The housing market slowdown in Europe.

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Abstract

This paper undertakes a European sight of the slowdown process in housing market, cause, consequences as well as the different reactions in the Euro-zone area and others European countries. It explain the main causes to explain the general downturn focusing on the interest rates environment and also in the capital market crisis, and their relationship with the housing market through the mortgage system. It shows the comparative figures to explain main differences among European housing market's cycles.

Key Words: housing, prices, edification, *credit crunch*, mortgage market, Europe .
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Markets slow and falter

2007 was the year that the great decade-long European house price boom ended. The year started so strongly on a wave of optimism but ended bleakly in virtually every country. That downturn continued into 2008 and looks likely to worsen.

A finger of blame has to be pointed at the worldwide credit crunch that started in summer 2007 in the aftermath of the US sub-prime mortgage crisis. However, the most important initial factors in the European slowdown were probably the more prosaic ones of increases in mortgage interest rates, which had been on a rising trend since the end of 2005, and weakening affordability. As a consequence of them, too many European purchasers could no longer afford to buy by mid-2007 and a downswing was virtually inevitable with or without the credit crunch. Unfortunately, the problem is that the impact of the credit crunch on lenders' capital reserves and sentiment towards housing markets means that what may well have been a moderate slowdown is now far worse.

Furthermore, once markets start to weaken, negative price expectations begin to come to the fore, with buyers deferring purchases in the expectation that prices would be lower in the future. Housing markets either freeze as a result or prices start to slide. They have already done that in a number of European countries, notably Denmark, and Ireland, the UK and the Baltic States but, as will be argued here, the house price slide is likely to spread throughout most of Europe and be prolonged.

On the supply side, the switch has been equally dramatic. For years, housebuilders bolstered by cheap credit had in many countries been rapidly expanding their output and buying up land in the expectation of continuing boom times. Having seemingly forgotten how quickly market conditions could reverse, they suddenly found the situation sharply changed. Since the onset of the credit crunch, rising inventories and financing problems have become common building industry themes.

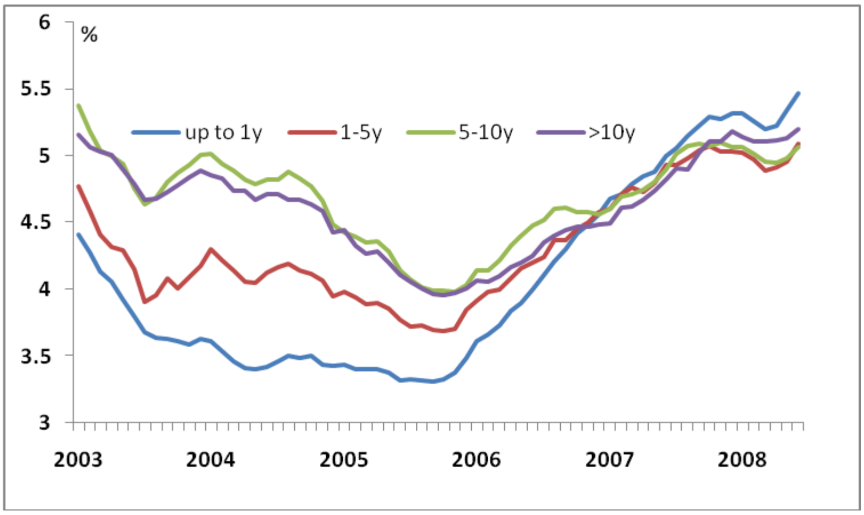
Even at heavy discounts, new homes sales are hard to clinch and it has been difficult to cut back production as rapidly as the fall off in demand, leading to growing inventories. Existing home owners when they put their homes on the market find fewer takers but are slow to reassess asking prices and set them at the new, lower realistic values.

Rising interest rates

Mortgage interest rates have been rising for three reasons. The first is a growing threat of inflation, which has encouraged central banks to push up their rates in attempts to tackle it by slowing growth and capital markets to adjust nominal returns upwards as well. The second is that the credit crunch itself has limited the supply of finance and raised its cost in consequence. The third reason is that mortgage spreads have widened, partly because of the credit crunch but also because of fears that mortgage lending has become more risky as housing markets slow and the threat of default in them rises.

The change in the interest rate picture has been dramatic over the past two years. European Central Bank Euro zone reference data on typical mortgage costs by the degree of fixity of their interest rate are shown in Figure 1 on a monthly basis from 2003 to mid-year 2008. The last years of the boom were driven by plentiful credit, which in some countries, like Ireland and Spain, was being offered at negative real interest rates. The subsequent hike in variable interest rates from the trough of the interest rate cycle in the autumn of 2005 to the middle of 2008 was a substantial 218 basis points rise. That added two-thirds to the monthly interest charges of a typical mortgage of that type.

Figure 1: Typical mortgage borrowing costs in the Euro zone Jan 2003- June 2008



What is interesting about the pattern of interest rates was that the spread between mortgages with different time periods of the fixity of their interest rates has altered substantially (Figure 1). During the final years of the boom, variable interest rate product costs fell the most; while in the subsequent period of rising interest rates spreads narrowed and then, after the onset of the credit crunch, the term-structure even reversed with variable rate products becoming the most expensive. In part, this reflects changes in interest rate expectations in money and capital markets but also the institutional framework of European mortgage lending.

Countries perceived to be most at risk of significant house price declines, such as Spain and Ireland – and the UK outside of the Euro zone, are those with much higher shares of variable interest rate mortgage finance. They have been particularly hit by the drying up of mortgage-backed securities (MBS) markets because previously many of these mortgages were repackaged and sold on. Nonetheless, in countries with a more long-term mortgage finance orientation, the typical product sold in recent years had a maximum 5 years fixation, so, as can be seen in Figure 1, the pattern of increase in mortgage costs has not been that different from variable-rate dominated Euro zone markets. However, 1-5 year fixed rate products have not suffered the same increase in cost as variable ones over the past year, reflecting the greater acceptability in capital markets of traditional mortgage bond financing over the more recent and risky securitised instruments where the market has effectively dried up.

Mortgage lenders in the UK had been by far the most active issuers of residential mortgage-backed securities (RMBS), with almost half of the European issuance, followed by those in Spain, the Netherlands and Italy (Table 1). Spain has also been a major issuer of more traditional covered bonds, where lenders have more guarantees from issuers than for RMBS. It was the second ranked country in outstanding volume to Denmark, followed by Germany and the Netherlands.

Table 1: Europe's residential mortgage-backed security and covered bond markets

€ billion, outstanding amounts 2008 q1

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

RMBS = Residential mortgage-backed securities
Source: Crosby, *Mortgage finance interim analysis*, HM Treasury, London, 2008.

Overall, five European countries have significant direct integration of their mortgage markets with international capital markets. Ranked in terms of the value of the oustanding debt, they are Spain, the UK, Denmark, Germany and the Netherlands. Other countries also have important indirect linkages through debt issuance by financial institutions and government, which ends up funding house purchases. The level of exposure of individual countries' mortgage systems to capital markets also depends on the role of such instruments as sources of funds at the margin, so the reach of capital market effects is greater than that measured in total outstanding volumes alone.

Back to an era of tighter credit rationing

One of the drivers of the long upswing in most of Europe's housing markets was greatly relaxed credit conditions as well as an era of low interest rates. Higher multiples of income and more generous loan-to-value ratios were on offer; while proof of details of income and ability-to-repay became far more relaxed. Initial periods of discount were commonplace; plus repayment of interest only mortgages became mainstream, as did the potential to borrow in foreign currencies or to purchase foreign properties.

This new world of possibilities worked fine for lenders when they could pass the implications onto others, via capital markets. But with the credit crunch, such an easy option dried up and institutions themselves found it difficult to raise capital or refloat previously issued securities as they become due. One major UK mortgage lender, Northern Rock, folded as a result.

Less spectacular events have occurred in the Euro zone, although this may in some cases be because of the greater concern shown by the ECB to keep mortgage and other institutions afloat and still offering mortgages than has been the case in the UK. The fact that the value of the issuance of new mortgages for house purchase fell by an incredible 71% between June, 2007 and June, 2008 in the UK, while only by 25% in Ireland[1] between 2007q1 and 2008q1, may have had something to do with variations in the stance of the respective monetary authorities as well as any market factors.

Whatever such short-term policy differences, a long-term effect of the credit crunch is likely to be stricter lending criteria. This will particularly be felt in those countries which experienced major relaxations of credit conditions, including most of Central and Eastern Europe, but it will probably affect most others as well.

Supply-side issues

How a downturn pans out depends on supply side issues as well as demand ones. What is more, European housing supply responses have been highly varied in recent years. The overall picture is of a supply-side that exacerbates price volatility and gluts of specific types of property when a boom ends.

Some implications can be seen by examining performance in the nine countries shown in Table 2, where they are ranked according to the size of the real house price rises they experienced from

1) Council of Mortgage Lenders and Irish Central Bank data.

1996 to 2006. The other columns in the Table measure the percentage change in housing output for the same period, and also for two sub-periods from 1996-2000 and 2001-2006, in order to explore the dynamics of supply responses.

The two countries listed in the table that were most radically different in terms of their market performance over the past decade were Ireland, which saw the greatest increase in house prices, and Germany, where prices actually fell. (Austria and Switzerland's housing markets were also out of synchronisation with the rest of Europe's, and CEE countries joined the boom late).

The range of real price changes over the eleven years for the other seven countries listed in Table 2 is relatively narrow, lying between 85 and 118%. (In fact, even these differences might be less if price indices were actually measured in the same way across all of these countries). By contrast, even when excluding Ireland and Germany, the range of housebuilding change goes from minus 19% in the Netherlands to plus 187% in Spain. Moreover, there is little correlation between the extent of price changes and the amount of extra building.

Table 2: The responsiveness of housing supply to house price rises

Country*	***% change real house prices 1996-2006***	***% change house-building 1996-2006***	***% change house-building 1996-2000***	***% change house-building 2001-2006***	***New dwellings per 1000 inhabi-tants 2004***
Ireland	188	177	48	78	19
UK	118	12	-6	21	3
Sweden	107	128	-1	94	3
Spain	102	187	29	101	13
France	99	58	16	37	6
Denmark	96	131	14	78	5
Nether-lands	88	-19	-21	-1	4
Finland	85	63	57	11	6
Germany	-14	-55	-24	-24	3

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

Source: M. Ball *European Housing Review 2008*, RICS, London and sources cited there.

So, the broad answer to the question of how supply reacted to a major, long-lasting price stimulus in Europe is with great unevenness: a response far more varied than for price changes. Spain, Ireland, Sweden and Denmark seem to have had the best supply responses over the period, though obviously not enough to limit price growth within them. The Netherlands and the UK fared worst, with output in the Netherlands actually falling by almost a fifth whilst house prices almost doubled.

Furthermore, housebuilding levels have to be examined as well as rates of change. The reason why Sweden's housebuilding growth rate looks so good in percentage terms is that it started from such a low level in the mid-1990s. By the end of the boom, its housebuilding rate in relation to its population was still relatively low.

In fact, many European countries' population-weighted housebuilding rates towards the end of the housing boom were quite low by international standards. Only 3 countries had higher building rates than the USA; in 17 others the rates were at least a quarter less and in 9 at least a half less than the USA's.

Three important points come from this supply analysis. The first is that across Europe, with a few exceptions, much of the impact of any demand shock on the upside or downside is going to be observed fairly immediately in terms of prices because relatively few houses are being built. The second is that, even in countries where supply eventually picks up, there is a long prior period when it does not. That helps to embed consumer expectations of continuously of rising prices, which may then fuel further price escalation. The third issue is that regulatory regimes of Europe, once they eventually become focused on additional housebuilding, encourage gluts of specific dwelling types and add to builders' optimism about future sales, thereby exacerbating supply overhangs when markets turn down. It is ironical that both the Netherlands and the UK have gluts of small, high density flats at present, despite their low overall supply-side responsiveness. Even high building countries, like Spain and Ireland, have a surfeit of moderate quality, far flung dormitory accommodation that was never especially popular even in the boom years.

Macroeconomic factors

Past housing market cycles have tended not to coincide that closely across Europe. In particular, in the downturn of the early 1990s, the UK market entered a downturn almost two years prior to that of several major continental countries. To an extent a similar pattern of some countries' markets slowing down earlier is also occurring now.

Comments that suggest that some European markets are going to miss significant downturns may be ignoring such cyclical timing effects. Even where the credit crunch has not had much direct impact, the interlinked nature of the European economy and its interdependence with the rest of the world will eventually affect virtually all housing markets.

The two greatest pressures are a general economic slowdown and strong inflationary pressures. General economic slowdowns are obviously bad for housing markets as they depress employment, earnings and consumer confidence.

The recent commodities boom has helped to push up inflation significantly with euro area inflation up to 4% in July, 2008 and well into double digits in the Baltic States and Bulgaria. Only the rapid slowdown in the Euro zone economy has kept the ECB from raising interest rates, but there are still risks of further interest rises and reactions in the capital markets that fund fixed-interest mortgages. Therefore, the near future of interest rate levels does not look bright for Europe's housing markets.

A paradox of current rising inflation is that increases in nominal mortgage rates have often yet to be reflected in rises in real interest rates. Many European countries have built in inflation adjustments to wages and rents, so that is helping to keep up the affordability of house purchase and limit defaults. As inflation comes down again, the real burden of mortgage costs may well rise, at least for a while.

The prospects for the world economy as whole are that a full-blown recession may be avoided.

The chances of one occurring in Europe are greater, according to current economic forecasts. Such a downturn, when combined with the interest rate environment, would push yet more of Europe's housing markets into periods of falling prices that are likely to last for several years, until greater optimism, spending power and credit availability return.

Conclusions

Two years ago few would have believed that an obscure part of the US mortgage market and a world commodity price boom could together bring Europe's buoyant housing markets to their knees. 'Soft landings' were all the vogue. Once again, the unexpected has traduced housing forecasting expertise. Some markets may still escape prolonged downturns and falling prices, but the chances seem to be weakening by the day.