 21.2: Housing completions by tenure 1990-2004



Source: Office of Deputy Prime Minister

Figure 21.3: Average floor area of new dwellings



Source: Housing Statistics in the EU 2002

The government has introduced a new, experimental, private sector rent index, which covers the past five years for England where most rental housing in the UK exists. It shows that rents rose by almost 30% between 2000 and the end of 2003, with most of the increases occurring in 2002 and 2003, though rents were softening early in 2004 (Table 21.2). Later in 2004 the rental market seemed to be strengthening, as demand increased in response to the weakening of the owner-occupied market.

Table 21.2: Private sector rents 2001-2004

	22001 q1	2002 q1	2003 q1	2004 q1
% change annualised	4.0	11.2	7.0	2.5

Source: ODPM

An average two-bed flat in London cost £1,441 per month (i.e. £17,292 a year) and £507 in the rest of Britain in summer, 2004, according to RICS Quarterly Residential Lettings Survey. Rental yields, however, are not particularly high, because of the prevailing level of house prices, though most landlords have made handsome capital gains during the recent period of rapid house price inflation.

Some tenants are attracted to renting by the ease of moving and the low transactions costs. Others are more sensitive to the relative costs of owning and renting. High rent levels, for example, have encouraged many younger households in London and the South East to opt for owner-occupation when mortgage interest rates are low, and vice versa. Expectations about house price rises, in addition, influence tenure choice. Periods when rising prices are expected encourage households to enter owner-occupation, and the opposite occurs when prices are expected to stagnate or fall. The current downswing in the housing market is likely to lead to a positive demand stimulus in renting for this reason.

Higher house prices in recent years have delayed moves by younger households into owner-occupation because of the need to save up equity to meet borrowing constraints. The average age of first time-buyers has risen noticeably in recent years. Several social groups face particular difficulties purchasing at prevailing prices. They include those working in sectors where earnings growth has been below average, such as public sector workers, and those in the private sector who are in the early years of their employment careers, or who have jobs characterised by a degree of salary or employment instability incompatible with homeownership.

Trends in migration and the labour market have stimulated rental demand as well. More flexible labour markets, in general, and the surge of foreign workers (mainly from the EU and North America) temporarily living in London have pushed up renting in the capital and elsewhere, because the tenure does not have the transactions and entry costs of homeownership. It is also common for younger British people to spend some time in London's labour markets and rent whilst doing so, before they

either find a job elsewhere or join other homeowners in a long commute back and forth to their central London jobs from more affordable homes throughout the South East of England.

Outside of the social sector, private renting and owner-occupation are common sequential stages in many people's housing life-cycles. For others, house purchase takes place as soon as the household is formed. These patterns can be seen in data showing that 46% of under 25 year olds rent privately, whereas 80% of 45 to 64 year olds owned, and only 5% rented privately.⁹

Social housing

Social housing is divided between local authorities (known for short as councils) and registered social landlords (RSLs), which are predominantly non-profit housing associations and trusts. By the early 1980s, the UK had almost a third of its housing stock in the social sector – one of the highest shares in Europe. Sharply reduced new building rates and sales of existing dwellings have substantially reduced social housing's role since then. By 2001, council housing's tenure share had declined by over half, to 14%.

The reduction occurred mainly through discounted sales to sitting tenants via a 'Right-to-Buy' programme. Tenants' propensity to purchase is influenced by the prevailing state of the owner-occupied housing market and interest rates, as expected capital gains influence the decision to buy and most borrow to facilitate purchase. Sales averaged over 100,000 units a year in the 1980s in England, and then slowed in the 1990s. They dipped to a low of just over 30,000 a year in the mid-1990s, and rose again as the housing market picked up.

Tenants having bought at a discount cannot sell within a set time period of a few years. Open market sales of previous council dwellings in recent years have led to a growing amount of the ex-council stock appearing in the private rental sector, especially in Greater London. Some companies are prepared to advance loans to tenant purchasers and part of the equity at the purchase stage, subject to a stipulation that the tenant subsequently sells the property to them at an agreed price at a fixed later date. Around 1.5 million council dwellings have been sold under the Right-to-Buy programme. The government has signalled its concern over 'abuses' and threatened to reduce further sales, though little has actually changed.

Around another 900,000 council dwellings have been sold in recent years to social housing institutions in an 'estate transfer' programme. Transfers take place after ballots of tenants, who often face a choice of no repairs and improvements if the dwelling remains under council control, or the promise of substantial renovation if they agree to the ownership change. The whole stock of council housing in Glasgow was transferred to such a new social housing organisation in 2001. That new entity instantly became Europe's largest housing landlord.

Neither central government nor local authorities seem keen to foster competition amongst social housing providers, as such transfers are generally in bulk to an existing or new RSL at notional low prices. Those new landlords then often become the sole provider of social housing in a locality, just as the local

⁹ England, 1999/00. Source: ODPM.

council used to be; whereas, in principle, it seems feasible to break up ownership amongst a variety of providers. The new landlords of transferred housing have raised substantial loans on the capital markets in order to undertake improvements. They rely on rental income receipts, virtually guaranteed by the housing benefit system, to service these loans.

It is too early to evaluate the success of the transfer programme. Yet, it contains potential financial and efficiency risks. If this new social housing model does create problems in the future, little piecemeal reform will be possible, because of the way in which these bodies have been set up and the long-term financing arrangements to which they have had to commit themselves. There is a good chance that much of the remaining council stock will be transferred to such organisations over the next few years. One side-effect is that the Right-to-Buy programme will gradually disappear, as currently only council tenants are eligible to purchase their properties, not the tenants of RSLs.

Developments in UK social housing altering ownership from local authority to RSLs are unique in Europe. In other Western European countries with traditional high shares of social housing, institutional arrangements have remained broadly the same. Moreover, the entirely different trajectories adopted by many Central and Eastern European countries, of a major expansion of owner-occupation through transfers to tenants of public housing at nominal prices, or of the sales of public rental housing to private investors in Germany, have been completely ignored in UK policy debate.

Social housing was once seen by its champions as the mass housing of the future, which, amongst other things, justified draconian rent controls in the private sector. Yet, as in several other EU countries, it is now increasingly the home for lower

income groups outside or on the margins of the labour market, certain minority ethnic groups and recent immigrants. Part of the private rental sector also plays a similar role by accommodating households whose rent is fully or partly paid through means-tested housing benefit (see later).

Around a fifth of the private rental sector's and over two-thirds of the social sector's tenants rely on 'housing benefit', the UK's term for means-tested housing rent allowances. Housing benefit pays up to 100% of the rent, depending on the financial circumstances of the claimant. 3.1 million households were receiving housing benefit in 2002/3, so this is a major item of public expenditure, at around £11bn.¹⁰ This represents a much greater share of GDP than equivalent programmes in other EU countries. Despite its significance, successive governments have been unable to reform the rent and benefit system substantially in order to reduce its costs, despite several attempts to do so. Proposals, however, are currently being outlined which would cap benefit to local average rent levels and aim to encourage tenants to 'shop around', though in practice in many localities, their effective choice is limited.

Social rent rises in recent years under the Labour Government have been far less than under Conservative administrations, so it has virtually abandoned attempts to bring social housing rents closer to market levels and to rely on personal housing allowances, as was once proposed. The political and financial costs of social housing reform have proved to be too great. In most years, rents have risen at around 2% or less in real terms, so that they have fallen further behind private sector ones (Table 21.3). Private sector rents rose almost 30% between 2000 and 2003; whereas council housing rents rose by 12% in the same period, and housing association (RSL) by only 7%.

Table 21.3: Social housing rents 1998-2003*

% Change	1998	1999	2000	2001	2002	2003
RSLs	6.4	4.2	2.3	1.1	4.3	1.6
Council housing	2.6	3.7	4.1	5.0	4.3	2.1

Source:ODPM

¹⁰ Survey of English Housing

Macroeconomic influences

As the accompanying data in the Factfile show, the economy in recent years has been in a strong position – with growth near or above its long-term potential, and with relatively low inflation and unemployment. The world economic slowdown has had only a limited impact on growth rates, and the economy is expected to grow at around its trend in 2004 and 2005.

A package of public expenditure measures came on stream in 2001, and government expenditure will continue to increase over the next couple of years. This has raised the share of public expenditure in national income by 6%, to 43% in 2004.

There is a risk that heavily indebted consumers, especially those who are homeowners, might generate a large negative shock to aggregate demand, so there are potential downside macroeconomic consequences of the current problems of the housing market.

The Bank of England raised interest rates to 4.75% by the summer of 2004 in response to the scale of consumer and housing borrowing. UK interest rates, therefore, are noticeably higher than in the Euro Zone area. This increased typical mortgage interest repayment costs, but the actual impact on new mortgage rates was limited to only around a 0.5% per cent increase over the year, because of the degree of market competition. Nevertheless, the interest rate rises were obviously important influences on the slowdown in house prices. Macroeconomic and associated economic developments are important reasons why the UK housing market continues cyclically to lead those in many other EU countries, as it has done for many years.

Mortgage market influences

Mortgage borrowing boomed with the rising housing market, falling interest rates and the extensive amount of remortgaging being undertaken by existing homeowners (Figure 21.4). 2004 saw new record levels of borrowing, though the rate of growth slowed considerably from the previous few years. Gross lending in 2004 q3, for example, at £81bn, was only 6% higher than in the same quarter a year earlier; whereas it had previously risen by 2.5 times in only 3 years. The autumn months also showed a decline in mortgage lending from the peaks earlier in the year, and were down on the previous year as well.

The spectacular mortgage growth was encouraged by record levels of remortgaging, as homeowners took out extra mortgage debt on their existing homes, although the share of remortgaging was down in 2004, at around 40% of all mortgage loans, compared to 47% in the previous year.¹¹

The proportion of borrowers who are first-time buyers represented half of borrowers in 1995, but this steadily fell to only a fifth as the boom picked up speed.¹² This partly reflects a common pattern in housing market cycles because, as the

market expands, prices become less affordable for new entrants, and the wealth effects of house price rises encourage more existing owners to move. Then, during the subsequent downswing phase, the ratio of first-time buyers increases again, as prices moderate and existing homeowners move less. The increasing role of the private rental sector for younger households, moreover, may mean that in the next downswing the share of first-time buyers does not fully revert to its old levels.

Mortgage lending to private landlords has increased substantially in recent years, in what has been dubbed a Buy-to-Let boom (see above). Buy-to-Let lending accounted for 17% of advances for house purchase in the first half of 2004. There are fears that a sharp slowdown in the housing market will pop a specific Buy-to-Let bubble, especially as it is concentrated in particular localities and, so, lead to sharply falling house prices radiating out from Buy-to-Let localities, causing general house price collapse. Those fears, however, are probably unfounded, because of the characteristics of Buy-to-Let borrowing and borrowers, and the scale of Buy-to-Let relative to the whole housing market.¹³

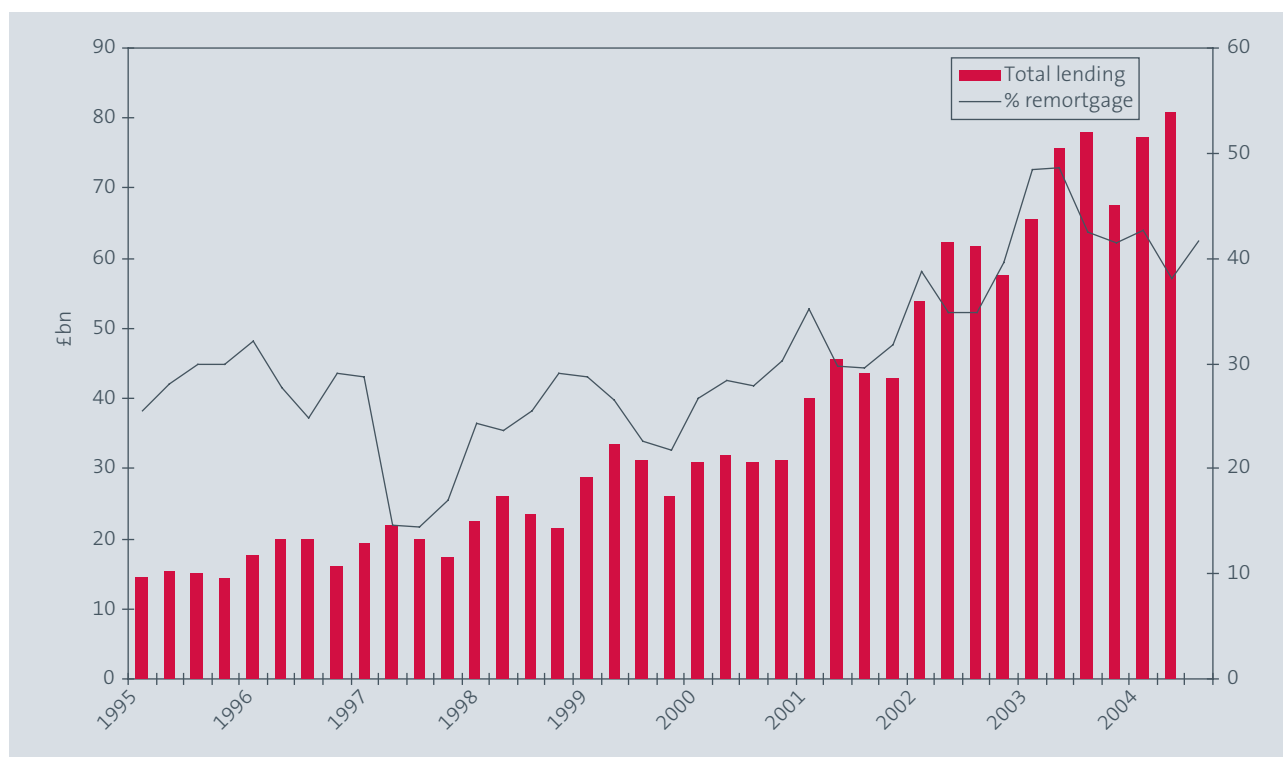
Most mortgages are of the traditional variable rate type. Under British practice, lenders' standard mortgage terms enable them to alter interest rates at any time, with no caps on the rate changes. A wide variety of new mortgage products, however, have been introduced in the past decade. There has been a marked increase in the use of 'fixed' interest rate mortgages, although these typically differ from the long-term contracts used in many other countries. Generally, the interest rate is only fixed for a few years, after which the mortgage reverts to the lending institution's prevailing variable rate for the remainder of the loan period – and it may contain redemption penalties.

The share of variable and 'fixed' interest rate mortgages has varied with the interest rate cycle and associated consumer expectations of the direction of future interest rate changes. Fixed rate mortgages peaked at 61% of new mortgage lending in 2q 1998, when expectations of interest rate rises were high. They then fell to 23% by 3q 2002, as progressively more homeowners expect interest rate stability or further cuts. By 2003, they were again rising, and accounted for around 40% of new loans in 2004 following interest rate rises and expectations of further ones.¹⁴

Competition in the mortgage market has been intense, and many lenders offer introductory 'cut price' offers. There are often no penalties for pre-payment in such products, so that borrowers tend to switch frequently in search of the best deals. An official government report criticised this practice, as it implicitly relies on cross-subsidies from mortgagees who do not switch regularly. The report argued that this type of market structure was one reason why the UK did not have a wider use of long-term fixed rate mortgages, as is common in many other European countries.¹⁵

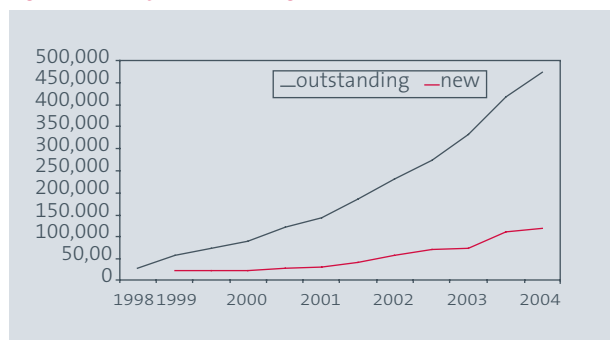
¹¹ See M. Ball *The Future of Private Renting in the UK*, Social Market Foundation and 'Property Investment Funds for the UK: Their Potential Impact on the Private Rented Sector', M. Ball and J. Glascock, CML, London, 2004.
¹² Council of Mortgage Lenders. ¹³ The Miles Report on mortgage lending. HM Treasury, London, 2004.

Figure 21.4: Total mortgages and remortgaging 1995q1-2004q3



Source: CML

Figure 21.5: Buy-to-Let lending 1998-2004



Number of buy-to-let loans
June 1998-2004 half yearly data

Source: CML

Competition between mortgage lenders is strong. New entrants abound, and most previous mutual building societies have now converted to profit-making plc status. Traditional specialist mortgage lenders have also branched out into a wider range of retail banking functions, and several have been taken over by major clearing banks. The largest traditional mortgage lender, the Halifax, merged with the Bank of Scotland in 2001 to form HBOS. In a rare cross-border takeover in EU mortgage markets, the Spanish company Banco Santander Hispano Bilboa in 2004 acquired Abbey, the second largest UK lender.

Table 21.4: The ten largest UK mortgage lenders, 2003

Ranked by outstanding loans	£bn	%
HBOS	172	22
Abbey	88	12
Nationwide BS	71	9
Lloyds TSB	71	9
Barclays	62	8
The Royal Bank of Scotland	48	6
Northern Rock	37	5
Alliance & Leicester	26	3
HSBC Bank	25	3
Bradford & Bingley	23	3

Source: CML

The banking sector had 71% of the residential mortgage market, and the remaining building societies and other specialist lenders had 20% and 9% respectively in 2001. The market position of individual lenders depends on the competitiveness of their mortgage and savings products, which tends to vary over time. Even so, mergers apart, the ranking of the largest mortgage lenders has been quite stable over time. This reflects the significance of consumer loyalty, the importance of branding, and the matching of competitive moves of the major players.

Factfile: United Kingdom

Background

Population (m) 2002	Population Growth % 1980-2001	Fertility Rate* 2002	Years Life Expectancy 2002
58.9	6	1.7	78

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

Services output as % of GDP 2000	Employed as % working age population 2002	GDP per head 2003 EU average = 100
72	72	104

* GDP per person employed 2002

Economic

	200	2001	2002	2003	2004f
Real GDP growth %	3.8	2.1	1.6	2.2	3.1
Growth in real private consumption %	1.9	1.7	2.5	1.8	2.0
Inflation – GDP deflator	1.4	2.3	3.3	3.1	2.3
Inflation – consumer prices	0.8	1.2	1.3	1.4	1.4
Unemployment rate %	5.5	5.1	5.2	5.0	4.8

Government

	2000	2001	2002	2003	2004f
Expenditure as % GDP	37	40	41	43	43

Housing market

	2000	2001	2002	2003	2004f
Growth in residential investment	-0.5	0.9	13.2	4.5	6.9

Taxes

Owner occupied housing	Capital gains exempt	Imputed rental income
Mortgage interest relief – no	yes	not taxed

Property taxes as share of all taxes 2002	Property taxes as share of GDP 2002
12%	4%

Housing Statistics in the European Union 2003, Eurostat, OECD, World Bank.

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