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European Housing Review 2012

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European Housing Review 2012

Report for Royal Institution of Chartered Surveyors

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RICS the mark of property professionalism worldwide

A report for Royal Institution of Chartered Surveyors

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Overview

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

This Review aims to:

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

The format adopted is to provide an introductory comparative chapter presenting an overview of recent developments and a summary chapter of country reports. It is followed by specific country reports on a chapter by chapter basis. These reports explain, where possible, the broad structure of a country's housing system, examine macroeconomic, financial, policy and other influences on housing demand and supply and evaluate current market conditions. The three major economies of France, Germany and the United Kingdom are examined in some depth, while the other countries are reported more briefly.

Given the large number of countries in Europe, it is not feasible to provide individual chapters on all countries. Instead, after the initial pan-European analysis, 13 countries are examined in detail. Emphasis is put on residential markets at the national level.

Housing markets are continually changing and there is a danger that information becomes out of date quickly. This report was completed in the last weeks of 2011 and therefore does not comment on or describe any events occurring later than that. Some headline data in Chapter 1 were updated in February 2012.

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

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

1.1 Limited price changes throughout Europe in 2011

For most countries, house price changes in 2011 were broadly similar to those of 2010 and in the main were relatively modest in scale, lying between plus and minus 5% on an annualised basis (Figure 1.1). Caveats about the variable quality of the house price measures and the fact that they may measure different parts of markets are important when looking at the detailed differences across countries. However, the indices generally indicate that European house prices are broadly flat or declining moderately; with only a handful bucking the trend with significant price growth. As general inflation rose in 2011, the real upward changes were in any case more modest than shown in Figure 1.1 and in countries where prices were declining the falls were somewhat greater.

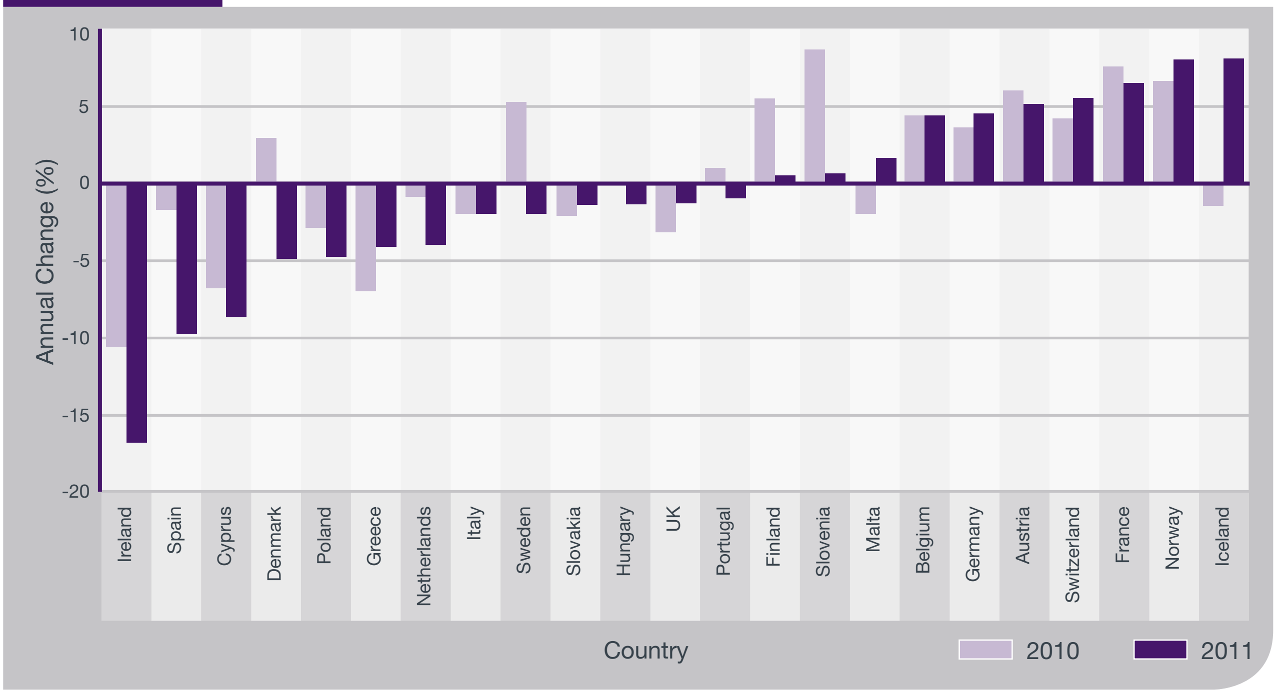
Indications towards the end of 2011 were bleaker than earlier in the year. External events were beginning to press down heavily on Europe's housing markets in the form of the slowdown in the world economy and, in particular, the Eurozone debt crisis. Their effects were seen most clearly in mortgage markets, where interest rates were drifting up and credit availability was being curtailed. Prices in most housing markets were softening at year end, although seasonal factors were influential in that outcome.

The house price outlook for 2012 appeared particularly poor at the end of 2011. However, action by the European Central Bank (ECB) late in 2011 offset the risk of a credit crunch. Better global economic news also lifted optimism in the initial weeks of 2012. Whatever happens, the 2012 outcome for Europe's house prices may well be worse than experienced in 2011, given the poorer state of Europe's economies at the beginning of 2012 than was the case a year earlier. Even so, in the absence of a dramatic worsening of events, major falls in house prices do not seem in prospect.

The key to future housing market changes will be the scale of the economic slowdown in Europe and how long it lasts. If the slowdown is moderate and recovery already starts in 2012, housing markets may not be that badly affected; especially if interest rates are low and mortgage availability keeps up. However, the situation could be far worse if the Eurozone crisis is unresolved or comes to a painful conclusion rather than a harmonious resolution. In that negative scenario, the consequences for Europe's housing markets could be grim, especially if there was a sharp curtailment of mortgage lending.

The downside risk is obviously worse for those countries in the Eurozone. Yet, even non-Eurozone countries' housing markets are going to be affected by problems within it. Those countries are major trading partners with the Eurozone and their own financial systems would suffer as well.

Figure 1.1 House price changes 2010 and 2011*



Reported here are all housing price indices or, if not available, single-family ones; except for Greece where apartment indices are used. Data are either December, q4 (or q3) changes with the previous year.

Sources: National Statistics Offices; Central Banks; Housing Ministries plus RICS Cyprus; Hypoport, Germany; Scenari Immobiliari, Italy; FHB, Hungary; REAS, Poland; Ci-Iberica, Portugal; Wüest & Partner, Switzerland; Lloyds-Halifax, UK.

1.2 Price change at the extremes

Of the outlier countries in terms of the rate of house price change in 2011, the data in Figure 1.1 highlight that most had been in similar positions in 2010. Moreover, each had special reasons for being there.

On the upward side of price growth in 2011 were France, Iceland and Norway. Not too much should be made of their exulted price growth because the increases they experienced were not that much greater than other countries with positive price growth. All had idiosyncratic causes:

- Buoyancy in France's housing market was aided by on-going stimulus measures that have now largely been withdrawn. Signs of slowing were apparent late in the year.
- Iceland's upswing reflects a relatively small bounce back from the massive fall in house prices seen in recent years after the collapse of its financial system.
- Norway's house prices have been accelerating since summer 2010, but it is in a unique position as an oil rich country. Its economic situation encourages credit expansion. The central bank is concerned about the nature and scale of mortgage lending and is therefore supporting tighter lending rules; like the central bank in Switzerland where house price growth is also strong.

The most notable change in the cross-country pattern of house price change was the ending of earlier strong price growth in the other Nordic countries. Finland posted much slower increases in 2011 than in 2010. Sweden and Denmark even experienced moderate price falls, with the downswing being greater in the second half of the year. Post-Eurozone accession house price increases in Slovenia also petered out in 2011.

On the downside were a number of countries with much larger falls in house prices than the European average: namely, Ireland, Spain and Cyprus. Ireland experienced the greatest price fall with -17% over the year. Prices now are more than 50% below their peak values, having previously quadrupled in the housing boom. The problems of Ireland's housing market persist, with one in six residential mortgages in arrears or restructured.

Not only did Ireland, Spain and Cyprus all have substantial price booms prior to their crashes but they also had huge building booms as well. Each one in consequence is still suffering from severe new supply overhangs.

Interestingly, absent from the group with major price falls are some countries at the forefront of current European debt problems: namely, Portugal, Hungary, Italy and Greece. It may seem odd that house prices are not collapsing in them but that may partly reflect the nature of current market contexts and some features of their housing systems.

Short-term housing market circumstances for these countries do contain some positive elements. Notably, none of them are suffering from post-boom supply overhangs. In addition, mortgage interest rates are at historically low levels, which ease repayment problems. However, that is not the case in Hungary where foreign currency based mortgage loans are in major difficulty.

These countries' institutional frameworks also have several characteristics helping to make house prices sticky in a downwards direction. When mortgage holders get into difficulty, the pressure is on banks to err towards forbearance. That stance may involve substantial costs to the banks themselves, as is presently the case in Hungary. Foreclosure is also a difficult, expensive and long drawn out procedure. So, even when defaults are quite high, as currently in Hungary and Portugal, there is not a major flood of properties onto the market on a par with experience in the USA.

The difficulty in loan enforcement has been one reason why historically mortgage use is relatively low in these countries and, although owner occupation is high, most owners own outright. At times of crisis, high outright ownership levels limit forced sales from the existing stock.

Another aspect of housing market behaviour in these countries is that mobility is low, with many people staying in one place for most of their adult lives. When times are bad, they often call on the support of broad family structures. This helps to keep them independent and avoids intervention by financial institutions and government agencies.

1.3 Europe's housing policy options have narrowed

An unfortunate difference between the present day and five years ago is that public policy is now far less capable of being able to stimulate housing markets when the need arises. In fact, policy may now intensify housing market downturn rather than react against it. This is not through deliberate intent but a product of unintended consequences. Policy makers are now far more constrained than they were in 2007/8. The effects can be seen in both monetary and fiscal policy.

Monetary policy:

- In 2007/8, interest rates could be slashed. Now, central bank rates are already low in most countries. However, some countries still have room for manoeuvre. For example, Sweden was able to start cutting rates again in late 2011, after the earlier increases of 2010 and 2011 targeted at slowing of its housing market surge.
- In 2008, central banks could make funds widely available for mortgage lending. Now, at least in the Eurozone and in some non-Euro countries as well, the focus is on sustaining government debt issuance and avoiding a credit crunch.
- Then, strict new mortgage lending rules were not in place and the emphasis was on forcing banks to be soft on payment arrears. Now, bank solvency is once again in question and strict new lending rules are simultaneously being put in place. They are aimed at stopping the next unsustainable boom but, in the current situation, further delay recovery.

Fiscal policy:

- In 2007/8, governments could wheel in substantial fiscal supports for housing markets. Now, governments are cutting what currently exists by way of supports as parts of austerity packages, as country chapters in the Review highlight. For example, major changes have taken place in Spain, France, Italy and the UK.
- Then, the tax attractiveness of housing investment would ensure good leverage for any government housing intervention. Now, tax benefits have been cut back and property taxes have been raised, so that housing investment is less attractive in the face of any positive stimulus to it.
- Sometimes, extra taxation is an indirect consequence of wider measures, such as the raising of VAT which hits new building in most countries and the provision of housing-related services including repairs everywhere. Higher income tax rates have adverse effects as well, including lowering the returns of private housing investors.

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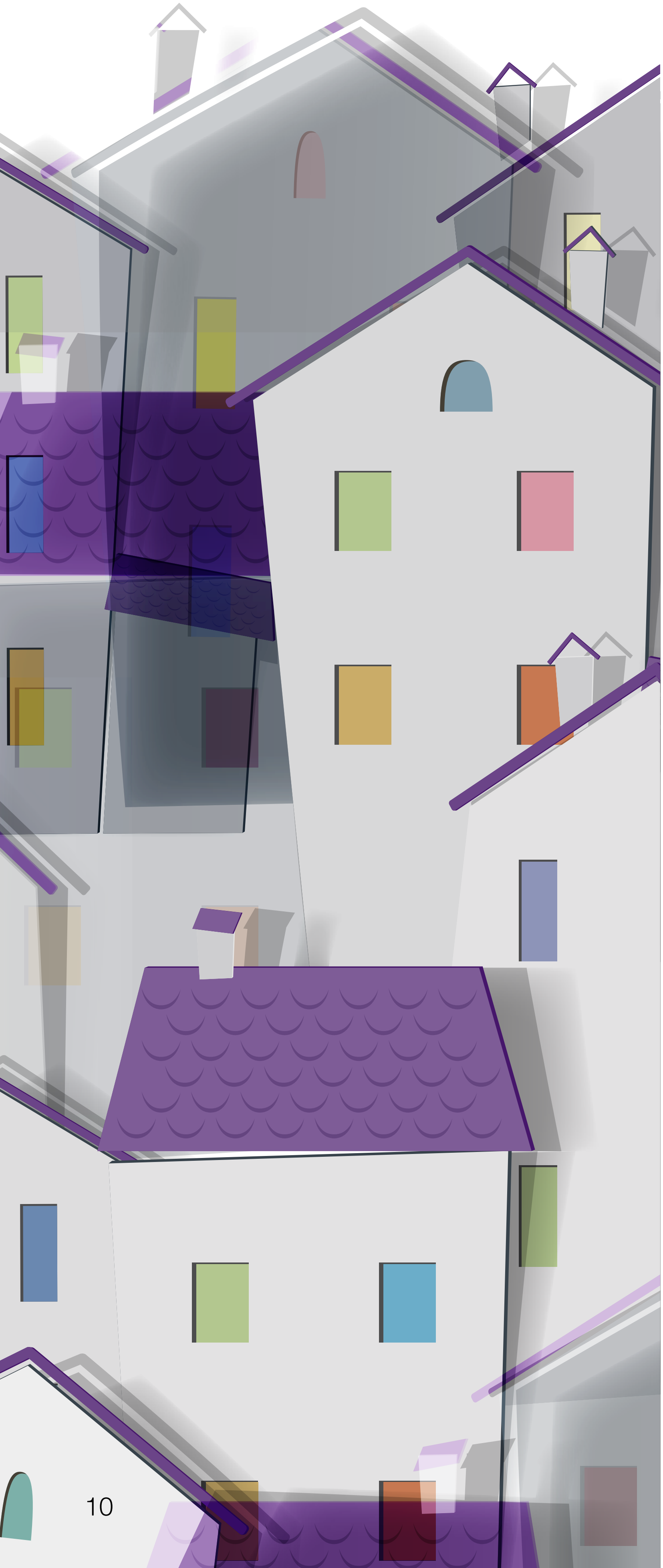
Apart from the factors just described, pro-cyclical extra taxation on housing may come about simply because of changes in tenure shares. Private renting has been growing in a number of European countries because of the problems of owner occupied markets. This means a wider share of the housing stock is subject to tax, because private renting is typically the most heavily taxed of housing tenures.

It is possible to argue that increases in housing taxation are a good thing, because housing consumption was given too many tax breaks before. Times of crisis, it could be said, are when such unpalatable reforms are politically possible. At least, that is what the new Italian government is hoping because most of the taxes in its austerity package are directed at housing.

1 M. Ball, Investing in private renting. Landlord returns, taxation and the future of the private rented sector , RLA, 2011.



1.4 The five year anniversary

In 2012, the European housing market downturn will be five years old. It started with the spillover into world financial markets of the US sub-prime crisis, as seen most clearly in the collapse of the UK's Northern Rock bank in autumn 2007. For some countries, the greatest impact was delayed until autumn 2008, following the aftermath of the demise of Lehman Brothers. However, 2007 still seems the better marker of the onset of European housing market decline.

Prolonged decline

One noticeable feature of this particular downswing is that it is lasting much longer than many previous housing market downturns, such as that of the 1990s. There are several explanations for its duration.

Some have predicted long periods of stagnation because of the scale of mortgage borrowing in the boom years. So far, deleveraging has been slight at best and mortgage borrowing has even expanded significantly in recent years in several European countries. Ratios of either personal debt to disposable incomes or mortgage debt to GDP in even the most indebted countries have only declined modestly to date. This has a double effect. On the one hand, negative equity or simply high levels of debt financially constrain many households from further housing market activity. On the other hand, financial systems have to raise substantial funds simply to sustain existing loans and, so, have less incentive to lend to new borrowers in consequence.

The principal cause of the prolonged agony of housing market decline has been the combination of the financial and sovereign debt crises . There is no clear end in sight, which has major implications for housing markets. Housing market forecasts typically predict upswings within a year or eighteen months of when they are made, but the past experience on which they are based has less credence is such distinctive times.

The spectre of a long decline, as seen in the Japanese housing market in the 1990s and 2000s or in the long, on-going downswing in the USA, cannot be dismissed lightly in a European context. But uncertainty is high and only time will reveal the when and how of housing market recovery in those countries where the downturn has been severe.

It is right to point out the positive housing market benefits of Europe's institutional characteristics: the welfare state safeguards; the mixed housing systems; the propensity for state intervention when markets turn sour; and the existence of low interest rates with mortgage holders able to access them. These factors have helped to temper downward housing market pressures in quite a number of European countries. Unfortunately, running counter to these beneficial European factors are the negative ones of the unresolved sovereign debt crisis and the broader policy conflicts over growth and austerity.

Variable house price performance

When looking at the past five years, some interesting features emerge across the core housing market variables of prices, housebuilding and sales volumes.

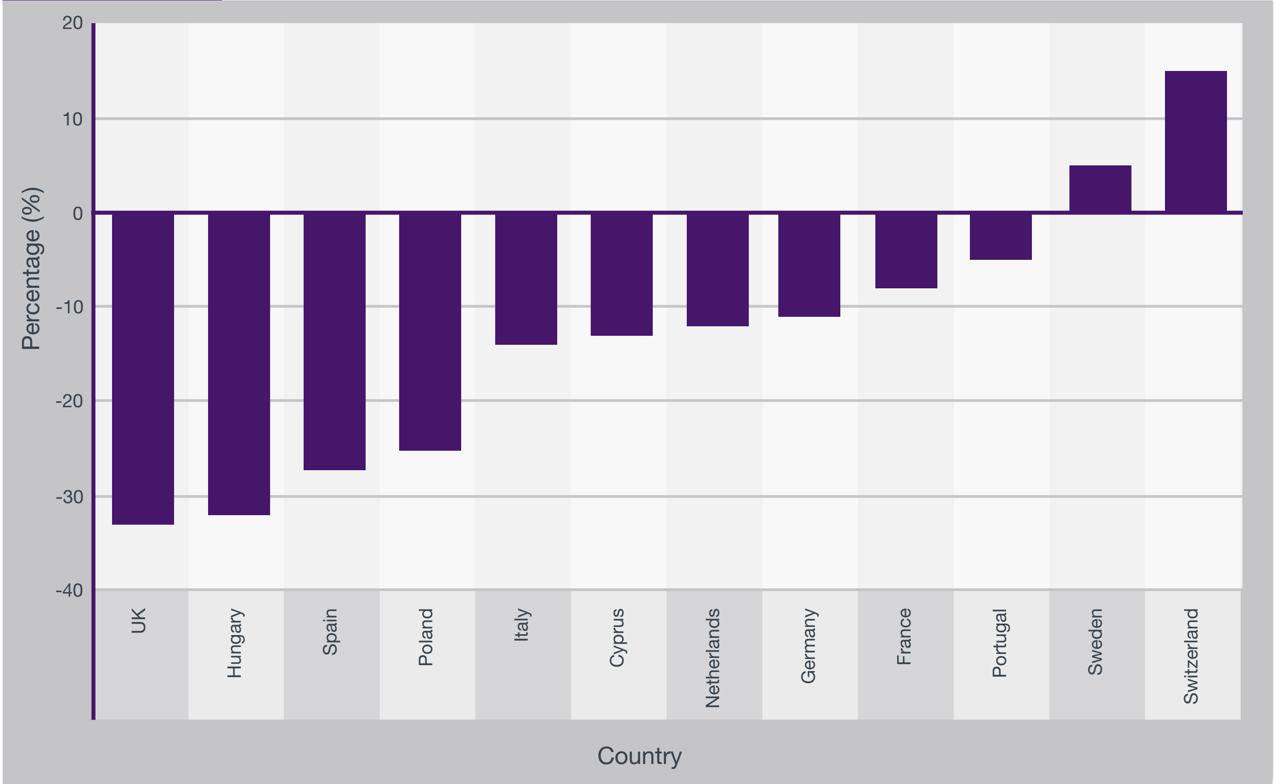
Figure 1.2 looks at the changes in real house prices from the previous peak to the latest available date for the countries considered in detail in this European Housing Review. Not too much weight should be put on relatively minor differences in house price changes for data reasons. Furthermore, for two countries, Sweden and Switzerland, there has not been a recent recorded peak and subsequent price downturn. So, for them comparison is made with 2007. Countries such as Ireland and Ireland, which had the worst experiences, are also absent form this analysis.

Despite these caveats, some interesting differences emerge from the comparison. The most notable is that the range of price changes is substantial, varying from -33% for the UK up to +15% for Switzerland. They show that some countries have now seen substantial falls in house prices, whereas others have not been affected. There is clearly not a single European experience of housing market change but rather substantial country differences.

The variation in the degree of price change does not foretell the future in terms of those that have done their 'correction' job and those still waiting on the side-lines. Simple cross-country measures of house price to income ratios and questionable rent-to-house price ratios are often cited in market commentary. However, they are unlikely to be successful predictors of future market developments for individual European countries. A macro-economic forecast of a country's economic growth based on a single ratio would have little credibility. Housing market forecasting models need similarly to be multivariate rather than to rely on rules of thumb.

The final feature that the five year price comparison shows is that Germany has not been immune from house price declines, although this is partly because house prices have lagged general inflation. They are down by -11% over five years from 2007 to 2011. However, there was some modest real upward price movement in 2011. Even so, such weak overall price performance occurred at a time when the German economy was amongst the strongest in Europe and contrasts with experience in Sweden where economic recovery was equally strong. The reasons for this difference in market behaviour are taken up in the relevant country chapters.

Figure 1.2 **Real house prices since recent peaks**



Note: where not recent previous peak exists, changes are from mid-2007

Sources: See country chapters

Collapsing housebuilding, lower transaction levels

A notable change across Europe since 2007 has been a sharp reduction in housebuilding. That fall has been far greater than for house prices. Demand for new homes has plummeted and lenders have been especially disinclined to advance mortgages on new homes. Another outcome of the credit squeeze is that developers are less able to raise finance for land purchase and building. This particularly affects new entrants which are the lifeblood of competition amongst residential developers.

The lack of demand for new homes has often been exacerbated by producers' pricing strategies. Builders tend to be even more reluctant than existing homeowners to cut prices when trying to sell their dwellings, so unsold stocks squeeze out new starts. But even in many countries with no supply overhang, output has fallen sharply as well, as is indicated by the change in building permits shown in Table 1.1.

The biggest falls have been in countries with erstwhile building booms, notably Spain and Ireland. But many other countries have seen housebuilding falls ranging from a third to three-quarters of previous 2007 levels. They include paradoxically Norway, despite its accelerating house prices. By contrast, Switzerland did manage to raise its output significantly, the only country in Europe to do so.

It is hard to think of many other major industries in Europe's economies that have seen such dramatic production losses over the same time period as residential building. Some governments did try to reverse the decline. In most cases, the measures were small relative to the scale of the problem. Only in France were the measures large enough to have a major impact. But attempts to lower that country's fiscal deficit saw virtually all of them cut by the end of 2011, so output there is now likely to fall in consequence.

One result of such drastically lower levels of house building is that the prices of existing homes are kept up, because they face far less competition from new dwellings. However, housing shortages are marked in many European countries and they have worsened over the past five years in most of them as the lack of new building gradually accumulates and restricts the available housing.

Market transactions are also at low levels, as is shown in individual country chapters. Low sales volumes result from poor economic circumstances and a reluctance to buy in situations where prices are falling. They also highlight an absence of newly built homes on the market because of the decline in housebuilding; the significant mortgage shortages in some countries; and the importance of limited default rates and a growth in renting, which have meant that few existing homeowners were forced to put their homes on the market. If forced sales had been greater, experience in Europe would have been much closer to that in the USA.

Table 1.1 **Change in residential building permits 2007-2011**

Countries	Percentage (%)
EU27	-44
Spain	-89
Ireland	-86
Greece	-75
Portugal	-71
Hungary	-68
Cyprus	-60
Denmark	-43
United Kingdom	-42
Netherlands	-35
Norway	-33
Poland	-28
Sweden	-18
France	-13
Germany	-7
Switzerland	36

Source: Eurostat

1.5 Mortgages

The overall growth in outstanding mortgages in the Eurozone as a whole was modest in 2011 at 2%. However, growth rates varied considerably between countries. Those with severely depressed housing markets saw slight falls in borrowings, but no indication of large-scale deleveraging of mortgage debt; although inflation has been eroding some of its real value. Other countries where housing markets were stronger experienced quite notable rises in outstanding mortgages, including France (Figure 1.3).

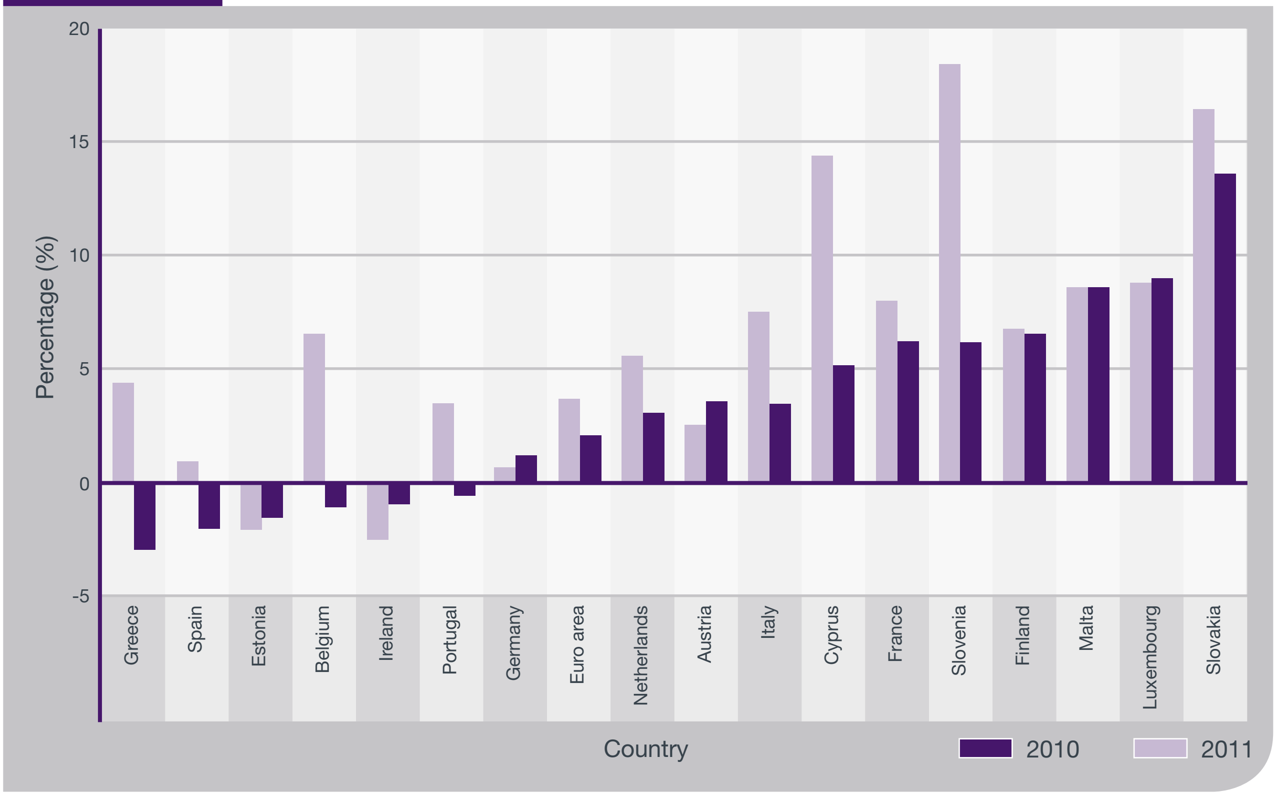
The degree of mortgage rationing across Europe has been highly variable in recent years. In countries such as the UK, it has been a major determinant of overall housing market sluggishness. By contrast, in many other countries mortgages seem to have been far more available.

Countries recently joining the Eurozone – Slovakia, Slovenia and Malta - continued to see marked growth in the use of mortgages. In Poland, although not shown in Figure 1.3, mortgage growth was also strong and much mortgage borrowing has recently been denominated in Euros, despite the country not being part of the Eurozone.

A worrying feature of mortgage markets in 2011 occurred towards the end of the year. In the Eurozone, net lending had earlier fallen sharply during the 2008 financial crisis but then had recovered within a matter of months afterwards, partly because of ECB interventions. Data for 2011 were again showing a similar sharp slowdown, indicating how much banks were pulling back from mortgage lending in light of the Eurozone crisis. In October alone, net lending fell by €18 billion, in a situation highly reminiscent of 2008 (Figure 1.4).

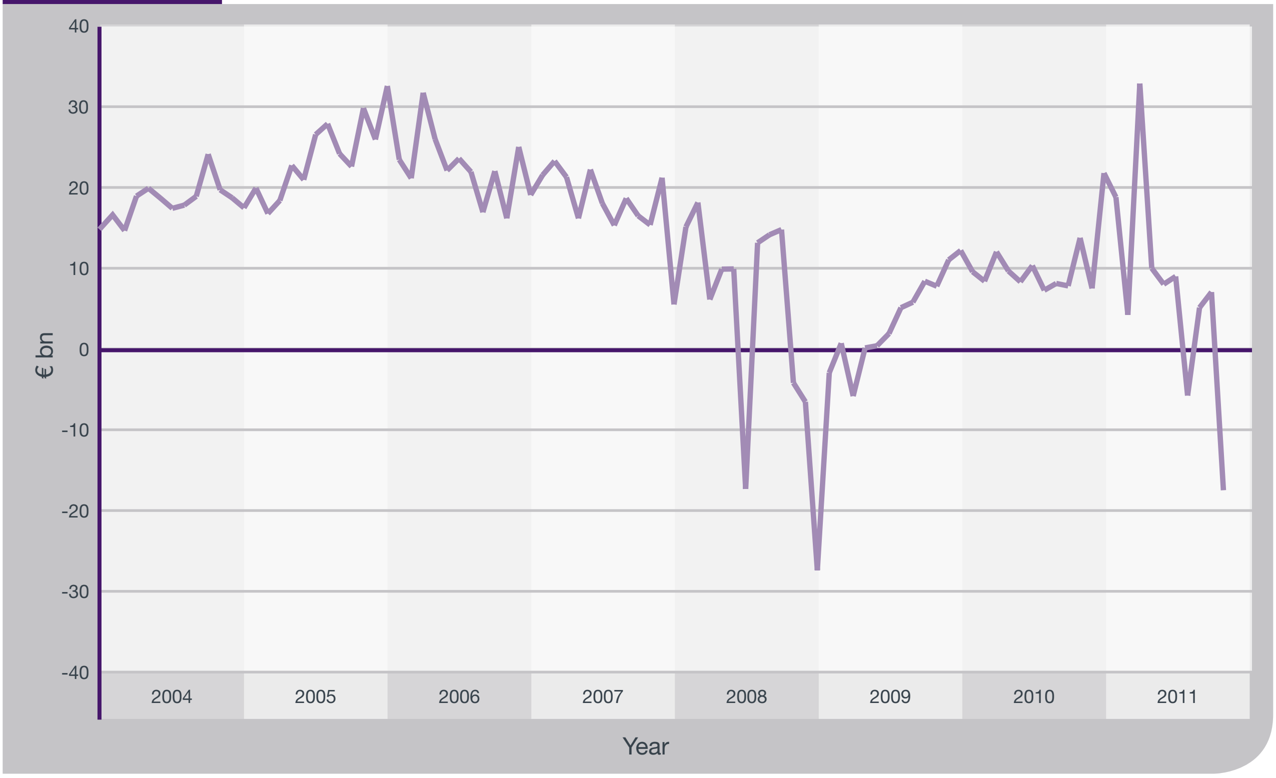
It remains uncertain whether Eurozone mortgage markets will bounce back as strongly in 2012 as they did in 2009. The Eurozone crisis is by no means resolved and any future shocks could easily influence mortgage lending. What happens in Europe's financial markets over the course of the year will clearly have crucial impacts on housing market performances.

Figure 1.3 **Growth in outstanding mortgage debt Eurozone countries 2010 and 2011**



Source: ECB

Figure 1.4 **Lending for house purchase in the Eurozone, net monthly flows February 2004 – October 2012**



Source: ECB

2.0 Recent Market Performances Country Summaries

This chapter provides brief summaries of contemporary housing market conditions in each of the thirteen countries surveyed in detailed country chapters. It aims to provide a snapshot view for those who do not wish to read each chapter in detail. Data sources can be found in Figure 1.1.

Cyprus

The housing market decline is now three years old, after an earlier boom. The RICS Cyprus index reported that apartment prices were -11% down in the first nine months of 2011 and house prices lower by -6%, with the overall fall expected to be -12% for the year. Since the inception of the index in the last quarter of 2009, prices have dropped by -19% for apartments and -11% for houses (in real terms by -23% and -15% respectively).

The housing market is actually made up of a series of sub-markets. The biggest division is between the holiday/second home areas and the five main towns where most Cypriots live, to which the prices above refer. Price declines had been greater in the coastal areas but in 2011 economic problems caught up with the domestic market and price falls were more problematic there.

A noticeable change in 2011 was a considerable tightening of mortgage availability, resulting from financial turmoil as Cyprus' banks were drawn into the Greek sovereign debt crisis. Little mortgage credit was available from the banks, especially in the second half of the year. This and the weak economy drew even the best residential areas into the housing price downswing.

As the economic and financial situation is likely to get worse before getting better, prospects for 2012 are for continued housing market weakness and a further softening of prices.

Finland

During recent years, house price rises in Finland have been some of the highest in Europe, driven by a strong economy and low interest rates. Yet, 2011 saw a slowing down. By December, national prices were up by only 0.4% on the previous year. The national rise was only half that of general price inflation in the economy, so real prices dipped by -2%. Nominal prices started to soften from mid-summer onwards.

With the economy rapidly slowing in the second half of 2011, squeezed real earnings and poor consumer confidence, negative pressures on the housing market were growing and are likely to continue in 2012. Unsurprisingly in the circumstances, housebuilding was showing signs of decline.

The previous expansion had been encouraged by low mortgage interest rates, strong mortgage growth and a good availability of credit. It remains to be seen whether the flow of mortgages can be sustained in 2012.

France

2011 saw price increases in the housing market. The official Notaires-INSEE existing house price index suggested rises of 6.5% over the year up to Q3 2011, or 4% in real terms. Prices had been rising by almost 8% in 2010 after falls in 2008/9. By Q3 2011, they were 12% up from their 2009 low and had reached the level of their previous 2007 nominal peak, although they were still -7.6% down in real terms. The rises were greatest in the Paris area with average prices up by 12% on an annual basis in autumn 2011. New house prices were up by 4% on the year in Q3 2011, according to CGEDD.

Transaction levels by mid-2011 had bounced back to their 2007 pre-crisis levels. Well over 300,000 dwellings were started in 2011, one of the highest per capita building rates in the EU. However, there were signs that the market expansion was slowing in the latter part of the year as economic and credit conditions deteriorated.

Housing market recovery had been encouraged by a range of stimulus measures that have now largely been withdrawn as part of austerity packages. These stimulus measures focused on the entry level to the housing market, incentives to landlords and social building. They spurred the faster price growth in apartments over houses, particularly in the higher priced parts of the country.

Germany

House prices in 2011 increased at a marginally faster rate than in the previous year, rising by 4.5% annually in December, according to the Hypoport index; up from 3.6% the year before. However, as general inflation also rose, the real rate of house price increase was actually marginally smaller than in 2010 at 1.6%. The Mortgage Banks Association's vdpResearch index suggested a slightly slower nominal rate or steady prices in real terms. Of course, Germany is large and regionally diverse, and such national indicators hint at firmer price pressure in the economically strongest parts of the country.

Current developments still do not suggest substantial increase in house prices is in the offing. However, the housing market cycle has remained at variance with much of the rest of Europe, because the country did not have the housing market boom of the 2000s but rather depressed conditions then. The economy recovered strongly after 2009, which helped to boost house purchases. Even so, Germany is not immune from the pressures from the world economy and Eurozone that are currently weighing down on most European housing markets. The economy slowed fast towards the end of 2011, leading to lower price growth and cutbacks in housebuilding.

Hungary

The downswing in the housing market intensified in 2011, as demand continued to evaporate. It was badly affected by the country's economic and financial problems. However, price falls were very modest, recorded at -1.3% in the FHB house price index in Q3 2011, or somewhat larger in real terms at -4.8%.

Prices had started to slide in real terms in 2007 with the onset of the world financial crisis and the sharp recession that followed. By the end of 2011, prices were over 30% less in real terms than they had been at the beginning of 2007.

One reason why prices have not fallen faster is the difficulty lenders have in foreclosing. A large number of mortgages are non-performing but the government has made it difficult for the banks to act.

Non-performing household loans were at the substantial level of 13% of the total in 2011, while a further 4% had been restructured, according to the central bank. To stem the tide of defaults, the government in 2011 decreed that households should have the opportunity until the end of the year to convert existing foreign currency debt into domestic ones at favourable exchange and interest rates. One result is going to be substantial losses to the issuing banks, many of which are foreign owned.

Until the economic situation improves and banks have the capacity and willingness to lend on a large scale again, the housing market situation is likely to remain poor. In light of current events, that may take some time to occur.

Italy

House prices have been falling since 2009, although at relatively modest rates of decline of -2% in nominal terms a year, according to Scenari Immobiliari. Taking into account general price inflation makes the real change somewhat greater at -4.2% for 2011. Overall, prices have fallen in real terms by -13% since 2009. Sales levels and housebuilding have also been drifting down.

The impact of the Eurozone crisis on the Italian government's ability to borrow is having significant effects on the housing market. Pressures on the banking system are squeezing mortgage availability, while the economic slowdown and higher taxes sap consumer confidence and the ability to buy.

In the austerity package introduced by the new Monti government late in 2011, the bulk of the proposed extra taxes in that package were imposed on house ownership. There was to be a 60% increase in the tax on imputed rental income; plus a 0.4% annual tax on the value of main residences, with a higher rate on second homes; plus the introduction of a stamp duty tax on transactions. Once these extra burdens are generally recognised as permanent, they will be capitalised into property values, causing a downward adjustment in house prices.

The prospects for the housing market in 2012 do not look promising, with a weak economy, poor credit availability and a new tax regime. Further price declines can be expected. If the Eurozone crisis is not effectively resolved, the consequences for the housing market would be particularly severe.

The Netherlands

Market conditions were poor in 2011 and prices continued to drift downwards. They fell by- 4% on an annual basis up to December for existing dwellings according to Statistics Netherland, or by around -6% in real terms. Average house prices were by then over -12% lower in real terms than they had been at the beginning of 2007. Prices have been on a gradual slide since mid-2008. However, prospects worsened notably during the second half of 2011, with the economy falling into recession.

Prices in the major cities have fared better than in the rest of the country. The economic and population heartland of the Randstad as a whole has experienced lower price falls than elsewhere. The market in 2012 is going to be under further pressure, given the weak state of the economy and a squeeze on mortgage lending. Consumer confidence is also low. Perhaps the biggest threat is a lack of mortgage finance.

Poland

The slowing in the economy and fiscal retrenchment are having an impact on the housing market but the scale is relatively modest compared to that in many other European economies. The asking prices of new dwellings in the 6 largest cities, according to REAS, on average were -4.8% down on the year. Nominal price declines have been relatively modest since the major adjustment in 2008/9. However, taking account of general inflation, real prices are down by around a quarter since 2008.

The continued downward drift in prices is being aided by high building rates relative to demand. By autumn 2011, the number of homes offered for sale by developers was the highest in the history of the market.

Poland is not being hit as badly as many other countries by the current Eurozone crisis and world slowdown. However, it is not immune, so with buoyant supply some future easing of prices is likely in 2012. Moreover, it must be questionable whether the continued high growth in mortgage loans is sustainable in light of the intensifying international credit squeeze. Without that support, the housing market could soften more.

Portugal

The slowdown in the economy caused house prices to stagnate and fall slightly in 2011, according to the Confidencial Imobiliário index. Asking prices were -1% down on the year in October and by -4.5% in real terms. House price change has been moderate for some years, falling by -5% in real terms in the six years between 2005 and 2011.

The October 2011 RICS/Ci Portuguese Housing Market Survey indicated how low housing market confidence had become. The National Confidence index fell from -53 to -60% and the National Price balance improved marginally from -65 to -64%, but was still deeply negative. Levels of new instructions to agents to sell were also falling throughout the year.

With a further darkening of economic prospects in the second half of 2011, housebuilding was again reduced. This can be seen in the leading indicator of permits issued for residential building, which was -17% down in Q3 2011 on the previous year.

Spain

House prices continue to slide and the rate of decline has accelerated from the modest falls in 2010. The official INE index, based on Notaries' housing contract data, was recording an annual -9.6% fall in existing house prices in Q3 2011. The Fotocasa index was indicating a -6.7% annual fall in November 2011; the Ministry of Housing's Q3 2011 figure was -5.6%; and Tinsa's was showing a -6.9% decline to October.

Spain's economic problems and continuing post-boom housing adjustments have both badly affected the residential market. By summer 2011, market transactions had fallen to only 40% of their levels in 2007. Housing market activity remains depressed because of weak demand, tight credit conditions, and falling prices. 2012 promises more of the same, or worse if the Eurozone's problems cannot be resolved satisfactorily. From being a fountain of growth as in the boom years, residential markets continue to weigh heavily on the economy as a whole at national and local levels.

The problems of the Spain's residential market remain amongst the worst in Europe. The housing market may level off in 2012, as many hope. Yet the risks of further major external shocks are high. Moreover, the country risks the danger of a self-feeding slide similar to that in the 1990s in Japan and that which has afflicted many parts of the USA more recently.

Sweden

The great Swedish house price boom finally ran out of steam in 2011. The prices of single family houses were down -2% on the year, according to Statistics Sweden. The real change was -5%.

Though house price growth declined with the world financial crisis in 2008, prices actually fell only briefly at the end of 2008 and bounced back strongly in 2009 and 2010 as the economy boomed and mortgage interest rates were low. In contrast to other European countries where prices falls have been the norm, real house prices rose by 5% between 2007 and 2011. However, upward price pressures were finally brought to a close with rising interest rates and a slowing economy in 2011.

The prospects for the housing market in 2012 are much poorer than they have been for a long time. The economy will take time to recover. What is more, expectations may shift as many consumers may feel that the housing market has passed a tipping point. If a sufficient number of them feel that values cannot be sustained, this could help to trigger a decline in prices. However, significant mortgage defaults are unlikely in the current interest rate environment and few developers have to unburden themselves of unsold homes, so any price decline is likely to be slow.

Interest rate cuts at the end of 2011 may have a stimulus effect. However, the impact on the housing market will be weaker than in 2008, because of recent macro-prudential policy directives aimed at tightening mortgage availability.

Switzerland

Low interest rates and plentiful credit have helped to push house prices up for some years. In fact, prices continued to rise in the 2008/9 economic recession. So, unlike much of the rest of Europe, Switzerland has been going through a housing market upswing. Real house prices rose by 14.5% from 2007 to 2011, a European record.

Price increases continued in 2011 and were 5.5% up on the year in Q4 2011, according to Wuest & Partner. House prices are generally very high and so is mortgage debt, which is currently growing at a fast rate. Housebuilding also remains strong, particularly in relation to apartments.

Rent levels matter in a country where most households are tenants. Asking rents have been rising and rose by 8% between 2008 and 2011, according to central bank data. By contrast, rents in new apartment buildings fell by -7% over the same period.

The housing market historically is prone to considerable volatility. Memories of the 1990s downturn may be influencing policy makers' current concerns about market overheating.

UK

Hopes that the recovery in 2010 was going to be a sustained one were dashed last year when prices drifted downwards. By December 2011, prices were down by -1.3% on an annualised basis. As inflation had been relatively high, the real change was -6%. As elsewhere in Europe, the nation's economic and financial problems were depressing the housing market.

The RICS Housing Market Survey in November 2011 reported continuing declines in prices with a net balance of -17%. However, the vast majority of surveyors reported only modest falls in the 0 to -2% range. New buyer interest was modestly picking up, the third month in a row. However, instructions to sell were also rising with the balance at +10%. Forward looking indicators suggested a similar pattern of moderately weak prices and slight increases in transactions.

During the pre-2007 boom, households borrowed large sums to finance house purchases so that the mortgage to GDP ratio rose to 85% in 2007. Since then, there has been some modest deleveraging with the total household debt to disposable income ratio falling from 183% to 166% in 2010. However, this debt overhang will affect the housing market and mortgage credit availability for some time to come.

Prospects are now highly uncertain. The housing market is likely to continue to soften in the face of a slowing economy, reductions in public expenditure, rising unemployment, and tight mortgage availability. However, price falls are likely to be moderate; whereas market rents are beginning to drift upwards.

Monetary policy in this weak economic environment indicates that mortgage interest rates are going to stay low for much longer than was anticipated earlier in 2011, which boosts housing affordability and limits arrears. However, recovery looks some way off and is likely to be only gradual when it arrives.

3.0 Cyprus

3.1 Continuing market decline

The housing market decline is now three years old, after an earlier boom. The RICS Cyprus index reported that apartment prices were -11% down in the first nine months of 2011 and house prices by -6%, with the overall fall expected to be -12% for the year. Since the inception of the index in the last quarter of 2009, prices have dropped by -19% for apartments and -11% for houses (in real terms by -23% and -15% respectively).

The central bank has also developed a house price index. It suggests that house prices doubled between 2003 and 2008 but then fell by around -13% from Q3 2008 to Q2 2011.

The Cyprus housing market is actually a series of sub-markets. The biggest division is between the holiday/second home areas and the five main towns of Nicosia, Limassol, Larnaca, Paphos and Famagusta-Paralimni, where most Cypriots live. Price declines had been greater in the coastal areas but in 2011 economics problems caught up with the domestic market and price falls were more marked there.

The RICS Cyprus and the central bank housing indices both refer to the domestic rather than the second home market. The RICS Cyprus index is based on a standard dwelling type and the central bank index is a modified, quality-adjusted one based on information from mortgage providers and subsequent adjustments on the basis of other market information.

A noticeable change in 2011 was a considerable tightening of mortgage availability, resulting from financial turmoil as Cyprus' banks were drawn into the Greek sovereign debt crisis. Little mortgage credit was available from the banks, especially in the second half of the year. This and the weak economy drew even the best residential areas into the price downswing.

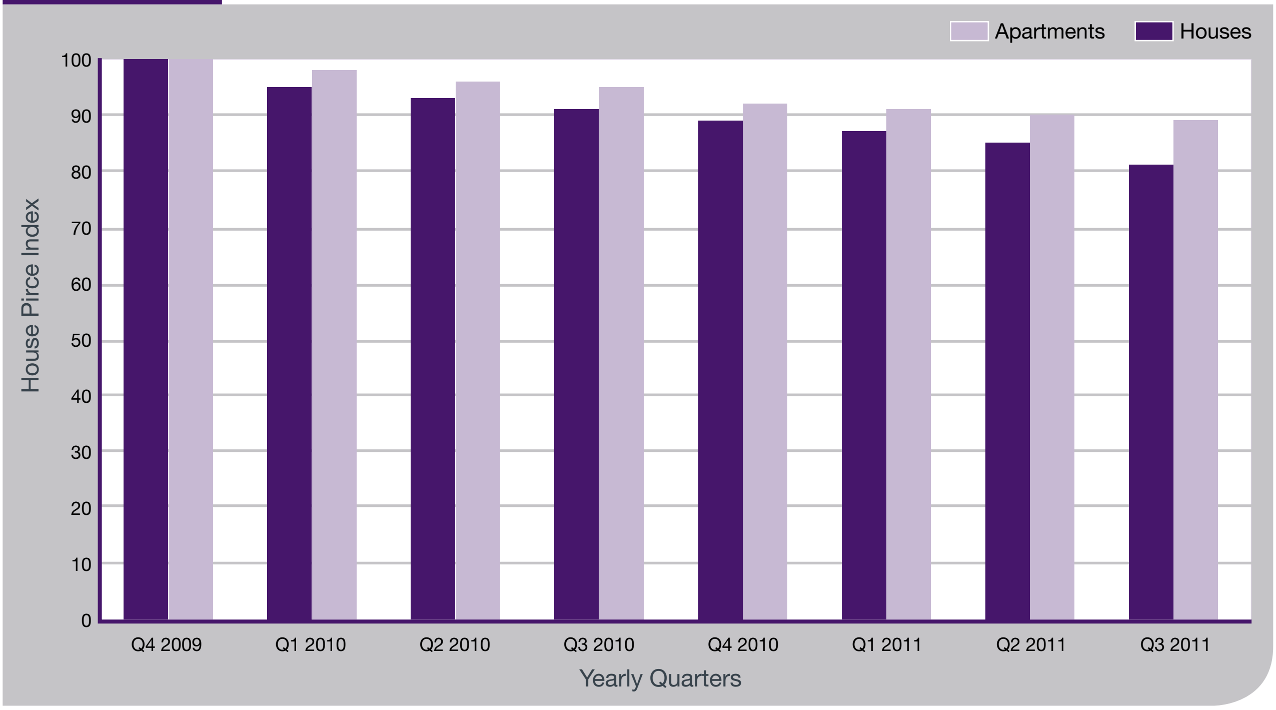
It is difficult to generalise about house prices in tourist areas because there is much variability due to property and site characteristics, especially the presence of sea views and beaches. However, prices have been more volatile here than in the urban areas: rising more in the boom but falling more afterwards. Local experts suggest that prices have dropped by approximately -30 to -40% from the peak, or more in secondary locations.

Rents in the stock had been rising at 3-4% a year in the recent boom years, somewhat above the general rate of price inflation, but have been falling in the downturn, according to the RICS Cyprus survey.

In an attempt to bolster the housing market, transaction taxes have been temporarily abolished for new dwellings and halved for existing ones for a 6 month period from December 2011.

As the economic and financial situation is likely to get worse before it gets better, prospects for 2012 are for continued housing market weakness and a further softening of prices.

Figure 3.1 **House prices RICS Cyprus house price index Q4 2009 – Q3 2010**



Source: RICS Cyprus

The earlier housing boom was driven both by domestic and foreign demand and easier credit conditions following accession to the euro. Traditionally, overseas buyers are mainly from the UK, attracted by the climate, cheap lifestyle, good public facilities and widespread use of English. During the boom, however, a wider group was attracted, most notably from Russia.

While many sales take place smoothly, there have unfortunately been a series of problems with regard to property purchase, including misleading advertising, failure to complete off-plan bought properties and illegal construction. Around 100,000 national and foreign owners are also unable to obtain title deeds. In some cases, they have been trying for 30 years and without possession of title purchasers find it difficult to sell. Under Cypriot law, title remains with developers until transferred after mortgages are fully paid off. While still holding title to dwellings they have ostensibly sold, they can take out further mortgages, impose fees and charges, and if they default, the mortgage holder can take possession over the head of the unfortunate owner. The UK Foreign Office urges potential buyers to proceed with caution and take qualified legal advice. This well publicised issue weakens overseas interest in the country; although the government says reforms are to be introduced.

3.2 Housing system

Owner occupation is around the EU average at 68% and many houses are owned outright. A further 14% are rented in the private sector. There is a policy emphasis on promoting owner occupation. Roughly 10% of the population are non-Cypriot residents, according to the 2001 census, and the share has risen since then.

3.3 Market transactions and housebuilding

Transactions data from the Cyprus property registries indicate a sharp fall in sales in recent years. The overall decline continued in 2011, with second quarter figures -22% lower than the year before. The number of foreign buyers had fallen from earlier peaks by over 80% in 2010 and numbers stabilised in 2011 but at a very low level. These falls reflect the poor economic climate, bad publicity, and the disincentives of buying in a declining market.

In the boom years, more than 6% of GDP was devoted to housing investment annually, significantly more than the EU average. This high level of building reflected the island's status as a holiday and retirement destination.

Excess new supply now characterises the market. This contributes to falling prices, to substantial cuts in housebuilding (though permit numbers remain quite high), and to abandoned semi-completed dwellings.

3.4 The economy

Up to the world financial crisis, the economy grew strongly, so that by 2009 GDP per capita was only 2 percentage points less than the EU average.[2] The world financial crisis badly affected the country and shrank the tourist market. The economy contracted by -1.9% in 2009, but then grew in 2010 by 1.1%. Expansion was further stifled in 2011 by the mounting sovereign debt crisis, problems over electricity supply, and the need to cut government expenditure. Growth was virtually zero in 2011 and is expected to be the same, or worse, in 2012.[3]

The impact of the Eurozone crisis on the economy has been great because Cypriot banks are large relative to the economy, with assets of more than seven times GDP. With substantial investments in Greek bonds, Greece's sovereign debt crisis has badly affected them so they have struggled to pass stress tests and to achieve capital adequacy targets. The economic consequences were a considerable credit squeeze and rising interest rates as spreads rose.

Inflation averaged around 2% for the four years up to and including 2007. The country is heavily dependent on imports, which pushed inflation to 2.5% in 2010. Despite the weak economy, prices were pushed up further in 2011 and were growing at 3.4% in the autumn.[4]

3.5 Mortgages

Over the past decade, housing lending has been rising fast from a low base. The total value of housing loans was still rising at over 15% a year in 2010 and 12% in Q1 2011.[5] However, the impact of the mounting Eurozone debt crisis then led to a sharp curtailing of credit.

Unsurprisingly with such rapid expansion over the past five years, the mortgage debt to GDP ratio has risen fast. It reached 69% in 2010 from a very modest level only a few years previously.[6] Consumers have been borrowing heavily for non-housing reasons as well, with only just over a half of their total borrowings related to loans for house purchase. As the economy slows and terms worsen, more households will face repayment difficulties.

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

Loans are typically offered on a variable or short-term fixed basis and tend to be noticeably more expensive than for similar products in many other Eurozone countries. Interest rates had been gradually falling in mid-2010 to 4.3%, but rose at year end and increases continued in 2011 as banks found it increasingly expensive to raise funds.

2 Eurostat 3 Eurostat. 4 Cystat. 5 Central Bank. 6 European Mortgage Federation.

4.0 Finland

4.1 The housing market slows

During recent years, house price rises have been some of the highest in Europe, driven by a strong economy and low interest rates. Yet, 2011 saw a slowing down. By October, national prices were up by only 1.6% on the previous year and by 2.9% in Helsinki. Yet, the national rise was only half that of general price inflation in the economy, so real prices dipped by -2%. Nominal prices also started to soften from mid-summer onwards.

With the economy rapidly slowing in the second half of 2011, squeezed real earnings, poor consumer confidence, and negative pressures on the housing market were growing and are likely to continue in 2012. Unsurprisingly in the circumstances, housebuilding was showing signs of decline.

Previous expansion had been encouraged by low mortgage interest rates, strong mortgage growth and a good availability of credit. It remains to be seen whether the flow of mortgages can be sustained in 2012.

4.2 Housing system

Two-thirds of households are owner occupiers. Single family homes are generally owned directly and around 40% of the stock is detached housing. However, half of homeownership is related to housing companies. Most of them manage only a few properties and residents own shares in them and pay regular maintenance, fees etc. Homeowners can deduct mortgage interest from their tax bills.[7]

Amongst the third of households that rent, half rent privately. The other half live in social housing provided by local authorities or non-profit organisations in receipt of state subsidies. Those supports are channelled through soft loans and interest rate subsidies. Rents are controlled in the social sector and, also, in the private sector where there is distinct legislation related to reasonable rent levels and rent increases.

Rents rose by 3% on an annual basis in September 2011 in both the subsidised and unsubsidised sectors. Since 2005, they have risen marginally above the general rate of inflation, but with somewhat greater increases in Helsinki.[8]

Marked shortages of accommodation are apparent in the Helsinki region but not elsewhere. There is even an excess of dwellings in some communities.

4.3 Housebuilding

Housebuilding was badly hit by the impact of the world financial crisis and volumes fell by over -40% between 2007 and mid-2009. However, it then recovered rapidly and was nearly back to its peak point by mid-2010 and stayed at that level through the first nine months of the year. The greatest buoyancy seems to be in smaller homes, because detached house building rates have been slowing.

Prospects for further expansion were indicated by the 14% increase on the year in granted building permits in September 2011.[9] Nonetheless, the increasingly poor economic environment in the second half of 2011 may see slower take-up of those permits than in the near past. Residential investment was showing signs of slowing markedly in the closing months of 2011 and is likely to weaken further.

4.4 The economy

With such an open economy and natural resource focus, the economy was hit badly by the world slowdown. In 2009, the economy shrank by a substantial -8%. Nevertheless, it then recovered rapidly in 2010, with almost 4% growth, and expansion was sustained for much of 2011. Momentum began to wane in the second half of the year, so growth is expected to be poor in 2012.

Inflation picked up in 2011, rising above 3%, so real earnings are being eroded and consumer confidence is low. Some recovery is expected in 2013.

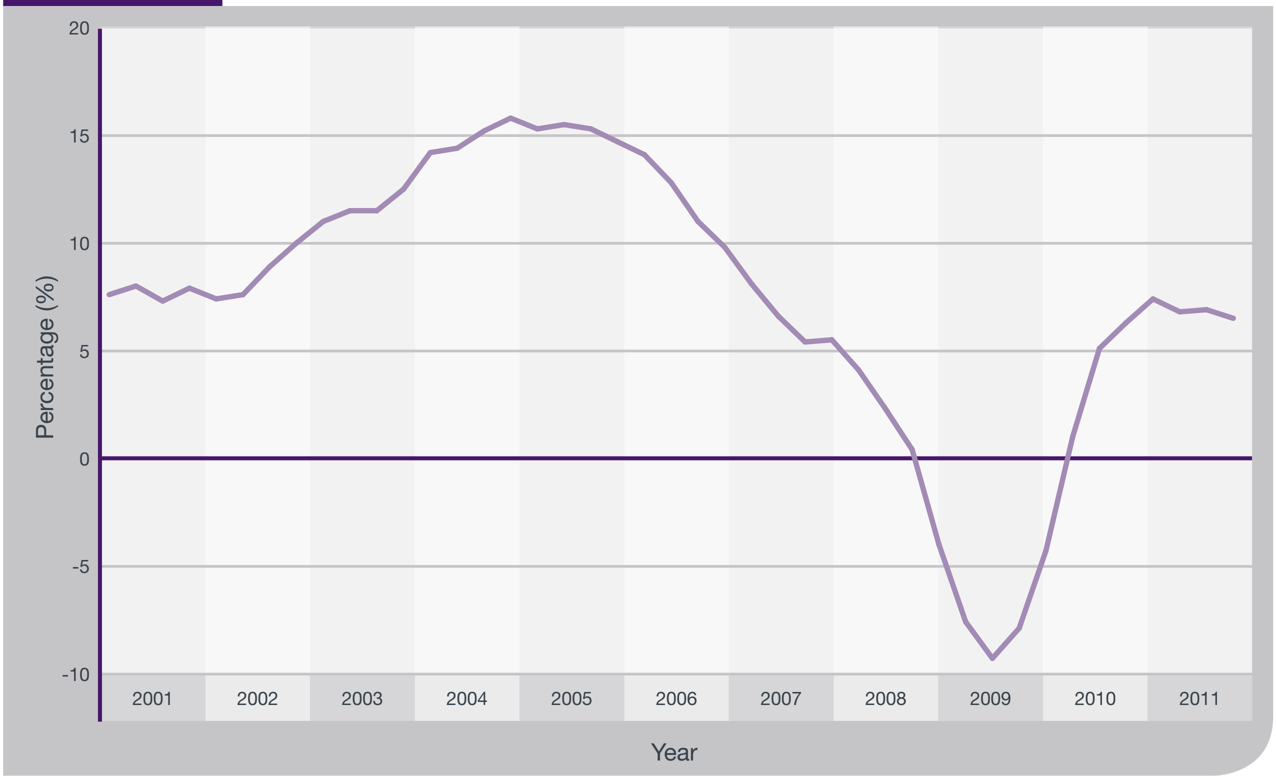
4.5 Mortgages

The mortgage market has been important in keeping up housing demand. Credit availability has generally been good in recent years. Following the dip after the Lehman crash in 2008, loan volumes recovered in 2010 and continued to expand in the first three months of 2011. The annual growth rate in September 2011 was 7%.

Mortgage interest rates have also been low; with an average interest rate on new loans of 2.6% in September 2011. There was a slight rise on 2010, when rates were below 2% at one stage. Most mortgage interest rates are of the variable interest type, linked to a variety of reference rates. However, caution about the future encouraged 10% of borrowers in September 2011 to lock in current levels and use fixed interest rates.[10]

7 Ministry of Environment. 8 Ministry of Environment. 9 Statistics Finland. 10 Bank of Finland.

Figure 5.1 Changes in house prices, Q1 2001-Q3 2011



Source: INSEE

5.1 Strong market showing signs of weakening

2011 saw price increases in the housing market. The official Notaires-INSEE existing house price index suggested rises of 6.7% over the year up to Q3 2011, or 4.3% in real terms (Figure 5.1). Prices had begun to rise in 2010 after falls during 2008/9. By Q3 2011, they were 12% up from their 2009 low and had reached the level of their previous 2007 peak in nominal terms, although were still -7.6% down in real terms.[11] New house prices were up by 4% on the year in Q3 2011, according to CGEDD.

The rises were greatest in the Paris area with average prices up by 12%. However, there were signs that the market expansion was slowing in the latter part of the year as economic and credit conditions deteriorated.

Housing market recovery had been previously encouraged by a range of stimulus measures that have now largely been withdrawn. These stimulus measures focused on the entry level to the housing market, incentives to landlords and social building. They spurred the faster price growth in apartments over houses, particularly in the higher priced parts of the country. Housebuilding expansion was also greatest in that sector.

For the country as a whole, apartment prices for the first half of 2011 were rising at a 10% annual rate whereas house prices were only growing at half of that level. The differential was strongest in the Paris region, where in summer 2011 annualised prices grew by 22% for Paris flats and only 7% for houses in the suburbs in the Ile-de-France, according to INSEE.

Transaction levels by mid-2011 had bounced back to their 2007 pre-crisis levels. This contrasts strongly with experience elsewhere in Europe where transactions have typically remained more subdued. Initially, experience was similar to elsewhere because transactions of existing homes had fallen by 30% up to 2009, according to CGEDD. But then the recovery in 2010 and 2011 was a rapid one, wiping out the earlier drop by mid-2011. However, sales rates are likely to decline again in 2012 because of the economic headwinds.

The situation with regard to new dwelling sales was less buoyant in 2011 than in the previous strong growth year. New homes sales had rebounded rapidly from their trough levels by autumn 2010 and were at similar levels to those prevailing in 2006 and 2007. However, this building recovery was encouraged by the stimulus measures and the steam went out of the recovery towards the end of 2010 as they were withdrawn. There was some renewed expansion later in 2011, brought on by the strength of demand in the market as a whole, though output remained below its 2010 levels.

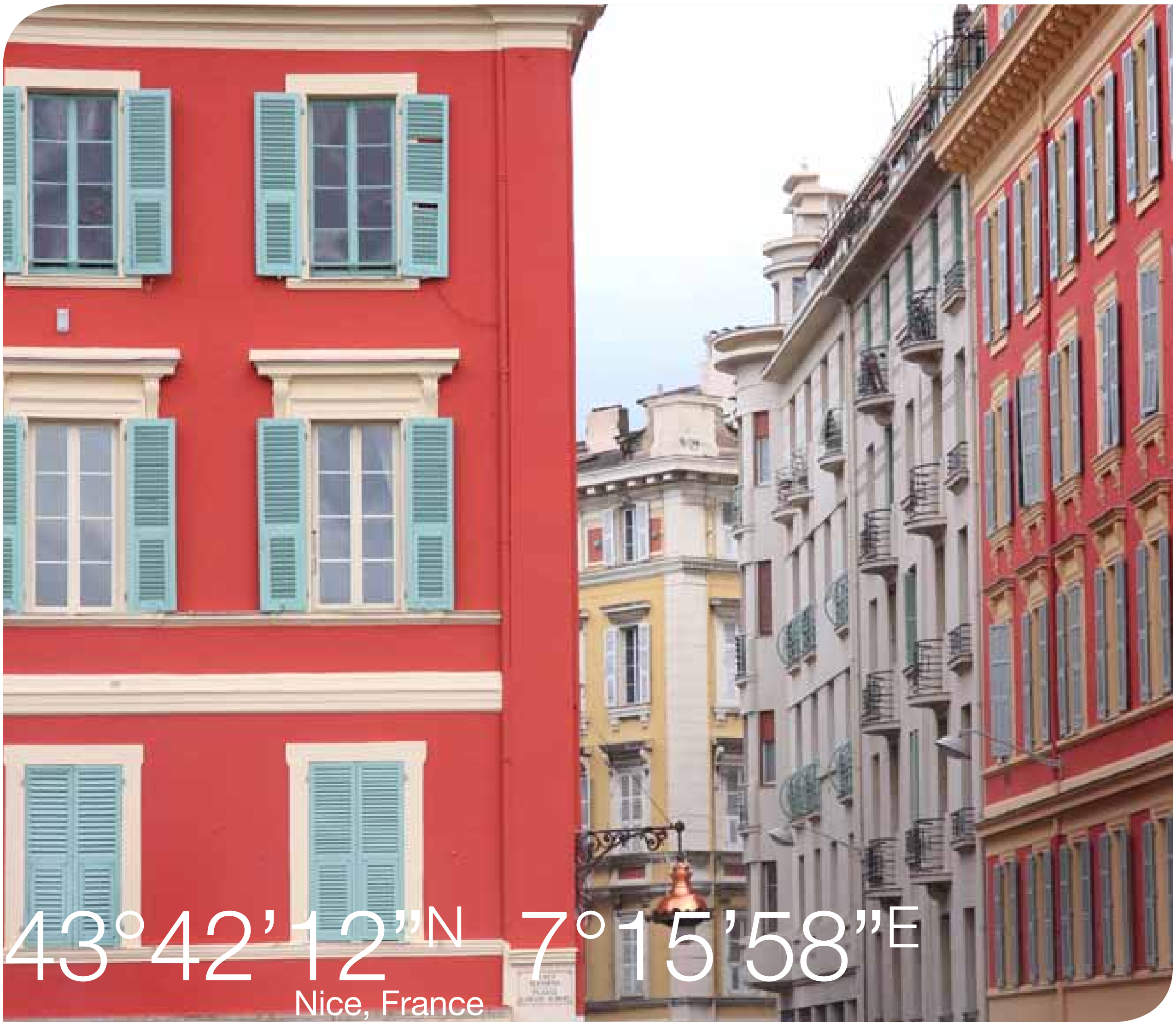
Continued fiscal austerity in 2012 is now the order of the day and, as the stimulus measures continue to wind down, the surge in demand they encouraged will disappear. Added to that, demand will have been brought forward to take advantage of them, which will now have to be replaced if the market is to continue to recover.

Prior to 2007, the housing market had been booming, with significant price rises occurring for a decade. In fact, real house prices doubled between 1996 and 2006. However, the rate of price growth actually peaked far in advance of the onset of the credit crunch in the summer of 2004, at 16% a year, and following that price inflation gradually subsided (Figure 5.1).

The French housing market, like most others, is no stranger to booms and slumps. House prices in the first half of the 1990s fell by around a third in real terms. In fact, prolonged marked real price declines have been a common experience of most previous downswings, so the recent downturn was a relatively mild one in comparison.

The current softening of the housing market is taking place in a different context from that of 2008. Then, the government was able to counteract the downswing with housing stimulus measures and lenders were able to sustain mortgage credit and offer attractive lending rates. Now, the priority of government is to reduce the budget deficit. To that end, property taxes are rising and housing subsidies have been slashed. In addition, the banking system is under tremendous strain because of the Eurozone crisis and lending conditions are tightening in consequence. Therefore, as the market weakens once again, there are fewer supports to counteract downward pressures.

To an extent, the earlier stimulus measures may in any case have over-achieved their aims over the past two years and helped to push up prices, particularly in the Paris region. But the current combination of events illustrates how difficult it can be to attempt to steer housing markets through fiscal policy.



11 INSEE

5.2 Housing system

France has 32 million dwellings: 84% are primary residences, 9% second homes and 7% are vacant. Of primary residences, 57% are owner occupied, 24% privately rented and 18% social rented.[12] The basic quality of housing is good, although there are some notable problems as indicated by a 2009 survey that showed that 52% of households had a housing quality problem (overcrowded, lack of basic facilities, home too small, damp or noisy).[13]

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

What is more, housing policy is deliberately used in a Keynesian way to manage demand in the economy, and was once again used in that way during the last recession. This aim is a stated goal of housing policy in a way rarely mentioned in other countries.

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

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

The urban riots of 2005 led to a strong policy response with regard to housing, which continues. A document was published ‘*Logement: le gouvernements ’engage*’, outlining more than 60 housing measures. One of them focuses on the demolition of the worst social housing and another on major renovation schemes of buildings designated to remain. An urban renovation agency manages many of the schemes (ANRU – Agence Nationale Pour La Rénovation Urbaine).

France has the largest stock of housing in the EU, when measured on a crude number per thousand population basis. Partly this is accounted for by the high level of vacancies: they have remained around 6-7% of the stock for many years. Such vacancies are associated with the continued rural to urban population shift and with rundown stock in older industrial areas. Moreover, for a variety of reasons, their owners may decide to keep some dwellings officially defined as vacant. Fiscal penalties on vacant dwellings have recently been introduced in an attempt to reduce the vacancy rate.

A fifth of the stock has been built since 1980 and two-thirds since 1945. The housebuilding rate is quite high by EU standards and it grew significantly during the final years of the pre-2008 boom. In the 1990s, an average of almost 300,000 dwellings was added to the stock each year and output was even higher in the 2000s, rising near to 350,000, and it remains at a high level. But, despite this high rate of building, shortages have remained, particularly of affordable housing in the main urban areas.

Almost 60% of the stock is individual houses, mainly owner occupied, and the rest are flats located in multi-dwelling structures, most of which are rented. 16% of the total stock exists as dwellings in high-rise buildings of 4 storeys or more. Much of the social sector is located in unattractive suburban areas. Although much has been spent on upgrading the social stock, many still need improvement.

Owner occupation

The number of households owning their principal home started to grow noticeably during the last housing boom after being stable for many years. Post-2008 measures further encourage home purchase. In 1992, it was estimated that 54% of primary residences were owned by their occupants. By 2006, the share had risen only marginally to 57%. That rate is notably lower than the EU average but an extensive programme of encouraging home ownership has continued, and so it has probably grown further since then.

Expansion of homeownership has taken place at a time of rapid household growth, so the number of homeowners has been rising quite rapidly. For example, between 1990 and 2005, there were 3 million extra owner occupiers in total; accounting for two-thirds of the total net increase in the stock.

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

12 INSEE. 13 National Housing Agency.

The current government has set itself a target of raising the homeownership rate to 70%. Achieving that aim would result in a major transformation of French society and at best must be regarded as a long-term goal. As part of this process, 40,000 social housing tenants a year are expected to become owners of their dwellings in a programme reminiscent of council house sales in the UK. However, sales in recent years have actually been running at a much lower, though still significant, rate.[14]

Housebuilding receives a variety of subsidies. They include potential exemption from property taxes on buildings, general tax credits and specific tax breaks for sustainable development. Renovations are also funded, especially when related to energy efficiency.

A subsidised mortgage loans policy exists in the form of an interest-free loan programme, known in France as the ‘prêt à zero %’ programme (PTZ). This scheme provides loans to moderate-to-middle income first-time buyers. Applicants are processed through the usual channels as parts of mortgage packages. This has made lending to such applicants more attractive for commercial firms, as the PTZ loan element is state funded, offering in practice a boost to the down payments that first-time buyers can make. This gives greater confidence to lenders as it lowers the default risk on their elements of the total loan packages offered to home buyers.

Since its introduction in the mid-1990s, many moderate income households have used PTZ loans. Up to 2005, they were used mainly to buy single family houses. It is common for younger French people to stay in their parents’ home through the early years of adulthood. 29% of men aged between 24 and 29, for instance, still live with their parents during which time they may accumulate savings for a housing down payment. So the PTZ scheme, by acting as an implicit deposit top-up, assists in smoothing the transition from parental home to home ownership, especially outside the higher priced areas. The maximum size of the loan depends on which region of France the dwelling is being purchased in, the amount of other borrowings, and whether the dwelling is new.

The zero-interest loan policy had been growing in significance over the past five years, as part of the programme to expand owner occupation. Early in 2005, a revised PTZ scheme was introduced and the scope of the programme was extended significantly by making it available for existing as well as new housing. Further reforms in 2006 increased the loan and income caps in the more expensive areas of the country. The monthly income caps on PTZ loans were then raised until the end of 2009 as part of the crisis-induced emergency package of housing measures.[15] Under a new PTZ+ scheme, income caps were abolished and loan length and terms improved; while the previous general tax reliefs on mortgage interest were abolished at the end of 2010, giving first-time buyers a fiscal edge.

However, from 2012, recent expansion of the PTZ scheme is going into reverse as part of the general fiscal squeeze. Approximately 360,000 first time buyers took advantage of the scheme in 2011, at a cost to the state of €2.4bn. The government wishes to reduce that by two-thirds to €800m in 2012 by restricting PTZ to new housing only again and further targeting the programme, if required, so that it fits within the new budgetary constraint. FNAIM fears a major impact on the number of property transactions in 2012.

Another source of financial aid to housing is the Pass-Foncier scheme, which provides soft loans to first-time buyers.

In 2011, higher capital gains taxes were introduced on housing, aimed particularly at second home owners. VAT was also raised on improvements to 7%.

Private renting

Almost a quarter of households rent privately and renters are generally located in the inner city areas of the large cities, with the greatest number in Paris. Such tenants are highly mobile: two-thirds occupy their dwelling for less than 4 years. Most landlords, 93% of them, are private individuals rather than corporations, according to INSEE surveys.

The number of privately rented dwellings has been fairly static over the past 45 years at around 6.5 million dwellings, although average quality has greatly improved over that time. The stock is relatively new in contrast to several other European countries. Nearly 60% of private rented dwellings were built after 1948 and as many as 14% after 1990, with new building encouraged by attractive renovation subsidies and land allocations.

Rental investment has been encouraged by an attractive tax regime, which includes incentives to buy and rent out new and renovated properties. The individual investment purchase tax breaks were reformed into the ‘Scellier’ scheme from the beginning of 2010, with depreciation allowances replaced by direct tax cuts for those that agreed to rent out a property for at least 9 years from purchase. The benefits were attractive but were reduced from 2011, suggesting that investors may have frontloaded their activity into the period prior to then.

However, the cost of the Scellier scheme was still €2 billion in 2011. With the government searching for ways to reduce public expenditure, late in 2011, the scheme was deemed too expensive and an announcement made that Scellier abruptly ends in 2012. With loss of such a substantial subsidy, the impact on the rental market is likely to be significant. Housebuilding in 2012 will be doubly negatively affected as investors will have scrambled to buy before the scheme’s end and brought forward purchases.

14 Housing Ministry. 15 National Housing Agency.

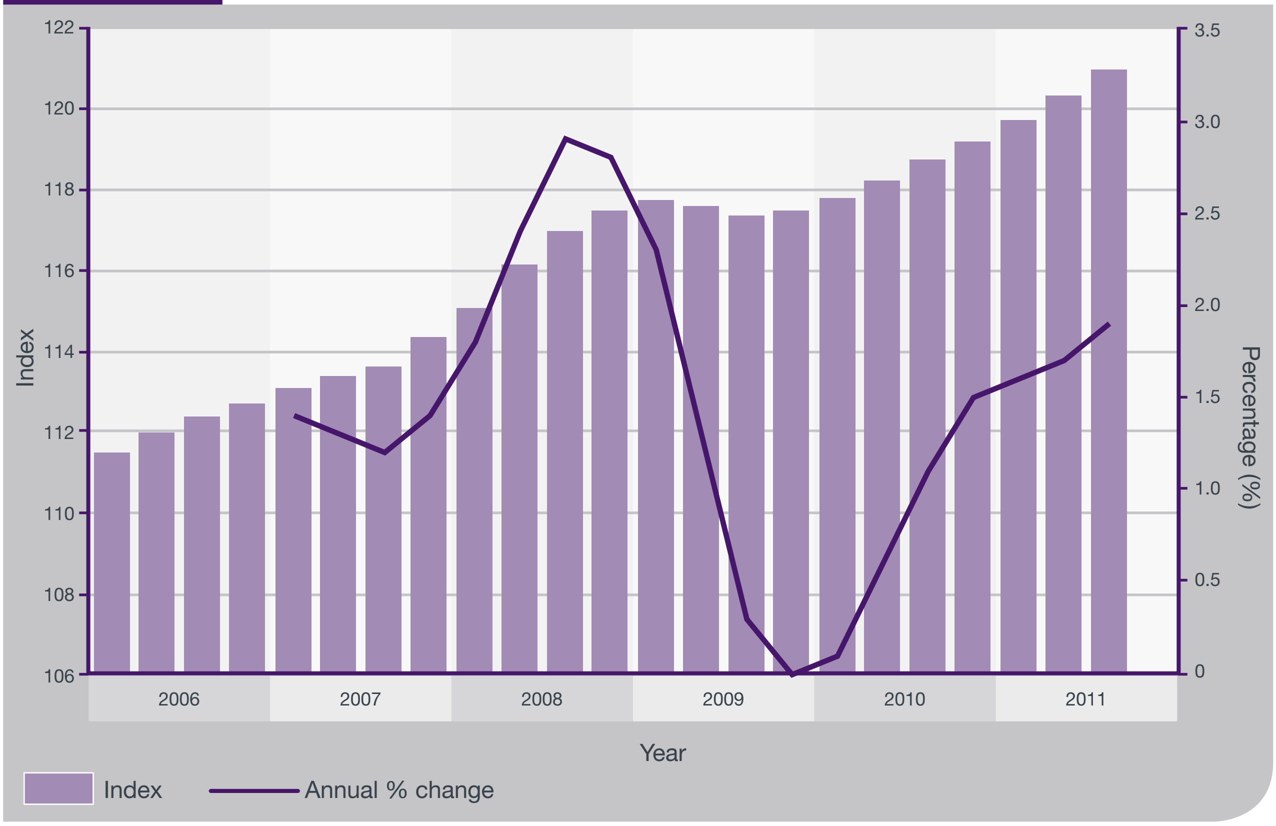
Rent control exists in a variety of forms, depending on the type of property and the length of the tenancy. Under the most common form of arrangement, rents may be freely agreed in leases for new and renovated dwellings but then subsequent rent increases are linked to an official reference index. This regulation was introduced in 1989 and so is often known by that date. It has been in force for all new tenancies since 1997. About 5% of the privately rented stock is subject to strict rent control under the terms of the rental law of 1948.

From 2006, the permitted formula for annual rent adjustments switched away from the construction price index, which was rising at a much faster rate than general inflation, to a composite rent reference index (known by the acronym IRL – Indice de Référence des Loyers). The new IRL index is based 60% on the consumers' price index, 20% on the construction cost index, and 20% on an index tracking landlords' estimated costs for management and repair. The IRL grew quite substantially during 2007 and 2008, reaching almost 3% in Q3 2008 reflecting general inflationary pressures. In 2009 as inflation fell, it flattened off but rose again in 2010 and 2011 (Figure 5.2).

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

IPD had reported strong returns for investment in residential properties up to 2007 in line with house price rises. In the 2008/9 downswing, total returns were slightly negative but they swung back strongly in 2010 to give a 9.9% total return.

Figure 5.2 **Rent reference index (IRL), 2006-2011**



Source: INSEE

Social Housing

Social housing is estimated to represent 19% of principal dwellings; 4.5 million units in all. They consist mainly of estates of flats and are concentrated in the Paris region and industrial areas in the north of the country. But there is also social housing provision in small towns and rural areas and in other central city areas. This stock is often more desirable than the great suburban estates. Around 10% of tenants move each year.

Social housing standards have improved significantly since the mid-1980s. This upgrade has involved large-scale public expenditure on refurbishment as a majority of the stock dates from the 1960s and 1970s, with only 9% built since 1990. Local authorities now have a target of providing 20% social housing in the new construction permitted in their areas and they are subject to central government scrutiny if they fail to meet it. However, many municipalities have resisted central government attempts to enforce this rule.

A major programme of social housebuilding and renovation was begun after the urban riots of the mid-2000s. Between 2005 and 2007, the construction of 276,000 social dwellings under a variety of programmes was agreed and funded. 2009 saw further funding.[16]

In the social sector, the prime determinant of rent levels is historic cost i.e. construction and other costs at the time the housing development was built. A recent study found that average social rents were 40% less than equivalent market rents, but they are lower than that in Paris and other high housing demand areas.[17]

Housing allowances are paid to tenants and to homeowners as a consequence of several pieces of legislation. The most common one, APL,[18] is also used to promote access to property ownership by partly covering mortgage costs. Over 10% of owners, around a third of private sector renters, and 48% of social housing tenants are in receipt of some sort of allowance: approximately 6 million households in total funded from programmes which cost €14 billion in 2007. ALF[19] is paid to households with children, and to young couples with no children, when household income is below specified levels; while ALS[20] is paid to single people, mainly students, who are not entitled to APL.

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

16 Housing Ministry. 17 INSEE. 18 Aide personnalisée au logement. 19 Allocation de logement à caractère familial. 20 Allocation de logement à caractère social.

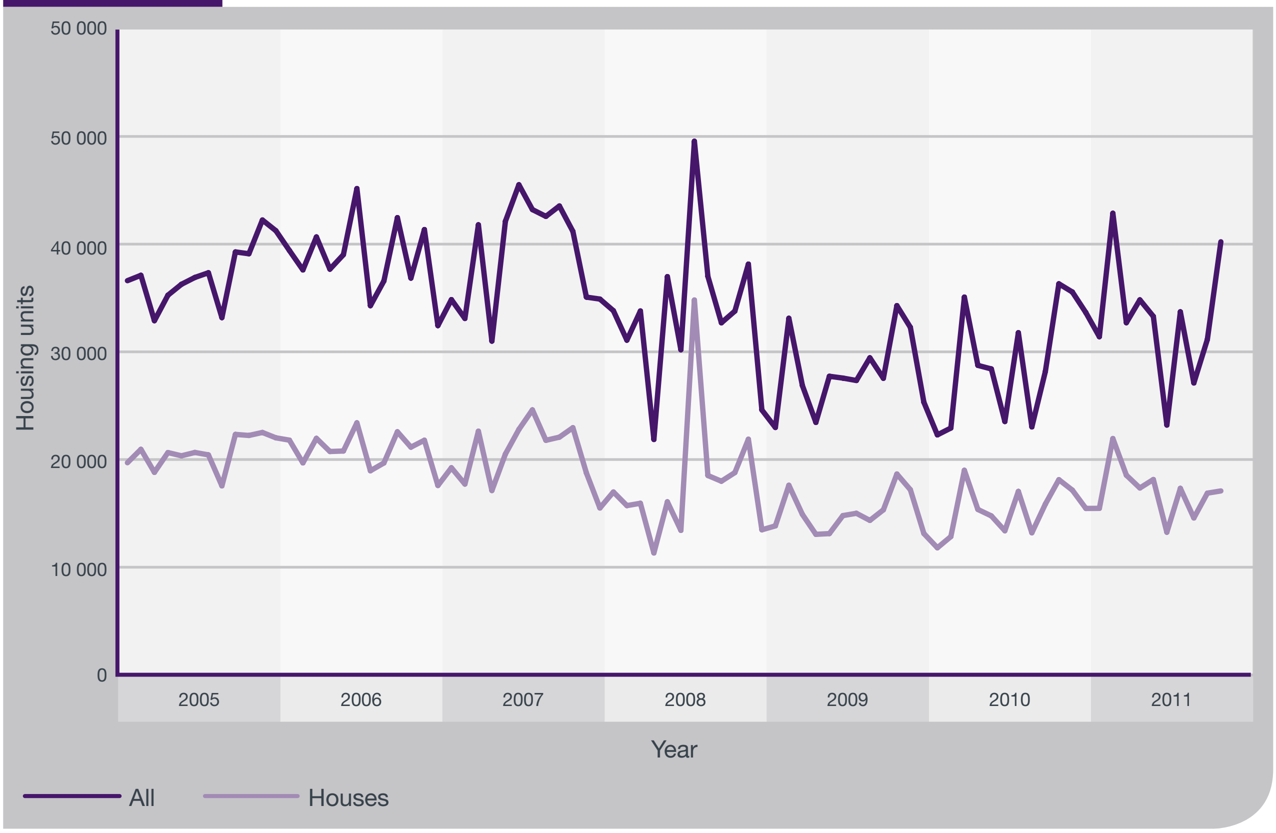
5.3 Housebuilding

Previously high rates of housebuilding that were checked by the onset of the world financial crisis have partly recovered. Housebuilding peaked at almost 420,000 dwellings in 2007. After that starts declined as the recession mounted but remained high in relation to most of the rest of Europe.[21] There was a surge in starts following the introduction of emergency housebuilding subsidies in 2008 but then they levelled off until mid-2010 when they surged again, encouraged by attempts to beat deadlines for subsidies and tax breaks (Figure 5.3). In 2011, well over 300,000 dwellings were started, one of the highest per capita building rates in the EU. Starts were far greater than in the UK, for example.

The increase in housebuilding over the past two years was particularly marked with regard to the building of blocks of apartments. This change in the composition of output reflected public intervention: particularly government social housing initiatives and affordable housing programmes for first-time buyers and other purchasers. In total, there is now almost an even split between single-family house and apartment building. As can be seen in Figure 5.3, housing output is less volatile than that of apartments. The resilience of houses reflects the growth of owner occupation; general demand for higher space standards; and the suburbanised nature of modern French society.

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

Figure 5.3 **Housing starts, January 2005 - October 2011**



Source: INSEE

21 Housing Ministry.

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

Social housebuilding does not depend on market conditions but rather on public subsidy, agency initiative and land availability. Political pressure has been strong to achieve extra housing output in this sector but budgetary pressures are now beginning to bite.

5.4 The economy

Moderate growth continued in 2011 at 1.5% but the economy slowed in the last quarter as the Eurozone crisis intensified. Growth prospects for 2012 look limited and recovery after that may be modest.[22] So, the general economic situation does not look good for the housing market.

The state plays a large role in economic activity. Fiscal stimuli and the existence of significant automatic stabilisers helped to limit the extent and duration of the post-2008 decline. Action with regard to the housing market was an important element of that. However, that increased the government deficit to 7-8% of GDP in 2009 and 2010. Fiscal tightening began in 2010 and continued in 2011 with a second austerity plan.

Inflation rose in 2011 to 2.1% but the weak economy is expected to lower it in 2012. Unemployment has been high at between 9 and 10% in recent years and is not expected to improve much in the near future. The overall share of people of working age in work is one of the lowest of the advanced economies with older and less skilled people most often not in work.

5.5 Mortgages

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

Contractual saving schemes, especially a home savings plan, the *Plan d'épargne-logement*, have been important traditional sources of finance for the owner-occupied sector. In it, individuals agree to save a certain amount for between 4 to 10 years. The interest they receive is tax free and, from 2011, calculated using weighted swap rates. They are topped up with a state funded premium. At the end of the contractual period, people can then obtain a below-market rate loan of 2.5 times the sum saved and can also use the money saved as a deposit on a home. There are around 11 million separate 'pass book' participants in the savings scheme - all members of a household may open one, regardless of age, including minors. The share of house loans financed by these schemes has declined substantially in recent years, due to the expansion of more attractive savings and loans options, especially in an era of low interest rates.

There are other loans regulated by the state, such as *Prêts conventionnés* (PC). Under the PC scheme, a public or private-public organisation (like the Crédit Foncier de France) is involved in mortgage contracts with private banks. There are further subsidised loans, such as the PTZ mortgages considered earlier.

22 OECD.

The main players in the mortgage market are the commercial banks; the mutual and co-operative banks, consisting mainly of Crédit Agricole, Crédit Mutuel and Crédit Foncier; plus other financial companies.[23] Competition increased during the boom years within the highly regulated, nationally-orientated, banking system. The outcome was an enlarged range of products and packages, narrower spreads, extended repayment times and increases in permissible loan-to-value and loan-to-income ratios. Yet, competition is still sufficiently limited to enable banks to impose risk-minimising terms; to exclude higher-risk customers; and to tighten credit conditions when market risks seem to be growing. The duality of competition and restraint, combined with the off-balance sheet nature of public mortgage loans and other related expenditure, has contributed to a low share of mortgage finance in GDP at 41% in 2010.[24] The figure of long-term loans to households, most of which will be housing related, is higher at 76% of household disposable income in 2008. It has been rising fast in recent years, as elsewhere. It increased from a half of disposable income in 1997 to 78% in 2008, and almost certainly has grown further since then as total personal sector financial liabilities have risen to 99% of disposable income.[25] Such ratios are similar to those in Germany but total household loan ratios are still much less than in either the UK or the USA.

In addition, mortgage interest rates have been low and, consequently, affordability has been improving and defaults are limited. As most mortgages have interest rates fixed for 5 years or more, purchasers can lock in good borrowing rates for some time to come. The government has also encouraged banks to keep up the flow of mortgages.

Although the government was obliged to intervene to prop up French banks during the financial crisis, none of the major financial institutions faced the same funding difficulties experienced by providers in some other European countries, such as the UK. In addition, few foreign players were active in the French market during the boom years, so that withdrawals from the market by them had no appreciable effect on the availability of finance. These factors probably explain why there was no sharp reduction in mortgage funding. In addition, when the government injected capital into banks in 2008 it expected them to lend additional funds to house purchasers. Given the country's institutional framework, this probably had more effect than similar exhortations elsewhere.

The housing market boom prior to 2008 was associated with a substantial growth in mortgage lending, which was rising at 15% at the peak in 2006. Post-Lehman, growth rates fell markedly in 2009 but then started to grow in 2010 peaking at a 9% annualised increase in May 2011. However, late in 2011, mortgage growth started to slow as demand weakened and credit conditions began to tighten in the face of the Eurozone crisis.

Mortgage interest rates were slowly rising through 2011. They were up 69 basis points (bp) for variable rate loans between October 2010 and 2011, and by 51bp for fixed rate loans. Reductions in ECB rates late in 2011 may lower variable rate ones in 2012, although bank spreads may offset that effect. Higher interest rates in bond markets were pushing fixed interest rates.

5.6 Demographic influences

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

The number of households is expected to increase annually by an average of between 240,000 and 260,000 from 2000 to 2020, with the fastest rates of growth in the initial years of the period.[26] Making assumptions about items such as immigration, vacancy rates, and demolitions and renewals, it is estimated that 320-370,000 new dwellings a year will be needed up to 2020. These estimates do not take account of economic factors, such as rising demand with higher standards of living or intra-regional migration to growth areas. However, neither do they take account of affordability problems, which have been significant in recent years, though they have improved over the last few years.

An ageing population is contributing to the rise in household numbers. The greatest increase is going to occur over the next couple of decades, with the number of those aged over 60 growing from a current 13 million to 21 million by 2035, after which time the rate of increase declines. By 2050, over a third of the population will, on current trends, be over 60.

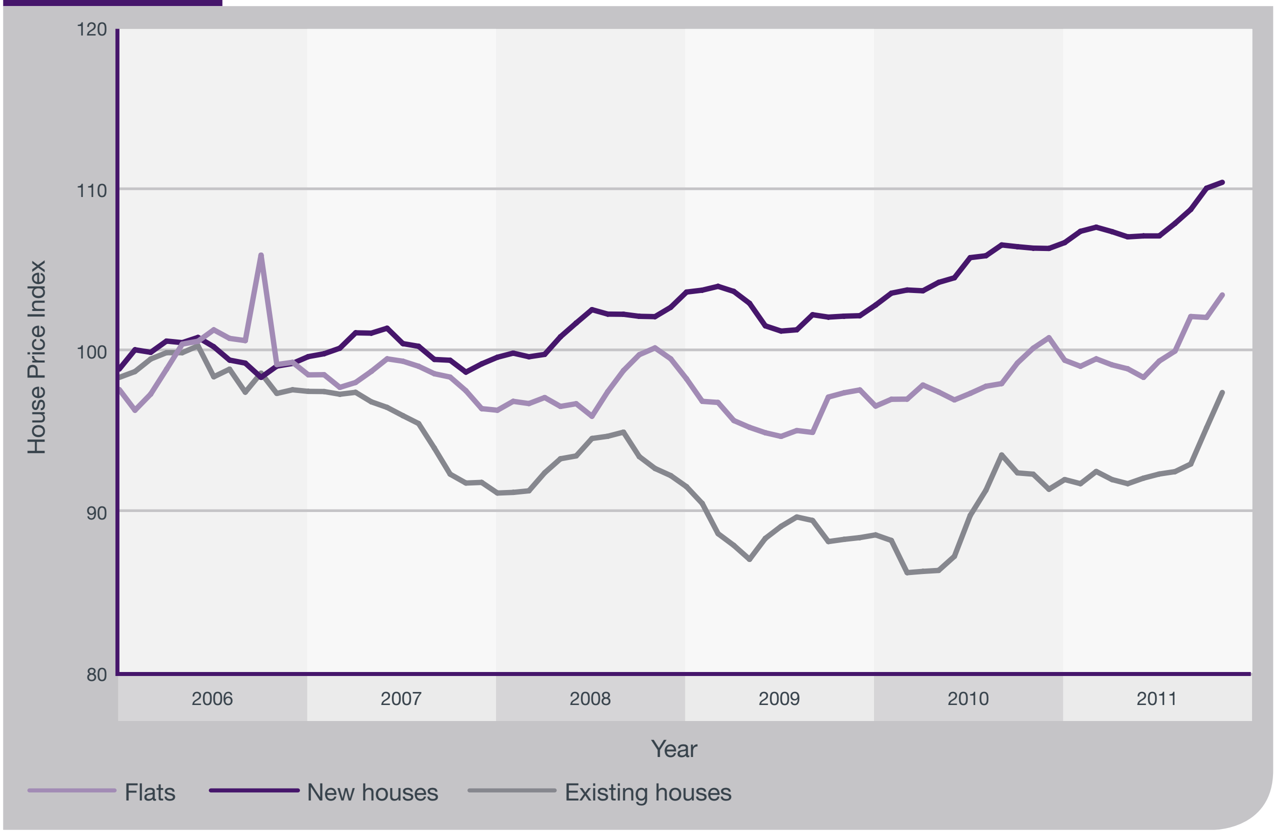
23 Bank of France. 24 EMF. 25 OECD. 26 INSEE.

6.1 Positive Growth continues

House prices in 2011 increased at a marginally faster rate than in the previous year, rising by 4.2% annually in November, according to the Hypoport index; up from 3.5% the year before. However, as general inflation also rose, the real rate of house price increase was actually marginally smaller than in 2010 at 1.6%. The Association of German Mortgage Banks' vdpResearch index suggested a slower nominal rate of 2.6%, or steady prices in real terms. Of course, Germany is large and regionally diverse, so that such national indicators hint at firmer price pressure in the economically strongest parts of the country.

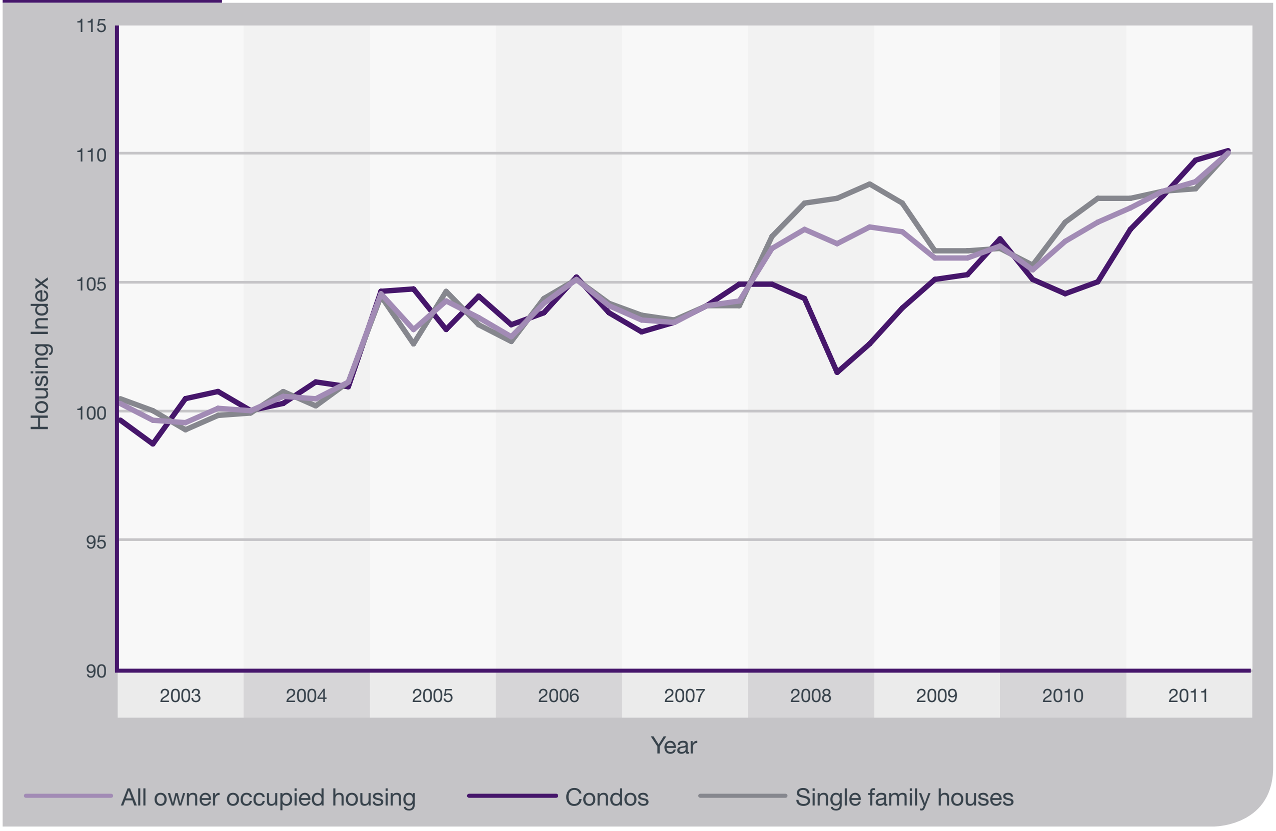
Current developments still do not suggest a substantial rise in house prices. However, the housing market cycle has remained at variance with much of the rest of Europe, because the country did not have the housing market boom of the 2000s but rather depressed conditions instead. The economy recovered strongly after 2009, which helped to boost house purchases. Even so, Germany is not immune from the pressures from the world economy and Eurozone that are currently weighing down on most European housing markets.

Figure 6.1 **Changes in house prices by type, August 2005 – September 2010**



Source: Hypoport

Figure 6.2 **Changes in owner occupied house prices by type Q1 2003-Q3 2011**



Source: vdpResearch

It is important to be aware that Germany's housing market is highly distinctive in its institutional structure and behaviour. Nominal price changes are consistently moderate by international standards. This moderation is due to a variety of causes. Purchasers traditionally take a long-term life-cycle view of entry into homeownership and that limits the impact of short-term events on prices. A single-family home is usually lived in for long periods of time once bought. Because of that, the proportion of second-hand sales in market transactions is far less than in most other mature housing markets. This means that the impact of newly built homes in recent mortgage borrowing data is more significant than in many other countries.

Within new build, practices work together to smooth out price fluctuations. Condominium purchase is a relatively recent phenomenon and is often associated with buying new dwellings from schemes where developers tend to hold sales prices steady as a marketing strategy. The new single-family home market is also distinctive because with many houses the purchaser buys a plot of land and commissions a home to be built on it. So, new homes price indices pick up many mortgages issued in relation to such completed dwellings. Their 'prices', in reality, track a weighted mix of construction costs and land plot costs lagged over a number of years, depending on when the land was bought and how long construction took. Therefore, although German house prices clearly do not fluctuate wildly over time, some of their observed smoothness compared with other countries' experiences has statistical and institutional reasons.

Two indices based on mortgage data were quoted above, in Figures 6.1 and 6.2. They each give a somewhat different picture. Much of that is due to the fact that they define terms in slightly different ways, so it is useful to describe in more detail what they report. The first index is that by Hypoport, which utilises data from its trades in private mortgages that it says cover 10% of all such transactions. The other is by the Association of German Mortgage Banks' offshoot, vdpResearch. It publishes indices based on the mortgages offered to home owners by members – which have totalled over 600,000 since 2003. Both are quality-adjusted (hedonic) indices.

The Hypoport index shows notable price variations between types of housing at the national level (Figure 6.1). From 2006 to early 2010, the prices of existing houses fell by around -15% but then picked up again in 2010 and 2011. However, they are still now -11% less in real terms than they were in 2006. By contrast, the prices of new homes seem to have risen fairly consistently over the same period, rising by around 11% overall, which roughly matched general inflation. This may reflect the fact that the costs of materials and labour rose in line with or above inflation. Finally, flats – which are solid condominium basis, have experienced only moderate price variation. They did fall by around -5% but then grew from mid-2009 onwards back to their 2006 level but they were still -7% down at the end of 2011 on their 2007 levels.

Turning to the vdp index, it mixes the results for new and existing dwellings together and shows steady price growth throughout the period from 2003 to 2011 (Figure 6.2). It suggests that over the period owner occupied prices rose by around 11%, which in real terms was around about a -5% fall.

Both price indices indicate an upswing during 2010 and 2011. However, it was of modest dimensions, especially in real terms. Some of that may have been a bounce back to previous nominal values. The existing house market may be the most represented of traded values, given the issues that surround new build noted above.

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

With long-term falling house prices, it is unsurprising that there has not been a rush towards owner occupation over the past decades, because of the potential capital losses buyers face from purchase. So the size of the tenure remains low. The most recent official survey showed the homeownership rate remaining stable: having dropped slightly from 43% in 2002 to 42% in 2006.[27] In addition, long-term tax and subsidy changes have depressed both investor and owner occupied housing demand. Expansion of owner occupation in a country with a majority of renters is also likely to remain a gradual process at best, though successive governments pay lip-service to the benefits of ownership and the desirability of its expansion.

The world financial crisis did not pass Germany by. Fears of bank runs in autumn 2008 forced the government to offer guarantees on bank deposits. Some institutions also had to be rescued. However, the 'pfandbrief' covered bond market, which is central to mortgage finance, was again functioning effectively from 2009, after severe problems in autumn 2008.

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

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

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

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

27 Federal Statistical Office.

6.2 Housing system

Low homeownership

The country has the highest rental share in the EU; a proportion only surpassed by Switzerland in Europe as a whole. The owner occupier share is 11% higher in the old Federal Republic area than it is in the East, but still low.[28]

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

The share of owner occupation varies considerably across the country. Broadly, the north and east have lower owner occupation rates than the south and west. This is not simply due to the old differences between the East and West but also to city politics. For example, policies in Hamburg and West Berlin traditionally emphasised rental housing. Due to these histories, they both remain predominantly renter cities, with homeownership rates of only 20% and 14% respectively.

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

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

The proportion of non-family households in the total is substantial, which meshes in with the high share of flats in the total stock. In this context, it is unsurprising that the country has one of the lowest average numbers of people per dwelling in Europe at 2.2. Around 70% of households consist of only 1 or 2 persons and average household size will continue to decline as the population ages. Some of the major cities have very high proportions of singles. In Berlin, currently half of all households consist of one person only, while in Munich the figure is 46%.[29] Average household size is smaller in rented accommodation, because singles and couples are concentrated there.

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

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

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

Thin and specific markets hinder clear consumer understandings of relative market prices and raise home search costs. Price information is harder to acquire in such market contexts and is of variable quality. Because of the low level of existing home sales, estate agents listings of owner occupied housing are much more limited than in countries which much higher levels of activity. So, when contemplating purchasing, the range of choice is typically less than in countries with bigger homeownership markets.

28 Federal Statistical Office. 29 Federal Statistical Office.

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

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

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

Tax-wise, there are no mortgage interest tax reliefs, imputed rental income taxes or capital gains taxes (after 10 years residency). For many years, newly built, single-family owner occupied dwellings did benefit from a specific tax break known as “Eigenheimzulage”, estimated to cost €7.5 billion in 2004.[30] From 2004, existing dwellings were brought into the scheme but, then, it was fully withdrawn in 2006.

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

Tenure-specific subsidies and tax breaks still exist. Owner occupied dwellings remain exempt from capital gains taxation, though it has risen for other investments, and tax breaks can also be derived by using specific craft workers in building work. Some legislative changes have improved the attractiveness of home ownership. In 2007, a new condominium act was passed, which has encouraged apartment purchase. Apartment prices have been much stronger in recent years than those for existing homes, which may indicate purchaser interest has been stimulated by these changes as well as that of investors.

Currently, around 40% of total household wealth is in housing, either via owner occupation or residential investment. This proportion is less than in many higher owner occupation share countries, especially as many Germans rely heavily on state pensions for their retirement income needs and so do not have significant pension assets in their wealth portfolios.

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

As noted earlier, housing policy is mainly a regional rather than a national matter. This is said to be one reason why housing statistics in Germany are limited. The regional Länder and local authorities have responsibility for housing and land-use policy and, as a result, can influence the local mix of housing tenures. Their powers are exerted in a variety of ways: through programmes related to housing renovation and urban renewal; housing subsidies; mechanisms for residential development land control; land ownership; via relationships with social housing institutions and with state-owned and regionally based co-operative savings and mortgage banks.

30 OECD Country Report, 2004.

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

1. **Land supply constraints** There are sometimes difficulties in obtaining appropriate land supply because of regional or local government reluctance to allocate land in land-use plans. In areas of high demand, for example, there are general planning constraints on suburban expansion, because of the general policy preferences of regional planning authorities on sustaining extensive green space in the more urbanised regions for recreational and environmental reasons.

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

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

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

2. **Fixity in the rental stock** Another frequent supply-side constraint is associated with regional and local level policies that hamper the transfer of rental properties into owner occupation or into the ownership of landlords that are more strongly market driven. This has weakened in recent years with respect to certain large scale transfers. Even so, the security of tenure offered to existing tenants, under general federal enabling and Länder specific laws and policies, frequently gives landlords little opportunity to sell out. Tenant associations are important lobbyists in local politics in a country where the majority of voters are themselves tenants. Generally, they are resistant to change.

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

6.3 Rental Housing

Private renting

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

The scale of small-landlordism is not unusual in Europe and has been sustained by attractive tax deductions. Tax breaks also probably account for the remarkably large number of lodgers recorded as living within owner occupied dwellings. Almost a quarter (23%) of owner occupied dwellings are said to contain 'lodgers', despite the fact that the more affluent parts of the population live in the tenure – a unique international practice encouraged by the tax laws. This statistical artefact helps to depress the apparent overall size of the owner occupied sector by bolstering the apparent number of tenants.

Rents are regulated both by broad federal rules and also by the policies of the 16 regional Länder in co-operation with municipalities, each of which has specific detailed rules that change periodically, creating a complex picture overall. The broad principle is said to be one of 'softening' of market rental movements, so most commentators conclude that rents follow market principles with a long lag.[31] However, there are insufficient studies to verify this claim accurately.

Rents are freely negotiated at the time when a household rents a dwelling. After that, however, rent controls apply. They may be linked to inflation or to rent levels in comparable dwellings, which are determined by the sheer weight of existing tenancies rather than by the relatively small number of current market transactions. If a dwelling's rent is less than in comparable ones, any increase is smoothed because it can only be implemented up to a maximum of 20% extra on the rent for three years. This means that overall rent levels lag far behind implicit current market rents when there is a sudden increase in demand or inflation. Nevertheless, rent controls have not been a political issue for some years now, because there is a general situation of oversupply in many localities and so market rents are either only rising gradually, or have actually fallen.

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

The IPD German residential index, based on 2,400 properties, showed a return of 5.1% in 2009. This was made up of a 4.1% income return and 1% capital growth.

Social renting

Social housing means something different from elsewhere in Europe, as it does not refer to a specific set of non-profit housing providers with special relationships to central and local government, but rather to specific subsidy systems. The social housing subsidy system, moreover, can be used by private landlords and for low cost owner occupation. Dwellings only remain in the socially rented sector for as long as they receive interest rate subsidies, plus around 10 additional years – which typically totals approximately 40 years.

In the East, the large rental stock was in a rundown state at reunification. The programme of housing privatisation in the East has been far slower than was originally anticipated. Social housing programmes have had to deal with large numbers of poor quality and empty properties in the East, where in 2002 there were 1.3 million vacant properties. Programmes of extensive demolition and neighbourhood regeneration are in place and will continue for some time to come. Old industrial areas in the West are facing similar problems, though on a smaller scale.[32]

There have been sales to private investors of rental homes in recent years by non-profits, industrial firms with residential estates and the public sector. Public sector and municipal bodies still own around 4.5 million dwellings. Some city governments are reluctant to sell social housing and other parts of the stock have limited market potential.

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

31 This is argued, for example, in *Structural Factors in the EU Housing Markets*, ECB, 2003.
32 *Wohnungswirtschaftliche Daten und Trends 2009/2010*, GdW.

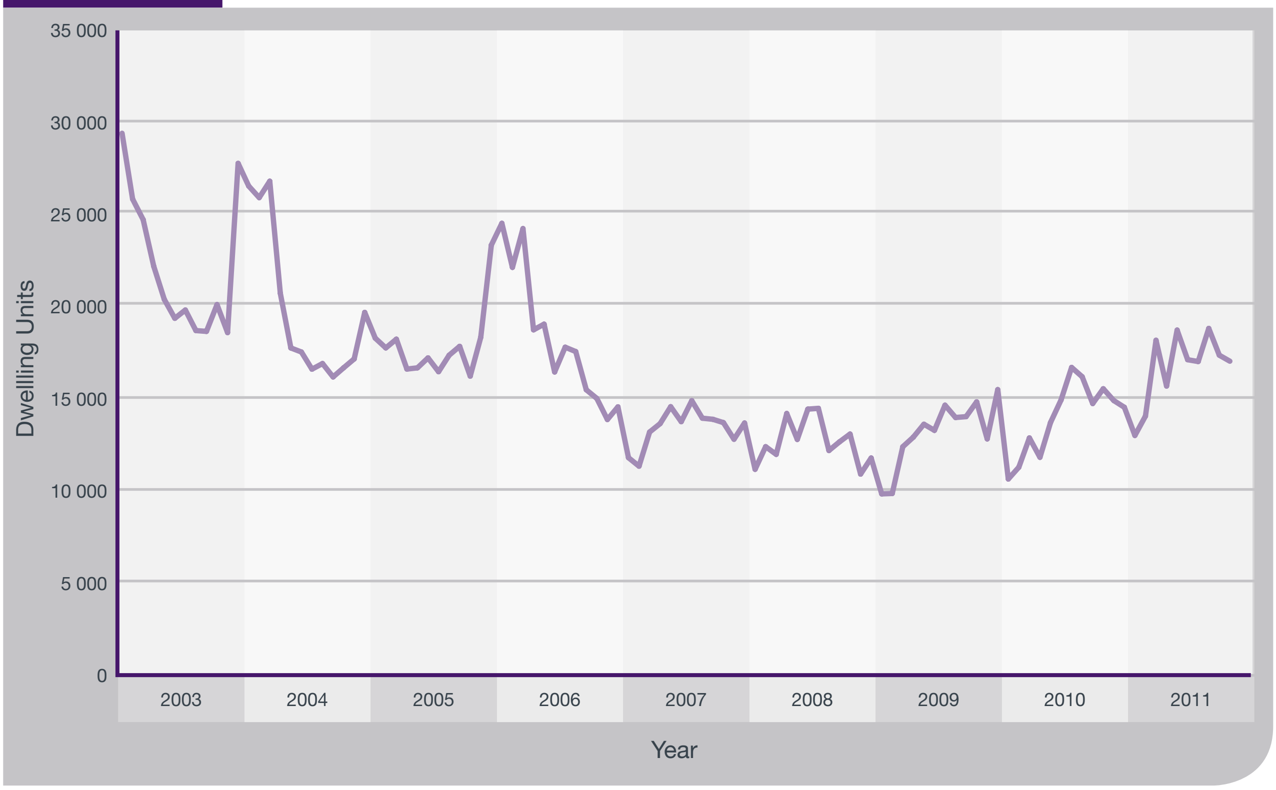
6.4 Housebuilding

Germany is now amongst the lowest per capita housebuilders in Europe in marked contrast to the persistent high levels of output in previous decades. However, in line with renewed strength in the housing market, output seems to be picking up again over the past two years. Dwelling permits were 22% up in Q3 2011, indicating the strong supply responsiveness of the country's housing system (Figure 6.3).[33] The extra building work is concentrated in the apartment market, where permits were up 35% on the year, compared with only 3% for houses.

There has been a long, substantial decline in housebuilding since the mid-1990s boom, when over 600,000 dwellings were built in the peak year of 1995. Output is now less than a quarter of that peak period. The building boom that occurred in the mid-1990s was stimulated by the post-reunification experience. Policy makers over-reacted to temporary accommodation shortages and new housing production subsidies and tax breaks were rushed through. In addition, the government provided low interest loans for housing investment and further incentives were offered in the East under the Promotional Area Act. It transpired that the scale of the building boom was out of all proportion to long-term housing demand, so by the mid-to-late 1990s signs of severe over-building in many localities were apparent. This encouraged a long downswing in the housing market and a rising vacancy rate, as excess supply came on stream and was only slowly absorbed.

The overall aggregate effect of the 1990s building boom was substantial. Altogether 4.4 million dwellings were completed between 1991 and 1999 – with most of the units being small to moderate sized apartments – and the overall housing stock rose by a considerable 11%. The scale of the new supply created during that period was sufficient to accommodate extra demand in many localities for a long time afterwards.

Figure 6.3 **Dwelling permits, January 2005 – October 2011**



Source: Federal Statistical Office

33 Federal Statistical Office.

6.5 The economy

After falling by almost -5% in 2009, GDP growth revived strongly in 2010 at over 3% and this expansion continued in 2011. However, with weakness in the world economy appearing, growth slowed sharply in the latter part of the year and is expected to continue to be weak in 2012. This has affected consumer confidence and will influence housing market activity, constraining the increases seen in the last couple of years.

Inflation has also been picking up. It had fallen to low levels in the recession but rising commodity prices and economic growth pushed it up again. In January 2011, the HICP increase was only 1.3% but by October it was 2.4%.[34] Slowing growth should dampen it again.

Unemployment was 10% on an internationally comparable basis in 2006 but has gradually fallen since then to 5.7% in 2010.[35] It is concentrated in the East and in the older industrial areas of the West. One structural problem affecting the economy is the remaining huge economic gap between East and West. The process of adjustment in the East, and with it the evolution of a more typical housing structure, still has some way to go.

Significant reductions in public expenditure in 2011 helped to meet structural deficit targets set out in a new fiscal rule. However, they contribute to slow growth. The measures imply less intervention in the East and older industrial areas.

6.6 Mortgages

The mortgage market relies on finance provided by one or other of the three branches of the financial system: the commercial banks, the public savings banks, and the co-operative sector. Via each route, a prospective purchaser may raise housing finance through loan packages. On offer are variable rate loans but more usual are mortgages with a rate fixed of five years or more; 10 years is the most common. There are prepayment penalties during the period that the rate is fixed. Around 80% of the housing loans held by banks of all types are long-term fixed interest mortgage ones. Mortgages secured on housing may also be used for other purposes and are often a source of credit for the small business sector. Many loans are advanced to housing investors as well as to homeowners in a country with a large private rental sector. Mortgages were 68% of personal disposable incomes in 2009.[36]

The country has a unique financial system and a large number of banks, with two-thirds of all the credit institutions in the euro area as a whole. Mortgage banks traditionally had the sole right to issue mortgage bonds (Pfandbriefe) in the capital market, though no longer. Their bonds are covered by the real estate mortgages (and other assets), they hold on their balance sheets in a matching process. A legal requirement is that these mortgages have first call on properties. High prepayment penalties and low mortgage default rates give confidence to bond investors with regard to the strength of the mortgage banks and their regulatory regime; especially a 60% limit on loan-to-value ratios and existence of strong capital bases and/or state guarantees of the issuing banks. Loan offers may consist of a mortgage bond loan which, because of its security, commands a good interest rate, and other elements with different repayment terms, degrees of security and interest costs.

34 Eurostat. 35 OECD. 36 OECD.

The existence of the Pfandbrief core to housing loan packages may confuse those not used to the German financial system into believing that loan-to-value ratios for residential loans are capped at its stipulated 60% ratio, which is not the case because other loans are often added into loan packages. For instance, in Q3 2010, 17% of new housing loans (€191bn) were unsecured ones and a similar ratio has prevailed in the past few years.[37] Nevertheless, credit availability is more strictly rationed in Germany than was the pre-financial crisis experience in many other countries. For example, there is conservative loan appraisal, no sub-prime segment, and thorough vetting of loan applicant details.

The Pfandbrief market has formed a model for others elsewhere in Europe and has fundamentally influenced the structure of mortgage lending in Germany. For decades, the main mortgage banks have been subsidiaries of the universal banking institutions existing in all three of the financial pillars. Within the universal bank framework, a variety of mortgage packages of first, second, etc. mortgages are sold to owner occupiers and landlords structured around the first bond-funded mortgage loan. Members of the Association of German Mortgage Banks had a market share of 27% of all housing loans in 2009, so the range of sources for loans is wide. For example, deposit-based lending, rather than the bond market, is typical for second mortgages.

Consolidation within the banking sector is effectively limited to changes within each ownership form, because of the distinctive ownership structures of the co-operative and state-owned banking sectors. Some state banks have merged in recent years and some have got into difficulties through over-ambitious lending and investment strategies and are currently looking for new owners, most notably WestLB. Yet, there are few pressures for major organisational restructuring, so a widely fragmented ownership structure remains. This limits the opportunities for scale-economies and innovations in the mortgage industry. One of the major changes of recent years has been a lengthening of the potential repayment period, which now is possible for up to 30 years.

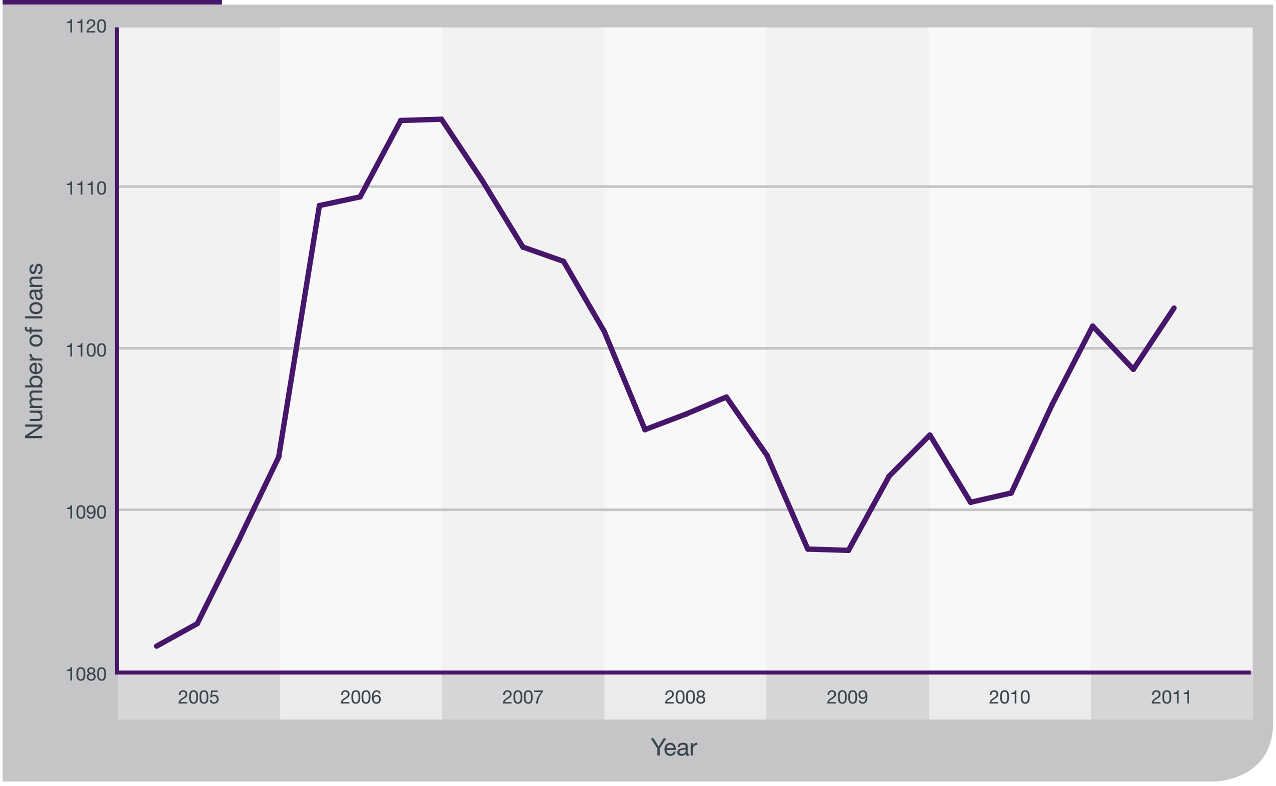
The mortgage banks' monopoly access to covered bonds was abolished in 2005, following pressure from the European Commission which was worried about the competitive effect of the public guarantees previously given to state-owned mortgage banks. Now any licensed institution has access to the Pfandbrief market. At the same time, regulatory and capital adequacy criteria have been strengthened.

37 Bundesbank.

Housing loans from building and loan associations, Bausparkassen, are common add-ons to bond funded mortgages. These institutions organise housing savings and loan schemes, whereby households commit to long-term savings contracts offering a below market interest rate in exchange for a similar termed loan advanced when required, providing that agreed savings thresholds have been reached. They play a relatively small but still significant part of housing finance activity. As with mortgage banks, most of the remaining 24 Bausparkassen are now parts of universal banks and their activities contribute to the mix of housing finance packages on offer.

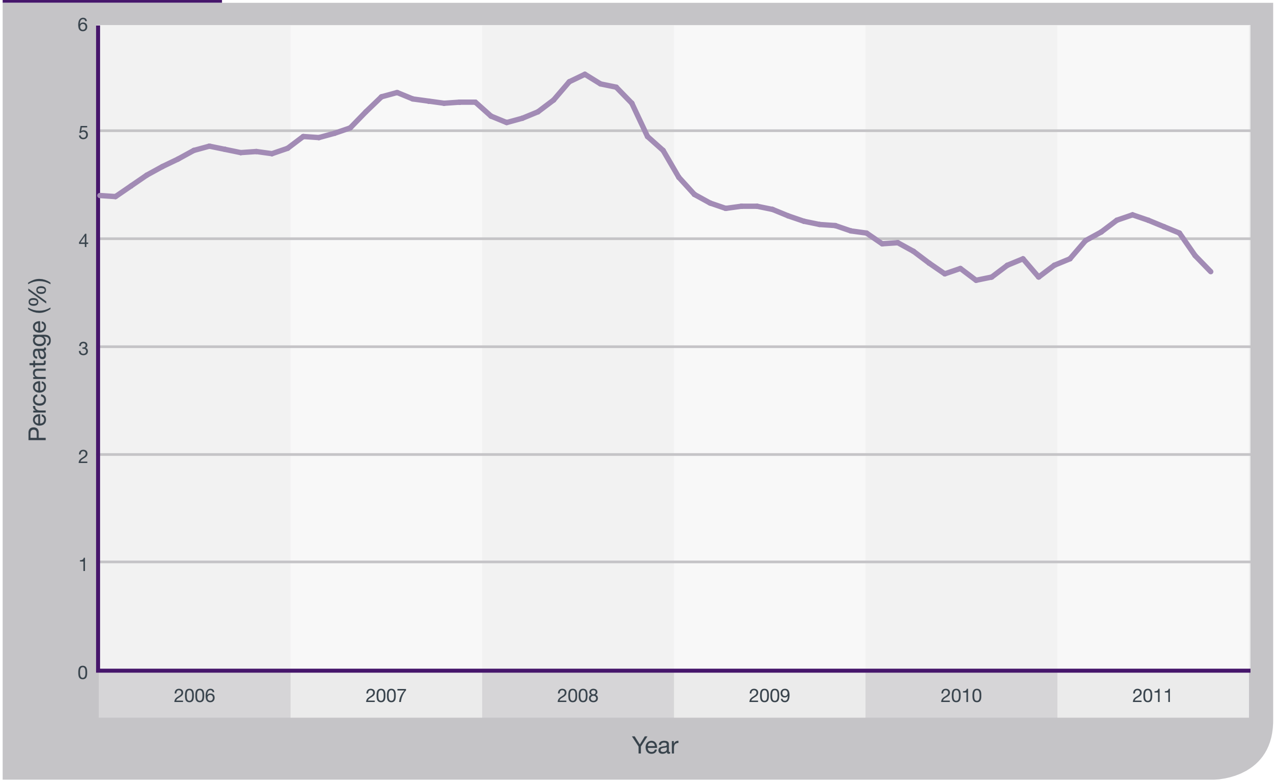
Housing loan volumes grew prior to 2007 but then fell somewhat during the crisis and levelled off between 2008 and 2011 (Figure 6.4). There was some expansion in 2011 on the back of the strength of the housing market. Home loan interest rates peaked at the end of 2008 and then fell with a slight upturn at the end of 2010 but were down again in 2011 (Figure 6.5). This development helped to increase housing demand.

Figure 6.4 **Housing loans, Q1 2005 – Q3 2011**



Source: Bundesbank

Figure 6.5 **Average interest charges on new housing loans, January 2006–October 2011 (Including all charges)**



Source: Bundesbank

6.7 Demographic influences

The population is falling slightly at present but is forecast to decline significantly. Recent estimates suggest that, at current birth rates, immigration levels and probable increases in life expectancy, the population will drop by 9 million to 74 million by 2050, more than a 10% decline.[38] However, population forecasting is an inexact exercise based on assumptions that may not hold, especially given the potential scale of future population movements within Europe, the geographic centrality of the country, and the problems that will arise with an ageing society.

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

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

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

38 Federal Statistical Office forecasts.

7.1 Severe stresses

The downswing in the housing market intensified in 2011, as stresses piled up and demand continued to evaporate. It was badly affected by the country's economic and financial problems. However, price falls were very modest, recorded at -1.3% in the FHB house price index in Q3 2011, or somewhat larger in real terms at -4.8% (Figure 7.1).

Prices had started to slide in real terms in 2007 with the onset of the world financial crisis and the sharp recession that followed in Hungary. General price inflation helped to erode real property values. By the end of 2011, prices were over 30% less in real terms than they had been at the beginning of 2007.

The house price fall accelerated in 2009 but then the rate of decline moderated notably in 2010 and 2011. This deceleration probably arose because sellers were becoming reluctant to cut asking prices further and, given restrictions on foreclosures, had limited pressures to do so.

Hungary's period of booming house prices was earlier and less sustained than those of most other central and eastern European (CEE) countries . Prices did increase sharply between 1998 and 2001, particularly in Budapest, with the greatest price growth concentrated in the new build market. But then it gradually petered out. So, from 2004 to 2007, the housing market was in the doldrums and then it contracted with the impact of the world economic crisis.

One reason why prices have not fallen faster is the difficulty lenders have in foreclosing. A large number of mortgages are non-performing but the government has made it difficult for the banks to act.

Until the economic situation improves and the banks have the capacity and willingness to lend on a large scale again, the housing market situation is likely to remain poor. In light of current events, that may take some time. The central bank does not expect meaningful growth in new loan volumes until after 2013.

Figure 7.1 **House price change, Q1 2005 – Q3 2011**

Source: FHB House Price Index

7.2 Housing system

At 90% of the housing stock, the country has one of the highest home ownership rates in both the EU and the world as a whole. Nowadays, 71% own outright, 18% own with a mortgage, 3% rent privately and 8% pay a reduced rent or nothing, according to Eurostat. Although owners with mortgages may be a relatively small part of the overall stock, they have a much greater impact on market transactions because few outright owners move.

The existence of substantial transactions in the existing homes market and the relatively good supply of existing dwellings relative to demand helped contribute to the lower level of price increases in the Hungarian housing market compared with those in several other CEE countries during the pre-2007 years.

Two-thirds of mortgage loans were used to buy an existing home in the first half of 2011.[39] As the housing market is broadly based, the new build market also does not dominate recorded transactions and price indices as it does in a number of other CEE countries.

7.3 Market transactions and housebuilding

Housebuilding has tumbled in recent years and housing transactions are low. In 2010, market transactions were less than a third of what they had been five years earlier and they stayed at that low level in 2011.[40]

Housebuilding is also sharply down. In 2010, it was -52% down on the 2004 peak, at 21,000 units. By then, housing production was evenly split between developers offering dwellings for sale and individuals commissioning homes for themselves. Around three to four thousand poor quality dwellings are demolished each year.

The housebuilding slide continued in the first nine months of 2011, when -38% fewer dwellings were built than in the same period the year before. The greatest fall was amongst developers as they cut back in face of falling sales. The number of permits issued over the same period was -62% down on the year. This reinforces other data indicating bleak prospects for 2012.

39 Hungarian Central Statistical Office. 40 Data in this section are from the Hungarian Central Statistical Office.

7.4 The economy

The economy slowed in face of external pressures, with recession expected in 2012. National debt has been downgraded to junk status; borrowing costs are rising; public expenditure cut; the currency is weakening; and discussions have been entered into with the IMF.

Weak recovery from the post-2008 recession was led by strong export growth but that is being hit by the world economic slowdown. Meanwhile domestic demand was declining in face of increases in taxation, deleveraging, and government cutbacks.

The country is sensitive to imported inflation and prices have been rising by 3-4% a year. Unemployment is also high at 11%.

A mild recession is forecast for 2012 by the OECD. The situation could be worse if the Eurozone's problems are not satisfactorily resolved.

7.5 Mortgages

The country's main economic and financial problem lies in the mortgage market. Non-performing household loans were at the substantial level of 13% of total mortgage loans in 2011, while a further 4% had been restructured, according to the central bank. Most of them related to mortgage loans taken out in Swiss francs account for a third of all private sector loans.[41]

The cost of servicing such debts in the past few years has soared, raising default risks. From August 2010, it became illegal to register a mortgage under a foreign currency loan. However, this was permitted again in 2011 for those on higher incomes.

To stem the tide of defaults, the government in 2011 decreed that households should have the opportunity until the end of the year to convert existing foreign currency debt into foreign ones at favourable exchange and interest rates. The central bank estimated that around a fifth of foreign currency borrowers would take advantage of the scheme. One result is going to be substantial losses to the issuing banks, many of which are foreign owned. They will be reluctant to lend more in such an uncertain regulatory environment. An already existing credit squeeze has thereby been turned into a severe drought.

The use of mortgages expanded rapidly up to 2009 from a very low base, though the total loan book is still only around 15% of GDP. However, because most mortgages are relatively recent in age, average LTVs are quite high at 70% (and 80% on foreign currency loans).[42] So, those purchasers that have used mortgage borrowing in recent years are highly sensitive to mortgage market developments and to falls in house prices.

There was a moratorium on eviction until mid-April 2011, although the situation has now eased. These measures temporarily benefited some households who were unable to keep up repayments. But they also imposed substantial costs on banks and encourage moral hazard, which increases the likelihood of further non-performing loans. A new support scheme, in which defaulters stay as renters, has been introduced making it easier to lift the ban, although again the lenders will bear the costs.

41 Central Bank. 42 Central Bank.

8.1 Sliding down

House prices have been falling since 2009, although at relatively modest rates of decline of around -2% in nominal terms a year. Taking into account general price inflation makes the real change somewhat greater at -4.2% for 2011 (Figure 8.1). Overall, prices have fallen in real terms by -13% since 2009. Sales levels and housebuilding have also been drifting down.

The country did not have a major house price boom prior to the world financial crisis, so current house price adjustments are not related to some bounce back from a recent upward surge. It is also not a country with extensive house trading, in which people move home regularly. Moreover, leverage within the housing system is low by international standards. All the same, the housing market forms an important part of the economy and people's finances.

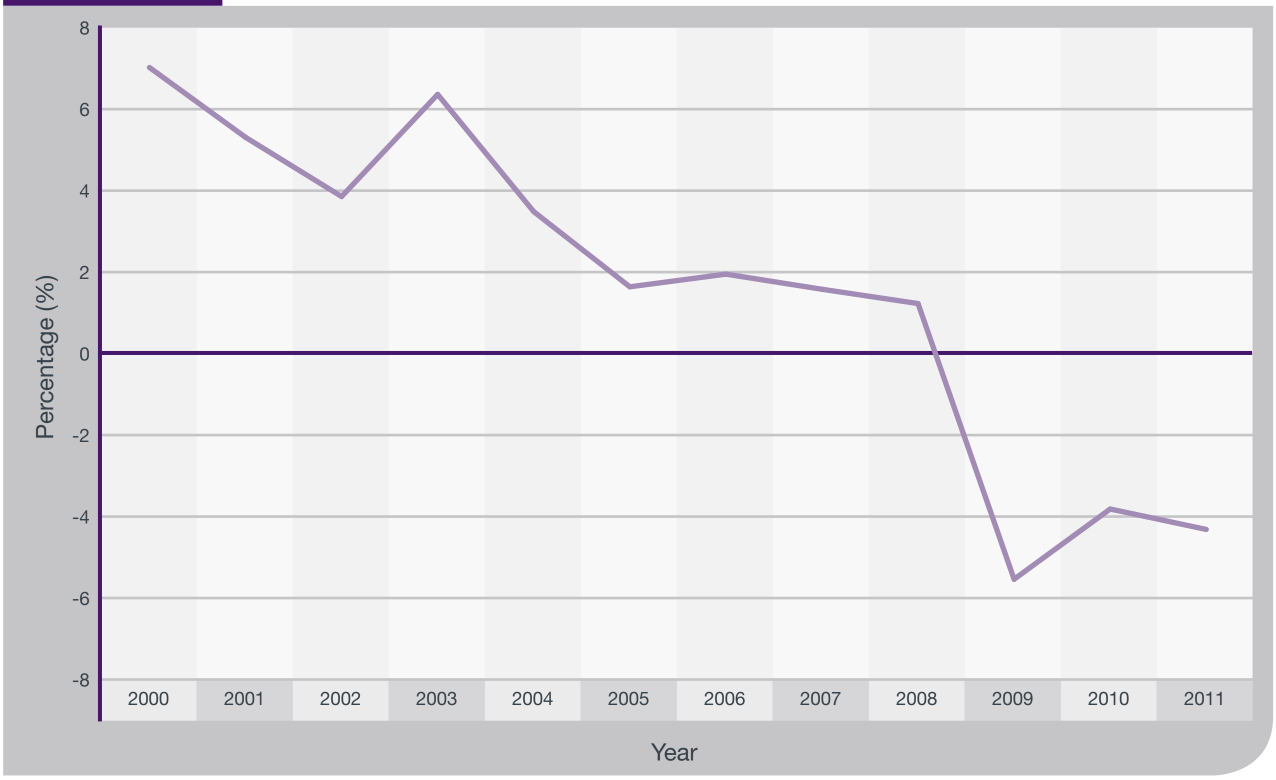
The impact of the Eurozone crisis on the Italian government's ability to borrow is having significant effects on the housing market. Pressures on the banking system are squeezing mortgage availability, while the economic slowdown and higher taxes sap consumer confidence and the ability to buy.

An important effect announced late in 2011 was the austerity package introduced by the new Monti government to narrow the fiscal deficit. The bulk of the proposed extra taxes in that package were imposed on house ownership. There was to be a 60% increase in the tax on imputed rental income; plus a 0.4% annual tax on the value of main residences, with a higher rate on second homes; plus the introduction of a stamp duty tax on transactions. Once these extra burdens are generally recognised as permanent, they will be capitalised into property values, causing a downward adjustment in house prices.

The government's emphasis on residential property may be understandable in a country where tax avoidance is frequent and property a haven for wealth. Moreover, it reflects a longstanding argument that property taxation is less economically damaging than other forms of taxation. Governments usually shy away from taxing owner occupied housing because it has universally proved to be politically unpopular relative to other types of taxation. However, the scale of the crisis and the technocratic nature of the new administration have weakened such political opposition.

The prospects for the housing market in 2012 do not look promising, with a weak economy, poor credit availability and a new tax regime. Further price declines can be expected. If the Eurozone crisis is not effectively resolved, the consequences for the housing market would be particularly severe.

Figure 8.1 **Real house price changes 2000-2011**



Source: Scenari Immobiliari

8.2 Housing system

Homeownership is high, with almost three-quarters of residents owning their home. About 60% of all households own them outright, with no mortgage burden in a country where widespread use of mortgage finance is quite recent.[43] If co-operative ownership forms are added, the share of owner occupation rises to over 80%. A high rate of owner occupation is matched by a declining share of private renting and there is little social housing. Renting is highest among lower income groups. Rent regulations with long-fixed term contracts and lengthy eviction procedures are not conducive to vibrant rental investment. Many younger people live with their parents into adulthood, which affects the scale and pattern of housing demand.

8.3 Market transactions and housebuilding

Purchases were at their greatest in the immediate aftermath of the founding of the Euro in the early 2000s. Current annual transactions are only two-thirds of the levels then. They dropped by -8% in 2011, which reflects a softening market.

The decline in transactions since the world financial crisis, though significant, has actually not been as great as in many other countries. There has been a long run comparatively low level of market transactions relative to the housing stock compared with countries like the UK. Once having purchased a home, Italians rarely move; whereas in other countries trading up to progressively better accommodation as living standards improve over the life cycle is common. A relatively high share of purchases is also financed without using a mortgage. Therefore, the tightening of lending conditions has had less of an impact on sales in Italy compared to other European countries.

A weak housing market means limited demand for new dwellings and housebuilding continues to fall as a result, though by relatively small amounts. Residential investment fell by -3% in 2011 and further declines are expected in 2012.[44]

Housebuilding figures are only indicative of true activity. The often informal nature of building means that much new housing and renovation fails to make it onto building permit, tax and data registers. Periodic amnesties eventually bring some of them into the fold. However, this informal market is likely to fluctuate in a similar way to the formal one. Proposed tighter tax avoidance rules may diminish its scale in the future.

8.4 The economy

Growth has been modest for many years and the economy was badly hit by the world economic crisis, with recession lasting through 2008 and 2009. Modest growth of 1.5% occurred in 2010 but the recovery stumbled in 2011 and the economy was back in recession by the last quarter. With the added strain in the wake of the Eurozone crisis of sharp reductions in public expenditure and increased taxes, the economy is likely to remain weak through 2012. Inflation rose in 2011 to 2.7% but, with the slowdown in the economy, it is now expected to moderate.

8.5 Mortgages

Mortgage use has been growing rapidly, but from a low base, so that outstanding mortgage debt to GDP is still only 23%, the lowest amongst the world's advanced economies.[45] After rising by 15% in 2010, raising prospects of a housing market revival, mortgages only grew by 3% in 2011, which is static in real terms. This slowdown reflected lower consumer interest and tighter credit constraints. Household loan defaults are at low levels, just 1.2% of total outstanding loans in mid-2011.[46]

43 Eurostat. 44 OECD. 45 EMF. 46 Central Bank.

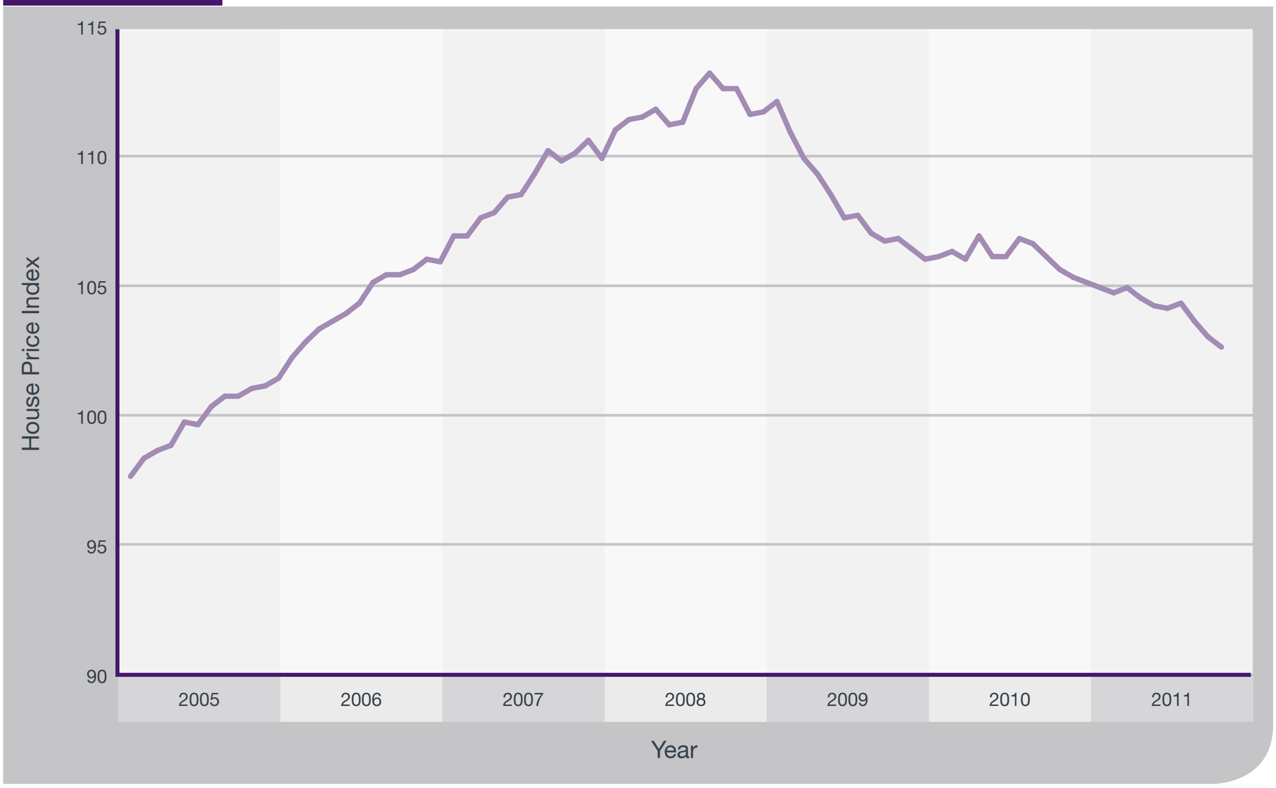
9.1 A weak housing market

Market conditions were poor in 2011 and prices continued to drift downwards. They fell by -3% on an annual basis up to October for existing dwellings, or by around -5% in real terms.[47] Average house prices were by then -12% lower in real terms than they had been at the beginning of 2007. Prices have been on a gradual slide since mid-2008 (Figure 9.1). However, prospects worsened notably during the second half of 2011, with the economy falling into recession.

Prices in the major cities have fared better than in the rest of the country. The economic and population heartland of the Randstad (the cities of Amsterdam, Rotterdam, The Hague, Utrecht and surrounding areas) as a whole has experienced lower price falls than elsewhere.

The market in 2012 is going to be under further pressure, given the weak state of the economy and a squeeze on mortgage lending. Consumer confidence is also low. Perhaps the biggest threat is a lack of mortgage finance.

Figure 9.1 **Monthly house price index, January 2005 – October 2011**



Source: Statistics Netherlands

47 Statistics Netherlands.

9.2 Housing system

The homeownership rate is just over half of the housing stock (53% in 2007). Owner occupation rates are far lower than the national average in some cities; particularly Amsterdam which has only 30% homeownership (in 2007).

The private rented sector is quite small and divided into a 'luxury' sector and a low cost, low quality 'controlled' one. Most rental housing (34%) is in the social sector, run by independent, non-profit, housing corporations.

There is rent control in place, though not in the luxury market. The government sets the annual rate of price increase. As a result, rent increases are typically modest and often below the general rate of inflation. Subsidised rents and attractive accommodation at good locations has kept many Dutch households as social tenants. There are pressures for change but they are not helped by the weak economy and the unattractiveness of house purchase when prices are falling.

9.3 Property sales and housebuilding

The biggest declines in the housing market have been in the volume of sales transactions of existing homes and in housebuilding. This suggests that the housing market has been exhibiting a fair degree of price stickiness. This is probably due to the limited number of forced sales during the housing market downturn to date. Instead, the market has settled into a much lower level of activity in the post-crisis years and will probably remain that way until recovery starts or further shocks push prices more sharply downwards.

Sales activity is subdued compared to its levels prior to the housing market slowdown. The number of sales of existing dwellings was -40% down by 2010 over their 2006 peak. 2011 saw a further decline, with the sales total to October down -4% on the same period a year earlier.[48]

Housing completions overall were -30% less in 2010 than they had been in 2007. There was some revival in the first half of 2011 of 9% on the previous year but that was mainly due to an increase in socially rented housebuilding. By contrast, owner occupied building was over 40% below the figure for the first half of 2008, in line with the fall off in existing home sales.

As part of economic stimulus measures, VAT on labour costs in construction projects was temporarily lowered until October 2011. This may have helped to boost housebuilding and repair and improvement.

The Netherlands has had a history over the past two decades of weak housing supply and strong demographic pressures for more homes. The past few years of much reduced housebuilding have consequently reinforced the mismatch between underlying demand and supply, particular in the Randstad region.

9.4 The economy

The world financial crisis pushed the country into recession with GDP falling by -3.5% in 2009.[49] Modest growth returned in 2010 but the Eurozone crisis and the renewed slowdown of the world economy led to further contraction in the second half of 2011. The squeeze on consumer expenditure has been particularly strong, driven by rising price inflation. Although unemployment has risen slightly it remains relatively low. The current expectation is that the economy will gradually pick up again from mid-2012.

9.5 Mortgages

The Netherlands mortgage market has not experienced much of a credit squeeze since the onset of the world financial crisis, though credit markets were tightening in the second half of 2011 and are expected to continue to do so in 2012. Last year, bank mortgage lending was down -6% on the year to September 2011, according to central bank data. Banks cannot fund their mortgage volumes through retail deposits alone and rely heavily on capital markets. Therefore, finding funds for mortgage lending will prove a challenge for them in 2012, given the credit squeeze in the Eurozone. Interest rates had been falling slightly in the first half of 2011 but those gains were reversed in the second half of the year in light of Eurozone turbulence.

People are encouraged to borrow large amounts by a combination of high income taxes, mortgage interest tax relief and mortgage insurance. Household debt is 128% of GDP, one of the world's highest, which makes households vulnerable to adverse economic shocks and negative equity. In 2011, lenders agreed to cap new mortgage loans at 106% of property values.

Securitisation has been an important feature of the mortgage market. Banks sell their mortgages onto special purpose vehicles (SPVs), which then issue new residential mortgage backed securities (RMBS). By 2007, the Netherlands had become the third largest European issuer of securitised mortgage debt after the UK and Spain, in spite of its much smaller size. The use of SPVs continued to grow until Q3 2010 but has declined since then (by -14% on the year by Q2 2011) as the Eurozone debt crisis has grown.[50]

Mortgages with interest rates fixed for 5 years or more used to be the most common form of borrowing but shorter interest rates terms are now popular, because of the lower interest rates. Market shares are now similar across the range of interest rate fixation: variable (28%), 1 to 5 year (32%), 5 to 10 year (33%) with a small amount for longer terms (1%).[51] Borrowers may take out packages of loans of different maturities and fixed lengths.

48 Statistics Netherlands. 49 Netherlands Central Bank. 50 Netherlands Central Bank. 51 Netherlands Central Bank.

National mortgage guarantees

A national mortgage guarantee ('Nationale Hypotheek Garantie', NHG) is an important element of the mortgage market. 90% of mortgage loans issued for properties worth €265,000 or less are insured in this way. During the housing market downturn, the maximum value for a property insured temporarily rose to €350,000 to encourage house purchase.

Homebuyers may insure against default caused by unemployment, health and family breakup by paying a small insurance premium. A one-off, tax-deductible fee is paid at commencement but borrowers can attract marginally lower interest rates from lenders which offset these costs. More than 100,000 loans were financed in this way in the first nine months of 2011; 26% of them for home improvements. Defaults are rising, though still relatively low. They were up by 44% in the first half of 2011, with 2000 expected in the year overall. Half were due to divorce and a fifth to unemployment.[52]

52 NHG.

10.1 Moderate decline

The slowing in the economy and fiscal retrenchment are having an impact on the housing market but the scale is relatively modest compared to many other European economies. The asking prices of new dwellings in the six largest cities, according to REAS, on average were -2.6% down on the year, or -4.6% in real terms. Nominal price declines have been relatively modest since the major adjustment in 2008/9. However, taking general inflation into account, real prices are down by around a quarter since 2008.

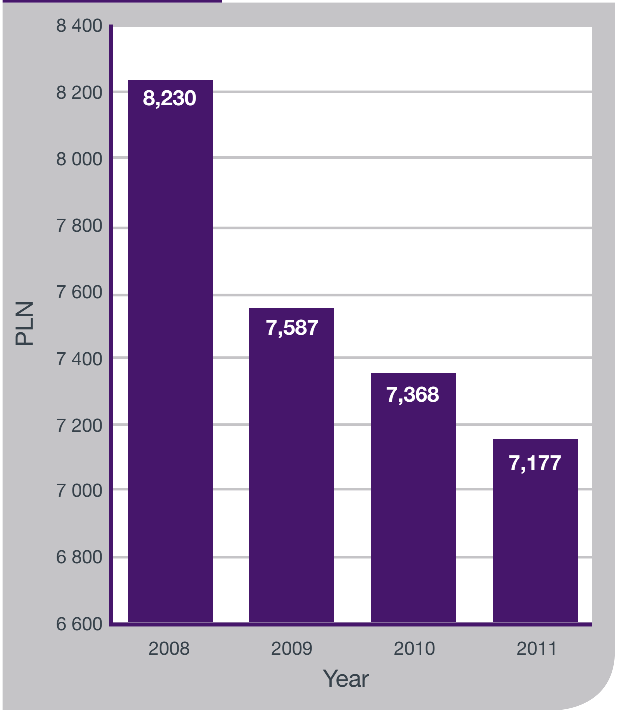
The scale of the earlier price boom was dramatic. Prices doubled in the short period from 2004 to 2007, so a downward adjustment was almost inevitable after such a speculative surge. Moreover, since then the supply side situation has greatly improved.

The continued downwards drift in prices is being aided by high building rates relative to demand. By autumn 2011, the number of homes offered for sale by developers was the highest in the history of the market.

Turnover in the year up to October 2011 was the greatest it had been since the end of the boom in 2007. In part, this may be due to the impending withdrawal of state subsidies for purchase under the ‘family on its own’ programme. In addition, mortgage growth was rapid with outstanding mortgages rising by 26% on an annualised basis in October 2011, one of the fastest increases in Europe. Such extra loan commitments are holding up demand and prices.

Poland does not look as if it is going to be hit as badly as many other countries by the current Eurozone crisis and world slowdown. However, it is not immune and with buoyant supply, it is likely that there will be some future easing of prices in 2012. Moreover, it is questioned whether the continued high growth in mortgage loans is sustainable in light of the intensifying international credit squeeze. Without that support, the housing market could soften markedly.

Figure 10.1 New house prices 2008-2011



Source: REAS

10.2 Housing system

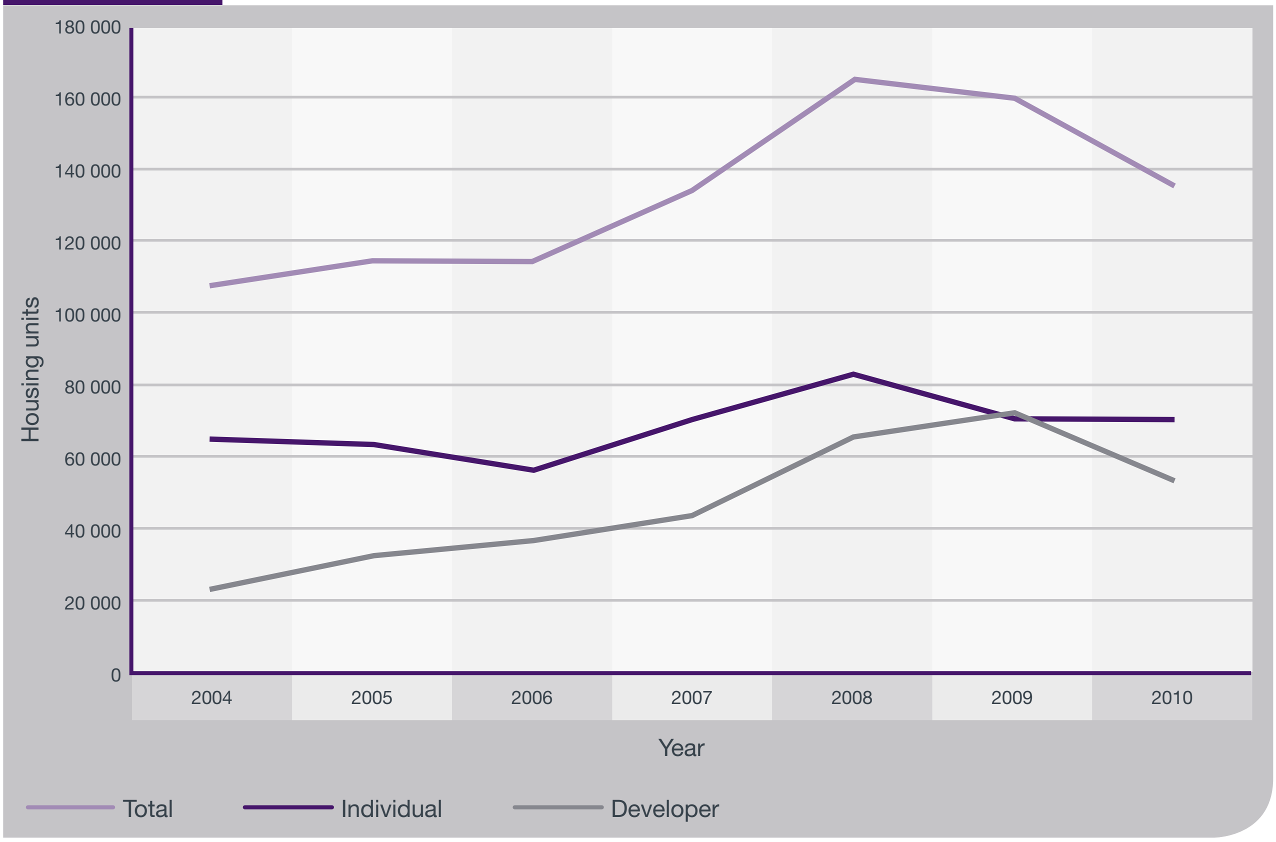
Overall, with the different types of property rights corresponding to private ownership, the rate of private ownership is over 75%. By 2008, 62% of dwellings were fully-owned by private individuals as outright owner occupiers with no mortgage and a further 4% were owners with mortgages.[53] However, 10% of that housing stock belongs to owners with 'rights of occupancy' flats in apartment blocks, similar to those in Scandinavia. Recently, the law has changed to allow full owner-occupancy rights in place of tradable rights in co-operative ownership.

Up to a fifth of the stock are various forms of social housing, after privatisations. Much of it is run down. Housing cooperatives are the largest holders of this part of the housing stock. The private rented sector is small and has been heavily regulated. However, there has been some recent liberalisation, particularly of new lettings.

10.3 Housebuilding

From 2004 to 2008, as house prices boomed, house-building rose by over a half, mainly due to a threefold increase in output by developers building for sale. Though commonplace for many years in Western Europe, the existence of developers producing for a mass market is a relatively recent phenomenon in Poland. Due to the time it takes to build housing, developers' output peaked in 2009, sometime after the start of the price downturn. Output fell by a quarter in the following year and by a further -8% in the first nine months of 2011. There were signs in Q3 2011 that building may rise in the future, despite the continuing fall in average sales prices. Starts were up by 2% and permits by 4%. Most notably, permits for developers were up by a substantial 21%. However, developers may have been trying to pre-empt the impact of new controls on them being introduced in a developers' bill put into law towards the end of 2011.

Figure 10.2 **Housebuilding by producer 2004 – 2010**



Source: Central Statistical Office

53 Eurostat.

10.4 The economy

The economy expanded rapidly between 2004 and 2008, driven by booming domestic demand. The world economic crisis then slowed growth but the country did not fall into recession, uniquely in the EU. In 2009, growth remained positive at 1.6% and accelerated to 3.8% in 2010 and 2011 was even better at 4.2%.[54] However, growth is expected to slow down in 2012, though still be one of the better ones in the EU in 2012. The problems of the Eurozone, which makes up the country's main export market, are contributing to reduced growth.

The public sector deficit has been increasing as a result of the downturn and associated stimulus measures and it reached almost 10% of GDP in 2010, although government debt is relatively modest at 65% of GDP. Actions to raise taxes and reduce public expenditure are lowering the deficit rapidly but general growth is slow.

Inflation rose to 4% in 2011, squeezing real incomes. Part of the increase was due to higher taxes, although personal expenditure is still expected to increase in real terms in 2012. Unemployment is high at 10% and expected to stay at that level.

10.5 Mortgages

Housing loans have been growing at a substantial rate. They rose 35-fold between 2000 and 2009 in nominal zloty terms.[55] However, the ratio of mortgage debt to GDP remains low at around a fifth of GDP.

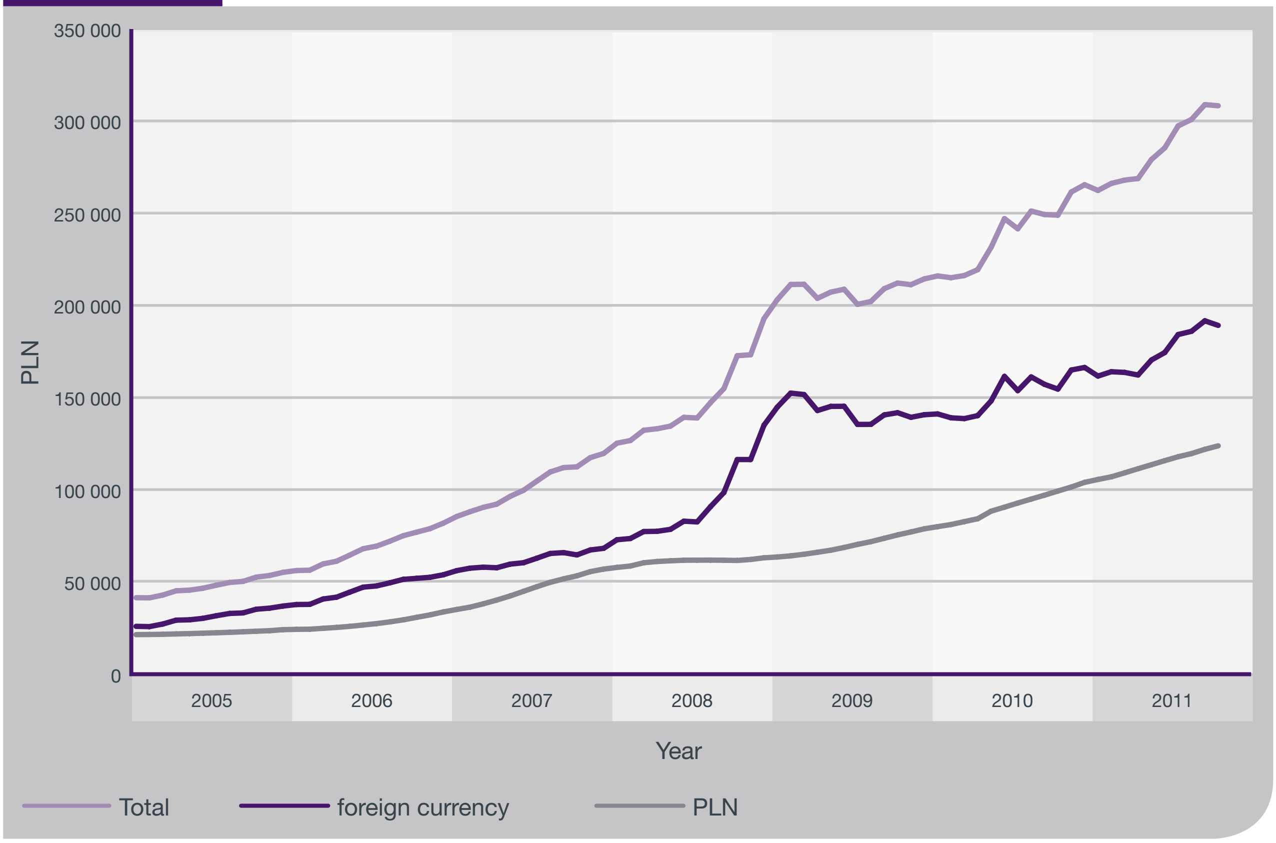
The credit crunch led to a severe cutback in new mortgage lending. However, the situation eased in 2010 and strong growth resumed and total outstanding mortgages were rising at 26% on an annualised basis in October 2011.

Even foreign currency lending recovered somewhat in 2011, although three-quarters of new loans by the autumn were zloty loans. Even so, almost two-thirds of outstanding mortgage loans are still foreign currency denominated. Therefore, the exchange rate risk remains high and could still lead to widespread defaults.

Many mortgages were taken out in Swiss francs and imposed strains on household budgets as the exchange rate worsened. More recent foreign currency loans tend to be denominated in other currencies than the Swiss franc.

The key factor driving mortgage lending in 2011 was attractive borrowing rates. They oscillated somewhere between 2-3% throughout the year. Hence, they were significantly negative in real terms.

Figure 10.3 **Outstanding mortgage January 2005 – October 2011**



Source: Central Bank

54 OECD. 55 EMF.

11.0 Portugal

11.1 Stagnation

The slowdown in the economy caused house prices to stagnate and fall slightly in 2011, according to the Confidencial Imobiliário index (Figure 11.1). Housing asking prices were -1% down on the year in October and by -4.5% in real terms. As can be seen from the below graph, house price change has been moderate for some years though it did fall by -5% in real terms in the six years between 2005 and 2011.

The November 2011 RICS/Ci Portuguese Housing Market Survey indicated continuing declines in market activity and prices and continuing low confidence. The National Confidence index remained at -60%, just above the lowest level recorded. Sales activity in November declined at the fastest rate since the survey began in September 2010. The balance of opinion was -44%, showing the extent of agents reporting falling sales in relation to available supply. The cause of the deterioration was highlighted as declining demand. Instructions to sell had in fact been falling throughout 2011, so there is no indication of a flood of distressed sales onto the market. The National Price balance fell from -64% in the previous to -70%, indicating a continuing softening of prices.

There were also signs that new house prices were also beginning to fall, as developers had to cut prices in face of a weakening market. This marked a significant change for the new build sector, because up to the end of 2011, it had managed to keep prices at steady levels.

There were also notable regional differences in house price changes, with the Algarve experiencing the sharpest house price falls. Southern Portugal is the country's major second and retirement home region, so demand there is more influenced by discretionary expenditure and foreign purchaser interest than elsewhere.

Problems in the owner occupier sector continued to boost demand for renting. Tenant demand and landlord instructions were both continuing to rise, according to the November 2011 RICS/Ci Portuguese Housing Market Survey. However, there were indications of an excess of rental stock with rents falling quite sharply. Survey respondents reported expectations of further declines to come.

Figure 11.1 **House prices January 2005 – October 2011**

Source: Confidencial Imobiliário

Given the scale of the economic problems facing Portugal, relatively moderate falls in house prices may come as a surprise. However, several factors may help to explain this situation.

1. The country did not have a housing boom in the immediate years prior to 2007. Its boom was earlier in the late 1990s and early 2000s. Consequently, the country was experiencing economic problems and a weak housing market well before the onset of the world financial crisis and sovereign debt problems. As a result, key features of the housing market had already adjusted to adverse conditions. For example, there has not been a substantial new housing supply overhang in recent years, as has occurred in neighbouring Spain. Moreover, housebuilding rates have fallen sharply over the past five years further reducing supply.
2. Portuguese households have low mobility and a tradition of purchase for life. This means that sales activity is relatively low. Home owners have also been reluctant to sell in a falling market.
3. Some households have high mortgage debts and negative equity and are particularly reluctant to sell and realise losses. Low interest rates have enabled them to avoid default, although arrears are rising.

11.2 Housing system

Three-quarters of households are owner occupiers and the rest are renters. 16% rent privately and fewer than 10% rent some form of 'social' or 'no rent' housing.

11.3 Housebuilding

Housebuilding has been on a long-term downward trend, with completions in Q2 2011 only half those of the same period in 2003. There was a house building boom around the turn of the century when the Euro was introduced, which partly accounts for the decline but new building has been badly affected by the mounting economic problems of the past few years.

The economic crisis saw a reduction in housebuilding, with completions down by a third between Q3 2008 and Q2 2010. But there was then a 16% revival over the next year (Q3 2010-Q2 2011). However, with a further weakening of economic prospects in the second half of 2011, housebuilding was again reduced. This can be seen in the leading indicator of permits issued for residential building, which was 17% down in Q3 2011 on the previous year.[56] Housing permits overall between 2007 and 2011 declined by 71% illustrating the scale of the decline that has been occurring in recent years. This degree of decline puts Portugal alongside Spain, Ireland and Greece in the extent of the collapses in housebuilding experienced since the onset of the world financial crisis (see Table 1.1).

As noted earlier, housebuilders are having to trim prices, which suggests that they will cut build rates in 2012. There is also substantial individual commissioned new building activity in the country but there is little information on it. However, given credit constraints and the state of the economy, activity is likely to be falling in this sector as well.

11.4 The economy

The economy has been shrinking due to marked reductions in aggregate demand caused by fiscal consolidation, credit constraints, lower investment, and weaknesses in the Eurozone and world economies. Economic growth fell by -1.6% in 2011 and the contraction is expected to be even greater in 2012.[57]

Oil prices helped to push inflation up to 3.5% in 2011. This further lowered real earnings, already squeezed by economic crisis. Unemployment is also high at 12.5% in 2011 and is expected to grow further as the recession intensifies.

Government debt is over 100% of GDP, which has put the country at the forefront of the Eurozone crisis. It will take many years to reduce indebtedness significantly.

Economic prospects are only likely to improve slowly. The economy will remain vulnerable to external shocks and indebtedness for a long time to come. The housing market therefore faces an unattractive economic environment for some time to come.

11.5 Mortgages

Mortgages are issued by banks and are variable interest rate ones. The residential debt to GDP ratio was 66% in 2010.[58] Outstanding mortgage lending growth rates have been modest since 2008, having been high in previous years. But in 2011, they turned negative for the first time, albeit by a marginal -0.4% up to June 2011.[59] By the second half of the year, residential mortgage offers were hard to come by as banks were cutting back loan offers sharply because of the debt crisis.

After the 2008 Lehman Brothers crisis, mortgage interest rates fell to a low of 2.2% in Q1 2010.[60] They have been gradually rising since then, partly in line with ECB rates but also because banks are widening their spreads in the light of worsening economic circumstances.

The central bank's credit survey in October 2011 indicated a marked tightening of mortgage lending, with higher interest rate spreads and stricter loan terms. The demand for loans was also much reduced. Respondent banks also indicated that further constraints were likely to be imposed in the future.

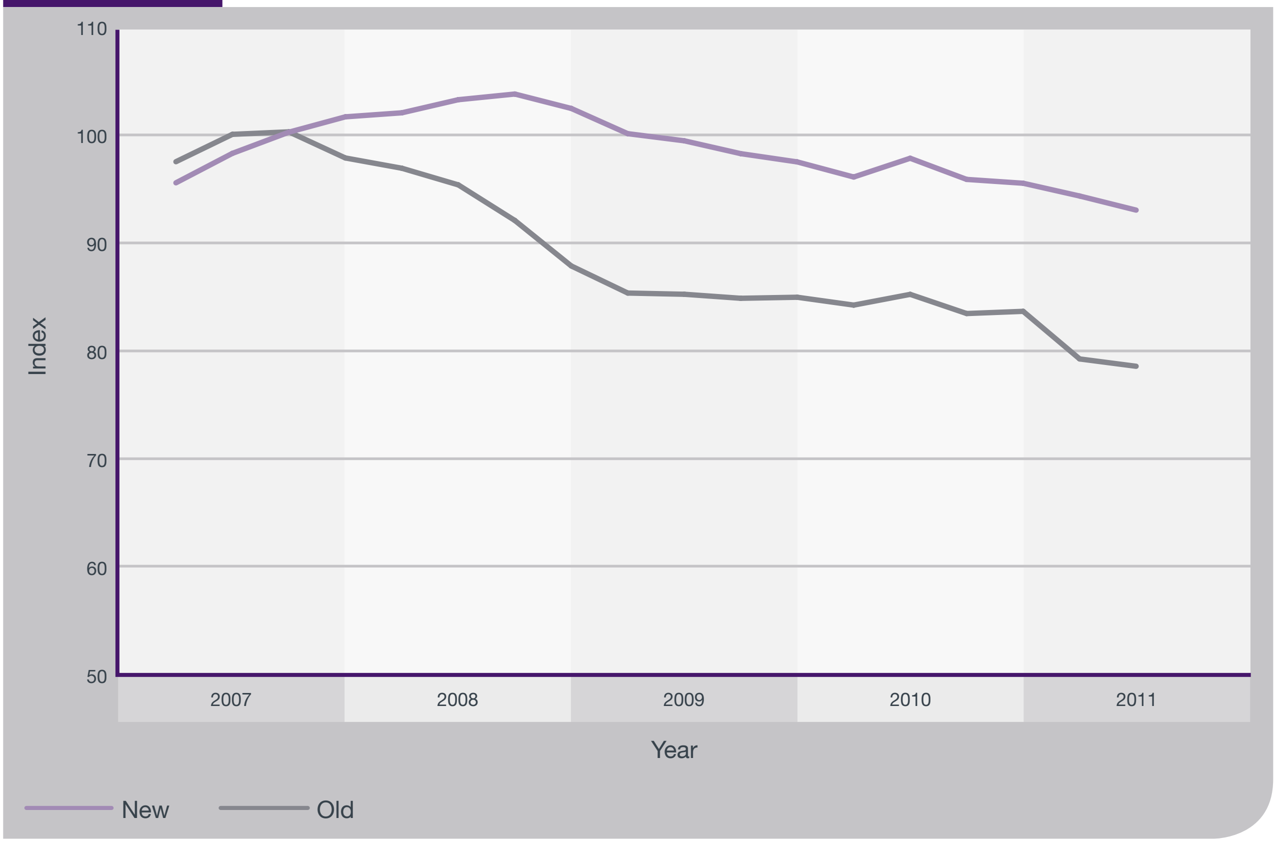
Mortgage defaults were at historically high levels and rising in 2011. The September 2011 non-performing loans ratio was 6.8% of total bank lending compared with 5.1% at the end of 2010.[61]

57 OECD. 58 EMF. 59 Central Bank. 60 EMF. 61 Central bank.

12.1 Market misery

House prices continue to slide and the rate of decline has accelerated from the modest falls in 2010. The official INE index, based on notaries' housing contract data, was recording an annual -8.3% fall in existing house prices in mid-2010 and -5.2% for new dwellings (Figure 12.1). The Fotocasa index was indicating a -6.7% annual fall in November 2011; the Ministry of Housing's Q3 figure was -5.6%; and Tinsa's was showing a -6.9% decline to October.

Figure 12.1 **House prices Q1 2007 – Q2 2011**



Source: INE

Spain's economic problems and continuing post-boom housing adjustments have both badly affected the residential market. By summer 2011, market transactions had fallen to 40% of their levels in 2007.[62] Housing market activity remains depressed because of weak demand, tight credit conditions, and falling prices. 2012 promises more of the same, or worse if the Eurozone's problems cannot be resolved satisfactorily. From being a fountain of growth in the boom years, residential markets continue to weigh heavily on the economy as a whole at national and local levels.

Since their 2007 peak, real house prices have fallen by -27%, according to the ENE index, and by a third on the Fotocasa measure. However, such falls have been insufficient to reverse the decline.

Mortgage defaults have been limited, partly because of lender forbearance, and much empty newly-built stock still has not been put on the market (and some may never be). So, indebtedness and still unrealised losses amongst consumers, lenders and developers continue to trouble activity.

The problems of Spain's residential market remain amongst the worst in Europe. The housing market may level off in 2012, as many hope. Yet the risks of further major external shocks are high. Moreover, the country risks the danger of a self-feeding slide similar to that in the 1990s in Japan, which has afflicted many parts of the USA more recently.

62 Housing Ministry.   63 *Spanish Survey of Household Finances*

12.2 Housing system

Property ownership is central to the housing market and to personal debt and wealth holdings. 83% of households are owner occupiers and almost a quarter own a second home, with 80% of total household wealth in housing.[63] Tax breaks for homeownership have been significant, including mortgage interest and capital repayment income tax reliefs plus additional breaks for housebuilding and housing savings schemes. However, most have recently been abolished or were going to be by the out-going government and continued austerity should see legislation enacted where necessary by the incoming government.

Rental housing is almost entirely privately provided. Reasons for the low levels of provision of rental housing are the advantageous tax breaks for owning long-term rent contracts favourable to tenants; and the inefficient legal eviction procedures. Actions have recently been proposed or taken in all these areas but whether they will be sufficient to expand the private rented sector remains to be seen. Pressures on rental markets are growing, because of current constraints on owning and a reluctance to buy when prices are falling.

Many non-Spanish people have holiday or retirement homes in Spain, because of the attractiveness of the climate and lifestyle. The demand for such accommodation forms an important part of the market, especially along the Mediterranean coast. The collapse in the housing market has badly affected this group, because there is often substantial excess supply and few buyers when prices are still falling. These owners have put considerable retirement wealth into Spanish property, which now is sunk into physically depreciating, illiquid assets with much-reduced present day values. Many invested during the boom years on the basis of over-optimistic expectations of capital gains and a poor understanding of the risks involved.

12.3 Housebuilding

Between 2006 and 2010 housebuilding fell by -92%, indicating both the scale of the earlier housebuilding boom and the extent of its collapse. At the 2006 peak, new building starts reached an incredible 665,000 units, but by 2010, only 63,000 were recorded. In current market circumstances, it is perhaps surprising that even that number were started.

The decline in building continued throughout 2011. By June, building starts were a further -16% down on the previous year.[64] 2012 offers limited chance of an end to the output falls although, as housebuilding numbers shrink, the rate of decline should moderate. On that basis, some forecasters were suggesting towards the end of 2011 that residential investment will level off in 2012.

Large numbers of unsold properties remain, owned either by developers or by banks that foreclosed on them. It is hard to get realistic figures on unsold, empty properties but the number is large, though believed to be falling.

To stimulate new housing demand, a temporary halving of VAT was introduced from August to December 2011. However, there is scepticism about whether this had any real impact, although it may have brought forward purchases planned for 2012.

12.4 Economy

The economy had been pretty much flat for most of the past two years. But then output dipped towards the end of 2011 and any recovery in 2012 is expected to be limited.[65] The country, as elsewhere, is being affected by the slowdown in the world economy and is being particularly badly affected by the Eurozone debt crisis. Government deficit reduction actions also continue to depress demand.

Inflation rose to 3% in 2011, which cut into consumers' real incomes and expenditure. This added to worsening consumer confidence. All of this affected housing demand.

The fall in residential investment has had a substantial downward impact on the economy. By Q3 2011, residential investment was down from its 2007 peak by a substantial 5% points of GDP. However, it was still 3.9% of GDP in 2011, which is still significantly higher than in many other countries suffering from stalled housebuilding.

Unemployment has rocketed as the country has struggled to replace the lost demand, to divert resources and to regain international competiveness. It was around 22% at the end of 2011, with much higher levels amongst younger people, and is expected to continue at such extraordinarily high levels for some years to come. Another lost Spanish generation is being created, on a scale even greater than in the last recession in the 1990s. This will have a substantial long-term effect on the housing market because far fewer younger households will be in position to enter homeownership in the years to come; lowering the demand for new homes and purchases from the existing stock alike.

63 *Spanish Survey of Household Finances* 64 Housing Ministry. 65 OECD

12.5 Mortgages

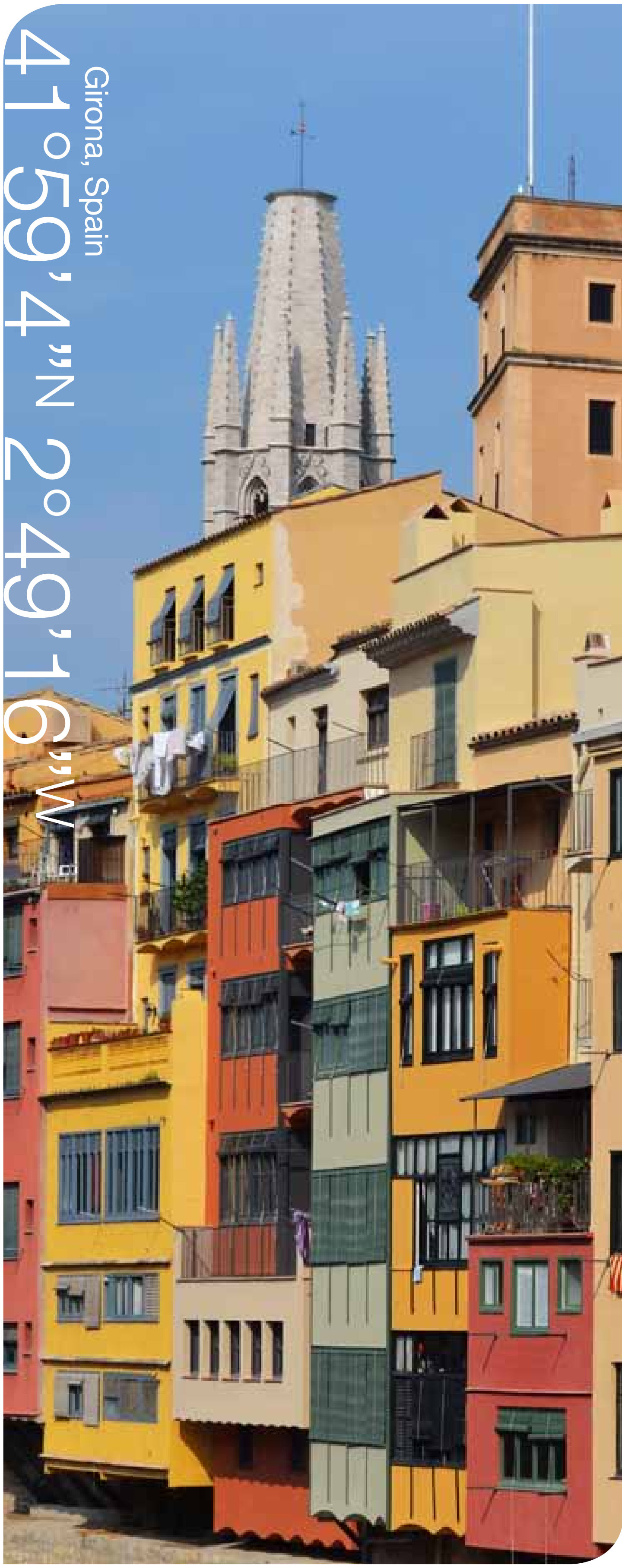
In the boom years, mortgage growth was expanding at double-digit levels. Growth stopped in 2009 but, until spring last year, it did not actually fall. However, for the rest of 2011, growth was slightly negative reaching an annual rate of minus -1.1% in October, indicating that slightly more was being paid back than lent.[66] This is the first sign of deleveraging (in nominal terms) of residential loans and may be a precedent for further contraction to come, especially given the tight credit squeeze. Household debt peaked at almost 130% of gross disposable income in 2007 and has fallen only moderately since then. So, households are still highly leveraged but defaults remain low.

Part of the reason for limited deleveraging has been the practice of lenders of trying to avoid defaults and asset write-downs. However, new realities are pressing and more defaults may now come on stream. Unemployment is affecting many families and some may now be coming to the end of their abilities to avoid default. Moreover, the further house prices fall, the greater will be negative equity. Unlike in parts of the USA, the financial penalties for non-payment of mortgages are high but, all the same, the incentive to do so is growing.

Low mortgage interest rates on the variable rate mortgage loans, typically taken out, have helped to sustain the financial viability of borrowers. Unfortunately, however, mortgage interest rates were beginning to drift upwards throughout 2011. They had fallen as low as 2.39% on average in June, 2010 but were 129 basis points higher by August 2011.[67]The financial crisis was being felt through tightening credit conditions, with loans becoming harder to find especially as the Eurozone crisis mounted towards the end of the year. Banks faced growing difficulties of raising funds from any other source but the ECB.

Another significant financial issue concerns the poor quality of many outstanding loans to real estate developers (active mainly in residential construction). Over half of the lenders' real estate loans are classified as 'troubled', including assets already acquired through foreclosures. The share of such troubled loans is 11% of all credit portfolios, but the incidence varies widely between institutions.[68]

Savings banks, the local and regional Cajas, have been most exposed to real estate losses. To resolve their problems, a Fund for the Orderly Restructuring of the Banking Sector (FROB) was set up in 2009. Balance sheet write-downs since then have totalled €105bn and Caja numbers have fallen from 45 to 15, with conversions to commercial banks and other strengthening measures.[69] However, major issues remain unresolved and further massive write-downs may be required. Furthermore, BBVA Research has argued that the 4,000 branch closures up to June 2011 were insufficient and estimates that a further 9,000 closures are needed.



66 Bank of Spain 67 Bank of Spain 68 Bank of Spain 69 Bank of Spain

13.1 Long price boom comes to an end

The great Swedish house price boom finally ran out of steam in 2011 and the prices of single family houses were only up by 1% on the year. As that modest increase was less than the general rate of inflation, the real change was actually -2%. The Stockholm region recorded a somewhat higher nominal rate of price growth at 3% but even that was flat in real terms and well down on the 10% increase in 2010.

In the previous decade nominal house prices had more than doubled, while altogether they had risen 2.5 times in real terms since 1997. Moreover, even though house price growth declined with the world financial crisis in 2008, prices actually fell only briefly at the end of 2008 and bounced back strongly in 2009 and 2010 as the economy boomed and mortgage interest rates were low. In contrast to other European countries where price falls have been the norm, real house prices rose by 5% between 2007 and 2011. However, upward price pressures were finally brought to a close with rising interest rates and a slowing economy in 2011.

The prospects for the housing market in 2012 are much poorer than they have been for a long time. The economy will take time to recover. What is more, expectations may shift as many consumers may feel that the housing market has passed a tipping point. If a sufficient number of them feel that values cannot be sustained, this could help to trigger a decline in prices. However, large scale mortgage defaults are unlikely in the current interest rate environment and few developers will have to unburden themselves of unsold homes, so any price decline is likely to be gradual, if it occurs.

Deteriorating economic conditions may dictate interest rate cuts again. If that does happen, the impact on the housing market will be weaker than in 2008, because of recent monetary policy directives aimed at tightening mortgage availability.

Figure 13.1 **House price changes 2000-2011**

Source: Statistics Sweden

13.2 Housing system

There are four principal tenures: single-family owner occupied, tenant-owner co-operatives, and private and public rental (Table 13.1). The first two are distinct forms of homeownership for houses and flats.

Taking owner occupation first: 65% of all homes are now owner occupied. There has been considerable growth in homeownership over the past decades, especially in relation to apartments, where ownership is rapidly catching up with renting. Expansion has been encouraged by favourable tax treatment, housing shortages and the sharp rises in property values, and the chronic rigidities existing in rental sectors. The latter restrict inward mobility in the strong growth regions and exclude many aspiring, younger households.

41% of all dwellings are straightforward, single-family owner occupied ones, with a small number of two family structures amongst them. This type of housing is rare in the other tenures, which instead are all segments of the 2.5 million apartments that make up two-thirds of the country's housing stock.

The second element of owner occupation is the tenant-owned co-operative sector, which now accounts for 22% of all dwellings. Under unique institutional arrangements, tenant ownership is the main way to own a flat in Sweden. The co-operatives legally own the buildings and directly take out mortgages to fund part of the value of the buildings and land. The remainder is financed through leveraged contributions from co-operative members in exchange for tradable occupancy rights attached to each of the co-operatives' dwellings. Co-operatives typically own only one housing estate or individual apartment building. It is either newly built or a modernised apartment block that was previously rented. This sector is now the most active in terms of market transactions and it is growing fast. There were almost 100,000 tenant-owned purchases in 2010; two-thirds more than the 60,000 acquisitions of single-family dwellings in the same year.[70]

Members are charged monthly fees to cover the co-operative's mortgage loan plus administration, taxes, insurance, maintenance and repair costs. Consequently the market prices of the specific flats individuals have a right of occupancy to depend not only on the property's physical attributes but, also, on the co-operative's debts, its management quality, its user charges and the implicit default risk of other co-operative members. These items may be hard to assess accurately before purchase.

With the growth of tenant-owned co-operatives, renting has been in decline. Nowadays, only 35% of all dwellings are rented; a share considerably down on previous decades. Around half of rented accommodation is owned by non-profit, local authority linked, municipal housing companies (MHC) and the other half is privately owned.

Rent controls and security of tenure are extensive. There are long standing systems of rent negotiation, whose effects link social and private rents together. Rents have to be comparable across a locality and private tenants can appeal to a rent tribunal if they are not. So, the overall costs of local MHCs essentially set the average rent level and they are usually well below free market levels. Such strict rent controls generate severe distortions in the housing market and restrict labour mobility.

Rent increases bear no relation to overall market pressures and may not match general price inflation. In 2011 rents were 2.6% above the previous year for MHCs and 2.3% in the private sector, while the consumer price index rose by 2.9%.[71] They have lagged well behind the long-term rises in property prices.

Table 13.1 **Estimated tenure shares by building type 2010**

Residence type	Rented	Tenant owned	Owner occupied	Building types
1-2 dwelling buildings	<1	2	41	43
Multi-dwelling buildings	35	20	2	67
Tenure totals	35	22	43	100

Source: Statistics Sweden

70 Statistics Sweden 71 Statistics Sweden

13.3 Housebuilding

Housebuilding levels have for a long time been some of the lowest in the European Union in relation to population size. On a trend basis, Sweden's low housebuilding rate is on a par with the Netherlands and the UK and, as a result, it is one of the Europe's supply laggards. Ironically, with the collapse in housebuilding in some other European countries in recent years, the country no longer looks as bad comparatively but still suffers from chronic supply shortages in growth regions. There is some residual excess supply in declining regions, where there have been major demolition programmes since the 1990s of thousands of empty social housing blocks.

The early price upswing years did see more than a doubling of dwelling production between 1999 and 2005, especially in relation to flats. Housing starts peaked in a major spike in 2005, encouraged by the bringing forward of projects to take advantage of building subsidies before they were abolished. Building rates then fell sharply even before the world economic crisis, halving between 2005 and 2009 to only around 12,000 units a year.

Housebuilding picked up again in 2010 to 18,000 units, two-thirds of them apartments. In 2011, the output of apartments was sustained but single family construction fell by -13% in the first nine months of the year. The slowing of the housing market and the economy in general are likely to have a depressing effect on housing construction in 2012.

A long run shortage of land has limited building, particularly in the single family home sector. This constraint has contributed to the strong rise in house prices. Generous state fiscal supports for ownership and rigidities in rental markets have played their part as well. Moreover, construction costs are high. This has a particularly significant impact in relation to apartment building and renovation. They are construction-intensive and are the main source of new housing supply, as noted above.

13.4 The Economy

The economy recovered strongly after the 2009 downturn. Growth was over 5% in 2010; a level that was sustained in the first half of 2011. However, the slowing world economy lowered exports and the economy decelerated in the second half of the year. Constrained by world events, growth is expected to be limited in 2012. This renewed economic weakness will be transmitted through to the housing market.

Inflation rose in 2011 from modest levels. The rise in the consumer price index was partly driven by increasing mortgage interest rates, which are included in it. But headline inflation is expected to decline again in 2012 as the economy slows.

13.5 Mortgages

Mortgages are mainly provided by Housing Credit Institutions (HCIs), a type of mortgage bank which is often part of broader financial conglomerate, but also directly by commercial banks. The country did not experience a full blown credit crunch in 2008/9 but conversely lower interest rates stimulated mortgage demand and helped to push house prices up.

Household credit growth has been strong for many years, rising at double digit levels until 2008. However, the rate of increase has been declining since 2009 and was 6% for mortgages in 2011, as the housing market slowed. Households are now quite highly indebted, at 1.7 times disposable incomes, although their wealth holdings are much larger.[72]

Since 2010, mortgage interest rates have been rising and the credit conditions have tightened in line with regulatory directives. The use of variable rates reached 80% of new loans in 2009 but by autumn 2011 was down to half as more households expected the very low interest rate regime to end.

Credit availability is underwritten by the state in some key areas. There is a capped home purchase default guarantee covering the interest payments of first-time buyers run by the Swedish National Housing Credit Guarantee Board (BKN). It also administers government credit guarantee programmes for housebuilding and conversions, up to 90% of market value. 16,000 dwellings were under guarantee in 2009, which represents a significant share of all residential building work.

72 Central Bank

14.1 Against the flow

Low interest rates and plentiful credit have helped to push house prices up for some years (Figure 14.1). In fact, prices continued to rise in the 2008/9 economic recession. So, unlike much of the rest of Europe, Switzerland has been going through a housing market upswing. Double digit annual price rises have not been happening, as they did elsewhere in Europe prior to 2008. But, all the same, house prices were up 17% in the autumn of 2011 on 2007 levels at a time when general inflation was virtually zero, according to the Wüest & Partner index, and they were up by even more on some other measures. Real house prices rose by 14.5% from 2007 to 2011, a European record. Price increases have also been strongest in particular areas, with central and southern districts of the country seeing faster price increases. The Central Bank worries that a self-feeding boom is underway and the financial regulator is monitoring the situation. It feels that the rise in prices is above what would be expected with current interest rates, income growth, and demographics.[73]

Price increases seemed to moderate in 2011 somewhat, as the economy slowed, with house prices up by 3.5% in Q3 2011. For owner occupied single family houses, they grew by 3.5% in the year. However, house prices are generally very high and mortgage debt is still growing at a fast rate. On average, households are already heavily mortgaged. Housebuilding also remains strong, particularly for apartments.

Rent levels matter in a country where most households are tenants. Asking rents have been rising and were up by 8% between 2008 and 2011, according to central bank data. By contrast, rents in new apartment buildings fell by -7% over the same period. Rents were not rising as fast as house prices because of falling interest rates. The rental component of CPI, which is heavily weight towards existing tenancies, rose by 1.3% in the year to June 2011.[74]

The housing market historically is prone to considerable volatility. A boom in the late 1980s and early 1990s was followed by a prolonged slump for the rest of the 1990s, during which time house prices and rents declined markedly. Memories of that downswing may be influencing policy makers' current concerns about market overheating.

Figure 14.1 **House price rises 2000-2011**

Source: Central Bank

73 Central Bank 74 Central Bank

14.2 Housing system

The homeownership rate is the lowest in Europe at 35% of permanently occupied dwellings in 2000.[75] However, the rate varies considerably across the country with owner occupation in some cantons (Swiss administrative area) rising to half of all dwellings and even higher renting shares in some of the major cities. There is only a tiny social sector, so that most rent privately. Most rented property takes the form of apartments but the housing quality is invariably good. Flats may also be owned on a condominium basis.

There are a variety of exceptional reasons for the high renter tenure share. They include the large number of temporary workers in the country, restrictions on foreign purchase, and the difficulty of gaining citizenship and with it access to credit. However, the sheer cost of owner occupation puts it out of the reach of many. Even so, there is no pressure for significant change and many are content to rent.

Falling house prices during the 1990s helped to contribute to the lack of expansion of owner occupation at a time of marked increases in homeowner numbers in most other European countries. Price rises over the past decade may have encouraged more interest in owner occupation, because one of the benefits of purchase is protection from future rent and house price rises. Counteracting that effect has been the growing entry barrier represented by those very same high house prices. Unfortunately, what has precisely happened to the homeownership rate over the past decade is unknown, because the latest available data on tenure shares are only for the year 2000.

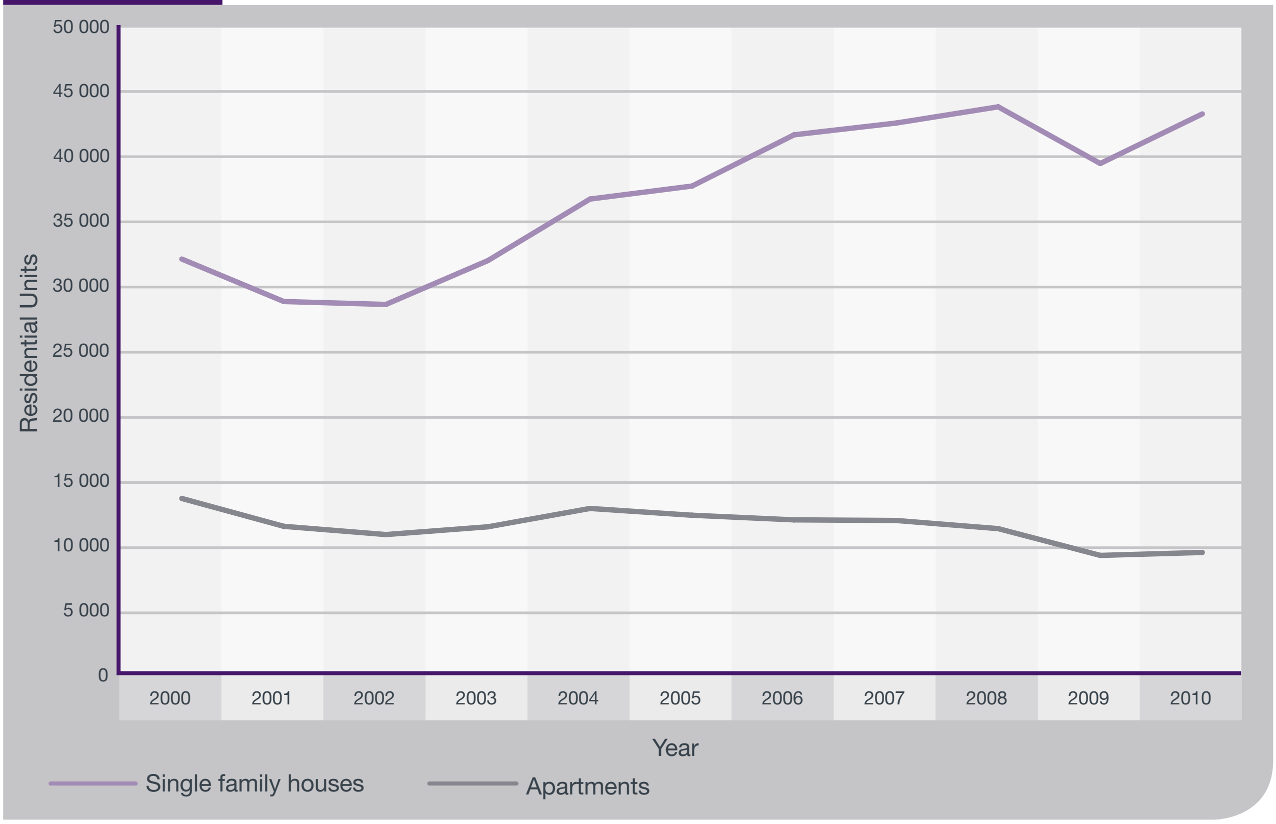
Rent control exists once dwellings have been initially let at open market rents. Subsequent rises for continuing tenancies are permitted only on the basis of official reference landlord cost indices. Moreover, younger renter households in cities tend to be highly mobile, so that controls have a real impact only on the part of the market where there are longer-term tenants. The low rents for tenants who stay in one property for a long time dissuade those that have settled down from moving into home ownership.

Despite the large number of renters, single family housing still represents 58% of the building stock and 65% of new residential structures. However, as each apartment building contains multiple flats, single family units are obviously a smaller share of the dwelling stock itself. Measured vacancy rates throughout the stock are exceptionally low at less than 1% of all dwellings.

Most of the rental accommodation is owned by private individuals; with corporates owning around 40% of it, according to 2000 census data. Private individual ownership of rental dwellings helps to account for the level of mortgage debt in the country, as small-scale investors leverage their own capital in their rental property investments.

75 Swiss Statistics

Figure 14.2 **New construction 2000 – 2011**



Source: Swiss Statistics

14.3 Housebuilding

There have been divergent trends in single family and apartment building over the past decade. Single family housebuilding has declined by almost a third since 2000, whereas apartment numbers have grown by a similar proportion over the same period (Figure 14.2). By 2010, flats represented 82% of all newly built dwellings.[76] Because price growth in the single-family house market has been strong, the presumption is that the decline in output of such units is a reflection of growing land shortages.

The level of housebuilding activity increased sharply in the first half of 2011 with a 14% annualised increase in dwelling completions and a substantial 37% increase in building permits issued.[77] Extra supply, if it continues, will add to dampening tendencies on house price growth.

14.4 The economy

The economy recovered from its world crisis-induced downturn strongly in 2010, recording almost 3% growth in that year. This helped to stimulate the housing market. However, the sharp rise in the value of the Swiss franc, as part of a flight to safety by international investors, then slowed exports and the economy as a whole in 2011. Continuing poor export prospects mean that growth is expected to be virtually flat in 2012, according to the OECD.

The economy will only pick up as the world outlook improves. It remains to be seen if the housing market will survive the current slowdown as well as it did four years ago.

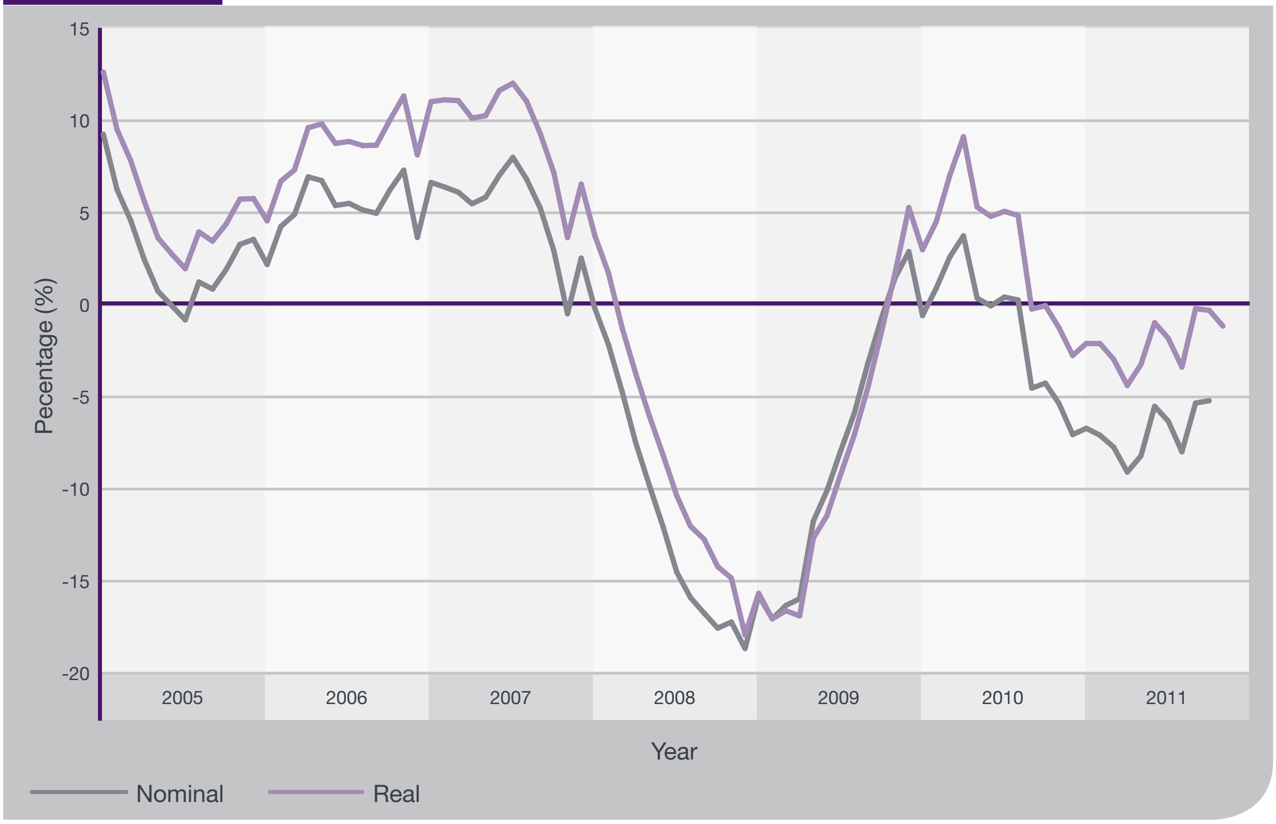
Inflation is low and has been for some years. As part of its strategy of limiting rises in the exchange rate, the central bank is deliberately keeping interest rates low to deter inward capital flows. However, that strategy is having knock-on effects in the form of low interest rates on mortgages and easy credit availability. The central bank has been critical of this consequence and the financial market stabilisation authority is pressurising lenders to rein back on mortgage expansion. If credit becomes tighter, prospects for the housing market will clearly weaken, so both the economy and credit availability have begun to turn against further housing market expansion, though the interest rate environment remains positive.

14.5 Mortgages

Household mortgage debt is almost 120% of GDP, one of the highest ratios in Europe.[78] Not all of it is related to owner occupation, because many private individuals are landlords and borrow to finance their investments. As a result, Switzerland shows that having a high share of renting does not necessarily bring either market stability or lower levels of personal debt any more than when a country has high rates of owner occupation.

76 Swiss Statistics 77 Swiss Statistics 78 Swiss Statistics & Central Bank

Figure 15.1 House price rises changes January 2005 – November 2011



Source: Halifax

15.1 Renewed softening

Hopes that the recovery in 2010 was going to be a sustained one were dashed last year when prices drifted downwards (Figure 15.1). By November 2011, prices were down by -1.5% on an annualised basis. As inflation had been relatively high, the real change was -5.7%. As elsewhere in Europe, the nation's economic and financial problems were depressing the housing market.

The RICS Housing Market Survey in November 2011 reported continuing declines in prices with a net balance of -17. However, the vast majority of surveyors report only modest falls in the 0 to -2% range. New buyer interest showed signs of picking up, the third month in a row. However, instructions to sell were also rising with the balance at +10%. Forward looking indicators suggested a similar pattern of moderately weak prices and slight increases in transactions.

London fared better than the rest of the country in 2011, especially in its more prosperous neighbourhoods. This was partly due to an influx of foreign demand but mainly because of the city's relative economic strength; a greater willingness to lend with higher confidence about market prospects; and purchasers taking advantage of current interest rates. House prices in London were flat in 2011 but in northern England and Wales they were -7% lower, said the Land Registry. The Halifax reported that prices have been quite volatile in Scotland, while in Northern Ireland they have fallen by more than a half since their peak. The RICS 2011 November Housing Market Survey highlighted Yorkshire and Humberside, the West Midlands and Northern Ireland as having particularly weak markets.

An important influence on the housing market and prices is consumer confidence. The revival in 2010 reinforced a belief amongst many that house prices always recover quickly, at least in nominal terms, and continue to trend significantly upwards because of housing shortages. However, in reality, shortages can lead to crowding up and lower housing standards rather than higher prices. That outcome is especially likely in times of economic and financial stress, as exist now.

Moreover, optimism has been reinforced by the nature of market predictions. Most forecasts since the downturn have consistently predicted price recovery within a year to eighteen months of the forecast date with a marked price bounce back after that. In light of such perceived future market dynamics, many hard pressed homeowners have adopted a wait-and-see strategy, believing that prices in the near future will be higher than now. Therefore, the supply of existing homes on the market has been limited. However, attitudes may change and confidence weaken noticeably if progressively more people expect that the current downturn is going to last longer and that there will be no appreciable increase in prices during the subsequent recovery.

Prior to the 2007 financial crisis, the housing market had boomed for over a decade. By the end of the upswing, real prices were 2.2 times higher than they had been a decade earlier and households were left with much higher levels of debt. Then, with the onset of the credit crunch, the UK experienced the most dramatic housing market collapse of the major European economies, due to a sudden shrinkage in mortgage availability and the onset of recession. Prices fell, transactions were dramatically lower, and housebuilding significantly reduced. However, the worst of the crisis was relatively short-lived and there was some degree of recovery in market indicators by 2009. As a result, the country avoided the painful experience of Ireland and Spain; partly because there was no supply overhang.

First-time buyers' deposit requirements now average 20% and many struggle to save for them. However, lower house prices and attractive interest rates made purchase in 2011 the most affordable since 2004. The average earnings to house price ratio had dropped from its Spring 2007 peak of 5.8 to 4.4 by November 2011; though it was still higher than the long run trend.[79] Interest costs have also been falling. October data showed first-time buyers typically had to spend 12% of their income on mortgage interest repayments and, when they moved and reborrowed, existing owners paid out 9%.[80] Even so, the number of loans continues to remain historically low.

During the pre-2007 boom, households borrowed large sums to finance house purchase so that the mortgage to GDP ratio rose to 85% in 2007.[81] Since then, there has been some modest deleveraging with the total household debt to disposable income ratio falling from 183% to 166% in 2010.[82] However, this debt overhang will affect the housing market and mortgage credit availability for some time to come.

Prospects are now highly uncertain. The housing market is likely to continue to soften in face of a slowing economy, reductions in public expenditure, rising unemployment and tight mortgage availability. Monetary policy in this weak economic environment indicates that mortgage interest rates are going to stay low for much longer than was anticipated earlier in 2011, which boosts housing affordability going forward and limits arrears.

Most probably, the housing market will continue to be broadly flat in nominal terms for some time yet and inflation will gradually continue to erode house prices and indebtedness. A sustained upward change will only happen when the economy as a whole shows more signs of growth. In the meantime, the housing market remains a drag on the economy as a whole.

There is also a considerable risk of a greater and more prolonged downturn. This would occur if the economy weakens more than is expected. Of great importance is the availability of mortgage credit. If banks are forced to restrict lending substantially, demand will weaken at a time when more owners may feel the need to sell. The government is constrained in its fiscal options and the bank rate is already low. Therefore, housing market policy instruments are much weaker than in 2007/8.

So, prospects for 2012 do not look promising. Renewed recovery looks some way off and is likely to be only gradual when it arrives.

79 Halifax 80 CML 81 EMF 82 OECD

15.2 Housing system

Almost two-thirds of UK households are homeowners. Yet the past decade has seen some notable changes because the owner occupation rate has started to decline somewhat from an earlier peak of 69% and renting has grown. In part, this is a statistical artefact related to the scale and allocation of vacant dwellings between owning and renting. Nonetheless, the decades of higher homeownership have come to an end, with the stock of homes in the tenure in 2010 falling by 290,000 from the 2005 peak. Whether this is temporary and due to the specific characteristics of the current housing market, or portends major social change, is a matter of some debate.

The tax and cost advantages of home ownership are still strong. Yet, house purchase is certainly both more difficult and less attractive in an era of higher risks, mortgage shortages and falling prices; which suggests predominantly cyclical causes. On the supply side, cyclical effects are similarly apparent. There has been a sharp rise in 'reluctant' landlords amongst previous owner occupiers and, also lower churn with some existing landlords waiting to sell but still renting out their property until the housing market improves. However, continuing housing shortages, high house prices relative to incomes, mortgage rationing, and a greater unequal distribution of income may be indicating something more substantial.

There is no tax relief on mortgage interest for owner occupiers since the gradual abolition of the tax-break during the 1990s. Capital gains are tax-free as is imputed rental income. There is no VAT on new housing, unlike the situation elsewhere in Europe, but expenditure on home improvements and extensions are subject to VAT at the current rate of 20%.

There is a stamp duty tax on transactions above £125,000 which rises in steps up to 5% for properties worth more than £1m. After each threshold, the whole of the purchase price incurs the new higher rate, so the tax creates pricing and transaction anomalies around the thresholds. As part of various housing stimulus measures in recent years, low valued properties have been temporarily exempt from stamp duty. The most recent measure is for first-time buyers wishing to purchase property up to £250,000 to be exempt but this will end in March 2012. Further stamp duty exemptions exist in certain disadvantaged areas.

The majority of dwellings are single-family houses. In England in 2000, 82% of households lived in houses, 16% in self-contained flats and 2% in bed-sits and other non-self-contained accommodation.[83] Today, over 90% of homeowners now live in houses. The housing stock is relatively old in comparison with many other European countries with 41% built before 1945 and only 13% since the mid-1980s.

Private renting

The UK now has probably the most liberalised private renting sector in Europe since the 1989 abolition for new tenancies of previous controls. There is only limited security of tenure for the first six months of a tenancy in the most common types of rental contract and rents are freely negotiable.

There has been a substantial recent increase in private renting with 4.5 million dwellings now in the tenure. According to the calculations of government statisticians, the number of privately rented dwellings in England rose by a substantial 1.5 million in just seven years between 2003 and 2010; a 55% increase.[84] In the most recent three full years between 2007 and 2010 alone, the rental stock rose by over three-quarters of a million. As many as 17% of English dwellings are now believed to be in the private rented sector, this is up from 9% only two decades ago.[85]

Younger and more mobile people in work are the main types of tenants. A quarter of tenants are on lower incomes claiming housing benefit. Once households become less mobile, they traditionally have tended to move into owner occupation when they have saved enough for the down payment or, less commonly, into social housing.

The typical rental property is a terraced house in an outer or inner suburb of a town or city. The property is unlikely to be new, only 13% are post-1985, and almost two-thirds are pre-1945, although most will have been recently modernised. Nowadays, 90% of landlords are private individuals and couples.[86]

Some tenants are attracted to renting by the ease of moving and the low moving costs. Others are more sensitive to the relative costs of owning and renting. House price expectations influence tenure choice. Periods when rising prices are expected encourage households to enter owner occupation and the opposite occurs when prices are expected to stagnate or fall. Demand cycles for owning and renting consequently tend to vary over time. Currently, more people are renting because of expectations of continuing falling prices as well as the greater problems in finding mortgages and raising deposits.

A weak economy continues to press down on rent growth. London apart, rents have failed to keep pace with inflation ever since 2007. London has been stronger but by how much is unclear, with one index reporting modest real increases in 2011 but another index suggesting high ones. It is hard to reconcile the two, but even London is not immune from economic headwinds and is unlikely to sustain persistent large rent rises.

The RICS Residential Lettings Survey October 2011 indicated rent rises were slowing, though high tenant demand still outpaced an increase in properties coming onto the market. Respondents suggest demand was being buoyed by the would-be buyers forced to rent through a lack of access to mortgage finance.

83 CLG 84 CLG 85 CLG 86 CLG

Social housing

Social housing is evenly divided between local authorities and registered social landlords (RSLs), non-profit housing associations and trusts. By the early 1980s, the UK had almost a third of its housing stock in the social sector, one of the highest shares in Europe. Sharply reduced new building rates and sales of existing dwellings have substantially lowered social housing's role since then. Council housing's tenure share has declined by almost two-thirds from its peak level but the growth of RSLs, partly through acquiring ex-council housing, has meant that social housing overall still accounts for 18% of the total housing stock, still one of the higher shares in Europe.

Discounted sales to sitting tenants and others have been substantial. Numbers have been low since the onset of the housing market crisis. However, the Coalition Government aims to revive sales to sitting tenants with much larger discounts announced at the end of 2011.

Social housing is now mainly the home for lower income groups outside, or on the margins of, the labour market and also for recent immigrants, as in several other EU countries. 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.

In a move away from the current haphazard, historic cost, rent setting policies, recent government proposals aim to raise average social rents to 80% of local market levels. However, at the same time, rent supports are being lowered, with levels of housing benefit reduced and eligibility restricted. Social housebuilding funding is also being changed, with a move away from central government direct grants to loan finance underwritten by the new higher rental incomes of providers.

Housing supply

The country has a severe housing supply problem, particularly in the economically strongest parts of the country. By international standards, UK per capita housebuilding rates are very low, reflecting the degree of planning constraint that exists. Between 1996 and 2002, housebuilding actually fell, despite the rapid rise in house prices over the period. There are twin problems of the amount of land on which housebuilding is permitted and the time it takes for developments to be processed through local planning, which can take years.

A reform of the planning system is underway in which greater reliance is to be placed on local initiative, with centrally laid down targets abolished. Central government has reiterated that it wants to see a significant expansion in housing supply and for the planning system to speed up. Extra central government funding to local government, dependent on the number of new local homes built, is being used as an incentive to permit more development.

How in the new planning regime local NIMBY-ism and reduced infrastructure budgets are going to be reconciled with hopes for extra housebuilding remains to be seen. A difficult period of transition is likely over the next few years.

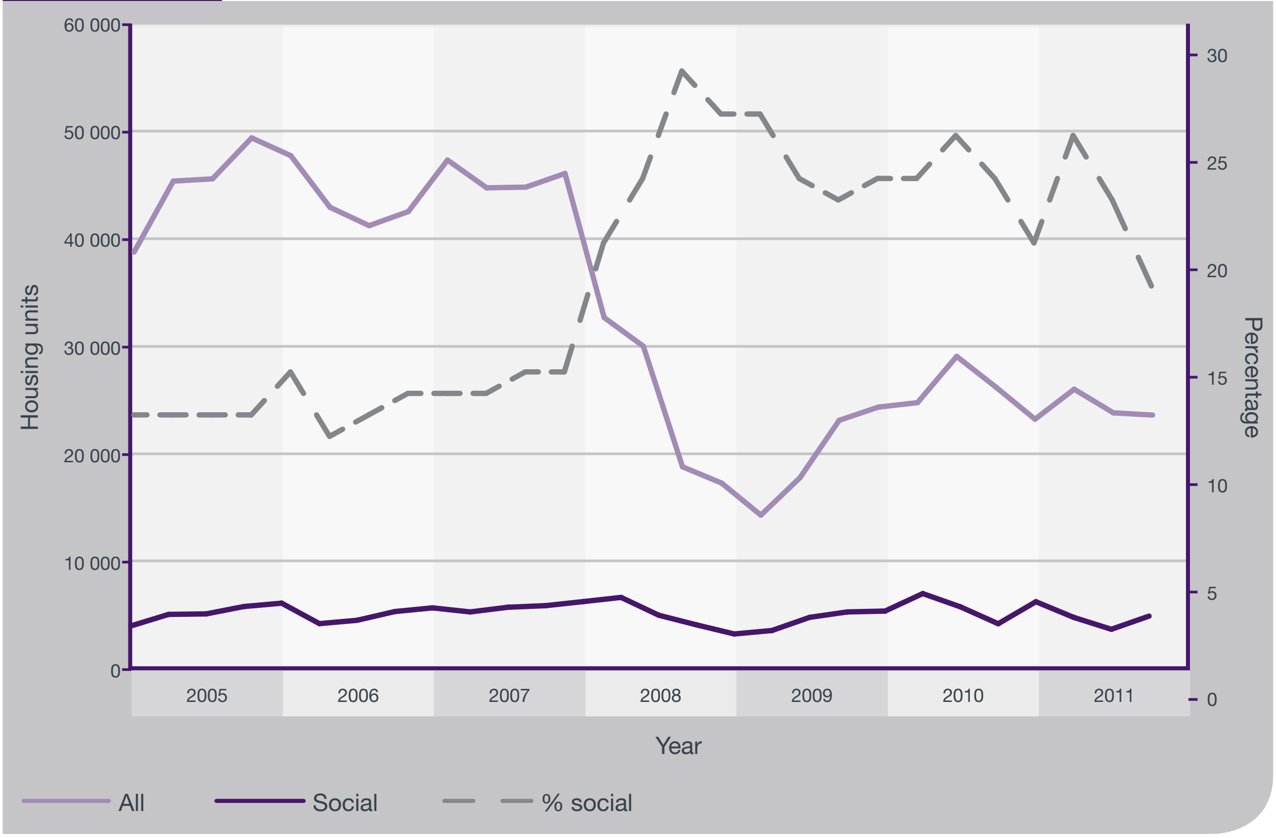
15.3 Market transactions and housebuilding

Transactions fell to only a third of their earlier peak levels by mid-2008. After that they recovered to steady state at around half of their pre-crisis levels. Activity remained somewhat higher in London than in the rest of England and Wales. The renewed market slowdown was apparent in 2011 with monthly transactions -7% down compared to the previous year. Further reductions in sales are to be expected, with a weak market environment. CML has forecast a -3% fall in 2012, but this forecast is subject to great uncertainty.

Housing starts had been running at over 40,000 a quarter prior to the crisis but crashed with its onset. They were then so low that they fell to below 15,000 a quarter at the beginning of 2009. Building sites were mothballed and stocks sold off quickly during that period. Government policies at the time helped to mop up any potential excess supply. With such a rapid cutback, the housing market did not suffer the large overhang of properties that continues to blight the markets of Ireland and Spain.

After the post-Lehman Brothers low point, housebuilding recovered somewhat and housing starts have broadly averaged around 23,000 a quarter since then. This is only marginally more than half the pre-crisis level. Expectations of a marked housebuilding recovery early in 2010 were soon dashed, as the housing market revival petered out.[87] Housing starts fell as market conditions worsened during 2011; by Q3, they were -10% down on the same period the year before (Figure 15.2).

Figure 15.2 **Housing starts and tenure shares in England Q1 2005 to Q3 2011**



Source: CLG

87 Data for England are used as it is more up-to-date but the experience of the other parts of the UK has been similar

What kept housebuilding from falling even further than it did was a relatively steady social housing output. Its share of housebuilding was around 12% prior to the crisis but during the worst of the crisis, as private starts collapsed, social housebuilding rose to over 25% of output and stayed proportionately high for the next three years. However, fiscal retrenchment and reform of the way in which social housebuilding is funded means that far less social housing is going to be built in the near future. Therefore, private sector output is going to have to rise by up to a fifth simply to sustain total housing starts in 2012, which could be hard to achieve.

Both the current Coalition government and the previous Labour government have introduced a variety of programmes aimed at increasing housebuilding. Towards the end of 2011, a further package of stimulus measures was announced. It included a proposed mortgage indemnity guarantee for new housebuilding; finance to encourage abandoned housebuilding sites to come back on stream; and greater sales of public land with payment for it only required after the newly built dwellings are sold. However, it is difficult to isolate the true impact of such programmes on actual building, partly because the scale of each programme has been small relative to the value of total housing output.

15.4 The economy

After two years of recession in 2008/9, recovery was underway in 2010 but petered out in the second half of 2011. The economy is expected to be flat overall in 2012, after some recovery from mid-year. The forecast for 2012 is faster expansion as activity begins to recover again.[88]

However, the situation could deteriorate further if the Eurozone crisis turns for the worse. Yet, as the United Kingdom is not a member of the Eurozone, it should not be as badly affected as member countries themselves.

Inflation rose to over 5% in the second half of the year. In combination with higher taxation, this put the greatest squeeze for decades on real disposable incomes. This obviously contributed to weak housing demand in 2011. However, inflation is expected to halve in 2012 and private consumption rise moderately so the income drag on housing demand will be lessened.

The onset of the recession caused the government deficit to increase rapidly to -11% in 2008 and it has stayed high since then. In response to this situation, the incoming Coalition Government in 2010 intensified an already existing programme of fiscal retrenchment. A programme of higher taxation and cuts in public expenditure was introduced, most of which started to come into effect in 2011. The deficit is coming down but fiscal austerity will continue for a number of years with impacts on the housing market. In addition, a resultant loss of public sector jobs has partly contributed to the rising unemployment, which was 8% of the workforce in 2011 and is expected to rise to 1.75 million in 2012.[89]

88 HM Treasury *Forecasts for the UK Economy: a comparison of independent forecasts*, Nov. 2011 89 HM Treasury

15.5 Mortgages

There has been a considerable reduction in mortgage issuance since 2007. Lending data highlight the scale of the change: net lending in 2007 was £9bn a month but only £0.7bn a month in 2010;[90] while new mortgage approvals were only 42% of their 2007 levels in summer 2011 (Figure 15.3). Though the worst of the funding squeeze was concentrated in 2008/9, lending was pretty much flat in 2010 and 2011.

Figure 15.3 **Number of mortgage approvals January 2007 to August 2011**

Source: Bank of England

Since 2009, net lending for remortgaging has been low and static, because the limited changes in interest rates since then have given borrowers little incentive. Therefore, the pattern of approvals for house purchase over that period closely tracks that of total mortgages (Figure 15.3).

Part of the mortgage decline was caused by less consumer interest in house purchase but mostly by substantially reduced supply. An inability to increase the supply of mortgage funds to meet potential demand has been a significant reason why the housing market has failed to revive substantially. Mortgage rationing through tight lending criteria has outweighed the existence of attractive mortgage interest rates.

The 2007/8 credit crunch dramatically affected the mortgage market because lenders had increasingly come to rely on capital markets for funding. Use was made of residential mortgage backed securities (RMBS) rather than covered bonds, which left lenders highly exposed when the financial crisis erupted. By 2007, the top ten mortgage issuers' use of customer deposit funding sources for net lending was only 55% with most of the rest coming from inter-bank and capital market sources.[91] The securitised financing route had also enabled specialist lenders to build up substantial market shares. As a result, the closure of the RMBS market during the financial crisis badly affected the supply of funds for mortgages. The ensuing mortgage famine precipitated the housing market decline. Though there are now some security issues, capital markets currently still provide insufficient funding for sustained increases in mortgage lending.

90 Bank of England 91 HM Treasury

Lenders' abilities to raise funds from wholesale markets have been damaged by the sovereign debt crisis, with knock-on implications for mortgage costs and availability. If the Eurozone crisis persists, this could constrain mortgage availability and raise costs in 2012.

The financial crisis redrew the map of mortgage providers. Most of the smaller ones that had grabbed significant market shares in the housing boom are now gone. Lending is now concentrated into a handful of major banks, several of which are still partly owned by the Government following bank rescues in 2007 and 2008. The Independent Commission on Banking's report, published in autumn 2011, was concerned about the need to raise the level of competition.

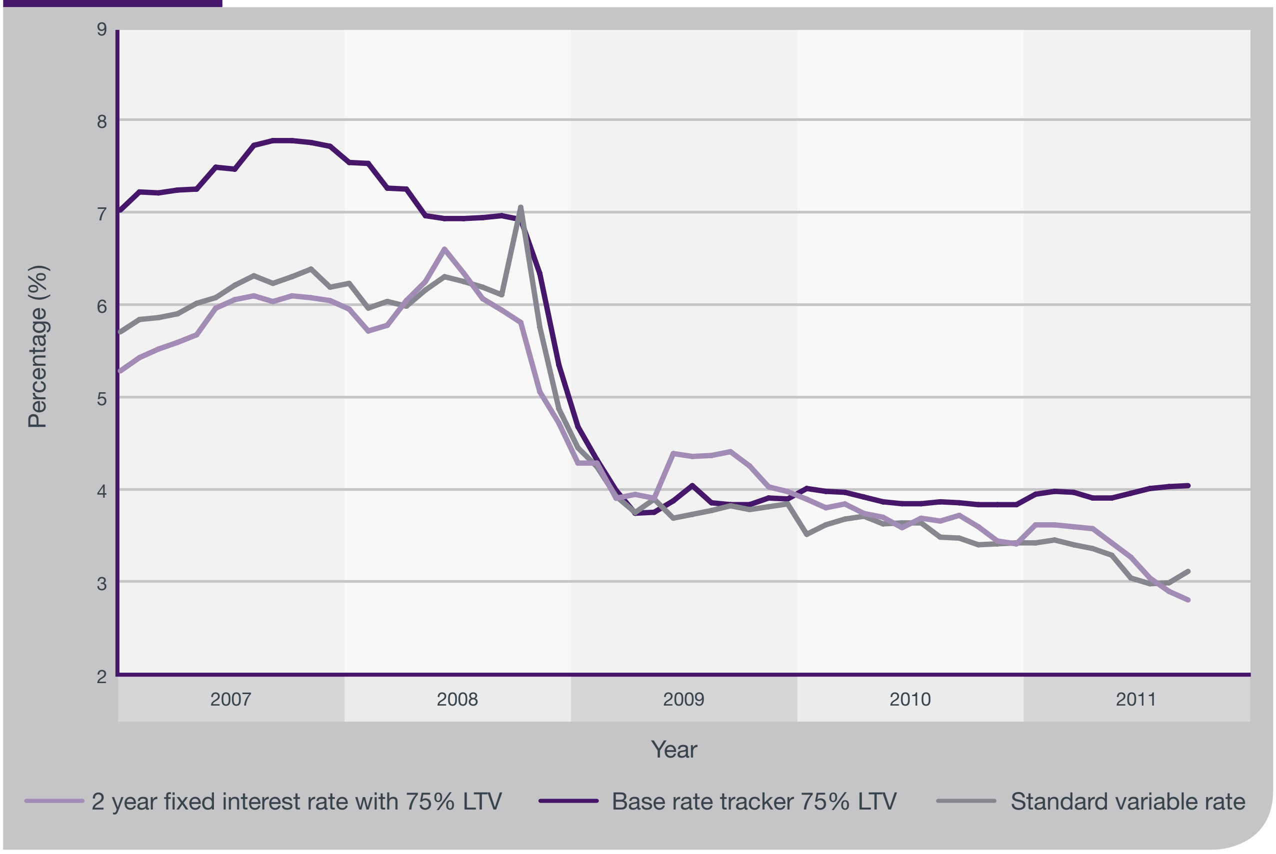
Arrears and defaults are very low. Arrears of more than six months are around 1%. The Council of Mortgage Lenders has forecast a modest rise in 2012 as unemployment increases. In addition, the FSA estimates that 5 to 8% of mortgages are subject to forbearance. It calculates that the six months arrears rate would rise by 0.5% without them.

Mortgages are traditionally of the variable rate type. Under British practice, lenders' standard mortgage terms enable them to alter interest rates at any time with no caps on the rate changes. A wide variety of new mortgage products were introduced during the boom years but then the majority of them were withdrawn as the financial crisis intensified. One of the main constraints has been related to loan-to-value (LTV) ratios, with 75% maxima typically imposed at the height of the crisis. However, higher LTVs became feasible again after 2009, though significant mark-ups were charged in terms of set up fees and interest rates.

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. The switch point encourages remortgaging.

Mortgage interest rates slowly drifted down in the first nine months of 2011 (Figure 15.4). They had been significantly higher and moving up prior to the Lehman Brothers crisis. After that, they fell sharply, which subsequently helped to revive the housing market. More recently, economic concerns and short run house price expectations have tended to outweigh their positive impact. Given the country's high inflation rate, real rates are notably negative but this should lessen as inflation comes down again.

Figure 15.4 **Mortgage interest rates January 2007 to September 2011**



Source: Bank of England

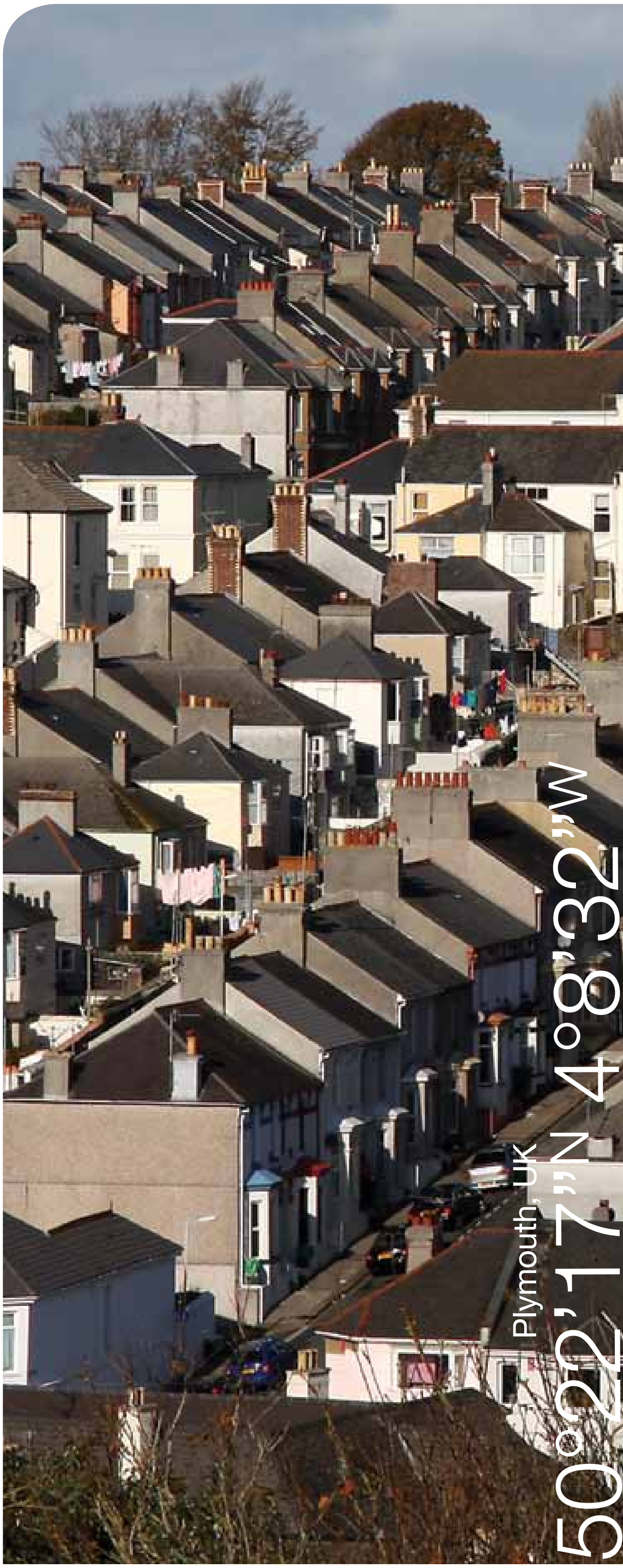
15.6 Demographic influences

Demographic projections for the UK have been sharply revised upwards in recent years. This highlights that pressure on the housing market from demographic factors will continue for a long time to come in contrast to some other EU countries, like Germany and Italy. The population of 61 million is expected to increase by 4.4 million by 2016 and to reach 71 million by 2031, if past trends continue.[92]

Recent government household projections suggest that there will be a further 6.3 million households by 2031 (29% more than in 2006), an annual growth rate of over 252,000. The majority of them will be one person households in older age groups. By 2031, a third of households will be headed by someone aged 65 years or older, up from 26% in 2006.

Along with these increases, the dependency ratio (people aged 65 and above as a percentage of those of working age) will rise from 25% to 38% in 2010. The increase in the share of the elderly is not as fast as in some other European countries but will still have a significant influence on future housing demand. Most of the growth in single person households, for example, will take place amongst those aged 50 or more.

Immigration has risen in recent years. It reached 252,000 in 2010. Emigration had been high but fell with harder economic times and this partly accounted for the rise in net immigration. Immigration puts particular pressure on the areas of greatest housing shortage because migrants move into the most economically dynamic areas, whereas emigrants are more likely to come from across the country. Immigrants have a disproportionate effect on demand in the private rented sector rather than on homeownership, at least in their initial years in the country.



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