REAL ESTATE MARKET AND SLOWDOWN INTERACTION IN COUNTRIES WITH TRANSITION ECONOMY

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Abstract

Euro zone countries with transition economy are more and more exposed to the processes of economic globalization. Their development and growth perspectives are valued in relationship with global financial slowdown aspects as well as in relation to business enterprise's and household's economical expectations. Rapid growth of international capital markets, investment flows and opportune credit policy among new open economy countries activated real estate market boom. Economic crises are often related to real estate market busts. Countries, wishing to reduce recession or prevent financial crisis, have to monitor and supervise the real estate market. Purpose of the article is to investigate the real estate market and slowdown interaction in countries with transition economy. Main conclusion is, that slowdown of accumulation in real estate market and slowed down growth in construction sector leads to real estate market recession as well as to economic slowdown.

Keywords: Real Estate Market, Growth, Real Estate Market Crisis.

Introduction

Euro zone countries with transition economy are more and more exposed to the processes of economic globalization. Their development and growth perspectives are valued in relationship with global financial slowdown aspects as well as in relation to business enterprise's and household's economical expectations. Many scholars have related changes of macroeconomic variables, such as GDP, unemployment, average monthly earnings, interest rate, inflation rate, international money flows to real estate market busts and booms in their research works and have concluded that the outcomes of real estate market processes depend on the role of real estate in an economic region. It follows that in order to foresee the tendencies and business cycles in the country's economy it is necessary to clearly define the trends of real estate market growth and slowdown.

Rapid growth of international capital, investment flows and opportune credit policy among open economy countries activated real estate market and it started demonstrating trends of growth. The role of banks is very important as they are main finance inter-mediators as well as the risk channel to the financial system of the country. Economic crises are often related to real estate market busts, there for to reduce recession or prevent financial crisis, real estate market must be monitored and supervised. However, the characteristics of the Lithuania's business structure focusing on the model of development have never been analyzed.

The phenomenon of real estate market growth and recession attracted the attention of different scholars and it is agreed that more research is needed for the dynamic changes in the market and their impact on the whole economy.

Novelty of the paper – the answer to the question what peculiarities of real estate market and slowdown may effect the economy new open economy countries.

Scientific problem The lack of a common opinion in the economic literature what threats or opportunities to the whole economy may cause real estate market and slowdown interaction.

Purpose of the paper is to investigate real estate market and slowdown interaction in countries with transition economy.

Object of the paper is the real estate market in Lithuania.

Tasks raised in the article:

1. To present a theoretical view in process of growth and crisis in real estate market.
2. To analyze related macro-economic data in Lithuania.

Research methods are logical and systemic analysis of research literature based on the comparative and generalization methods as well as statistical methods.

Features of real estate market growth and crisis

Euro zone countries with transition economy are joining the processes of economic globalization more and more. Their economy development and perspectives are valued in relationship with global financial

development aspects as well as business enterprise's and household's economical expectations. Many scholars have related changes of macroeconomic variables, such as GDP, unemployment, average monthly earnings, interest rate, inflation rate, international money flows to real estate market busts and booms in their research works and have concluded that the outcomes of real estate market processes depend on the role of real estate in an economic region (e.g. Green, 1997; Tsatsaronis & Zhu 2004; Otrok & Terrones, 2005; Edelstein & Tsang, 2007; Snieska et al, 2007). It follows that in order to foresee the tendencies and business cycles in the country's economy it is necessary to clearly define the trends of real estate market growth and recession. The globalization and Lithuanian's integration into the world market, as any other new phenomena, increases the risk for the companies going into business (Startiene & Remeikiene, 2007).

Processes of real estate market growth and crisis compose assumptions of real estate market dynamic changes so called a real estate cycle. Boom and bust of real estate prices are named as the real estate cycle (Herring & Wachter, 1999). Such cycle model is developed to link the interaction among real estate and macroeconomic factors. Different industries do react differently to cyclical changes. Some of the most cyclically sensitive industries, such as construction, are predominantly small businesses (Navickas et al, 2006). The real estate price is the key factor for analyzing the real estate cyclical behavior. However variant variables of macroeconomic factors are met in scientific literature, but most of scientist's empirical analyses give evidence that economic fundamentals influence real estate price fluctuations (e.g. Muellbauer & Murphy 1997; Edelstein & Tsang, 2007).

Figure 1 demonstrates how real estate cycle may affect country's economic activities, such as construction sector, finance sector as well as household's behavior. Real estate (RE) growth and recession chain presents the real estate price fluctuation suggestions as well.
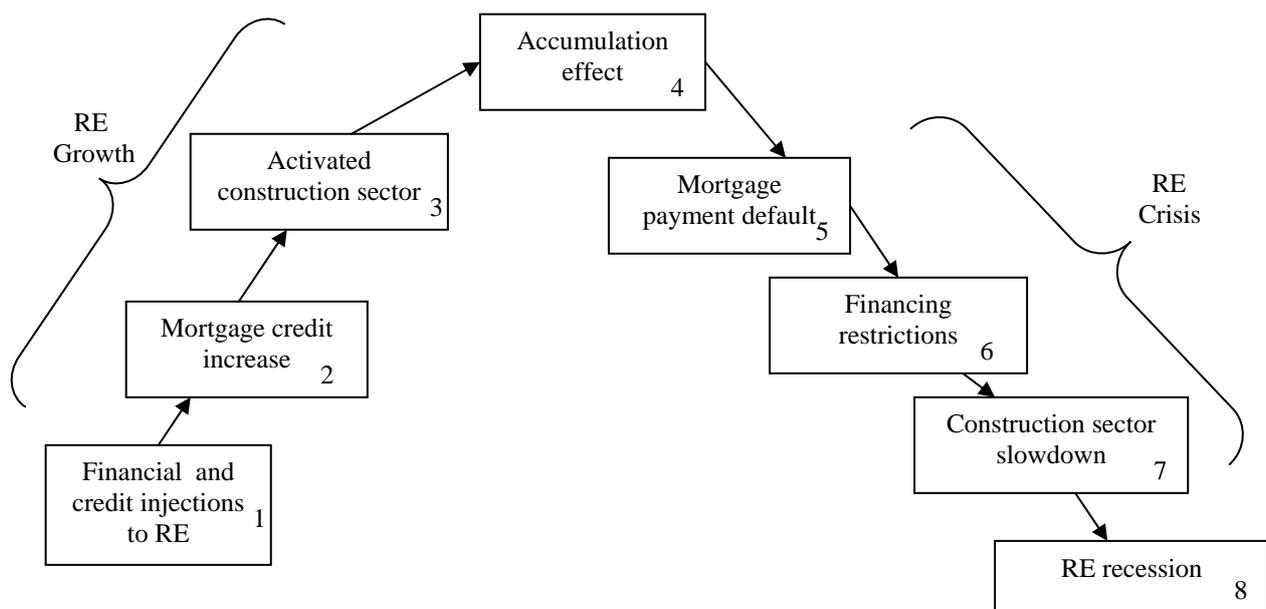

Figure 1. Real estate growth and recession chain

Chains from 1 to 4 demonstrate trends of real estate price growth, and chains from 5 to 8 indicate real estate price settling and downfall.

In early stages of development of countries with transition economy real estate market participant's activeness, due to legal and financial restrictions was as intense as was allowed by accumulated household's personal savings. Therefore supply exceeded demand level in the market and the real estate price was at its lowest level. Rapid growth of international capital, investment flows and opportune credit policy among open economy countries activated real estate market and it started demonstrating trends of growth (1). As the greatest money demand is in the period of economic growth (Snieska & Venclauskiene, 2008), people want to improve their living conditions and seek to get credits (*see* Relationship between 1 &2). The role of banks is very important as they are main finance inter-mediators as well as the risk channel to the financial system of the country. The feed-through from house prices to private consumption occurs either via saving responses to households' perceived wealth or via collateral effects on household borrowing (Catte et al.,

2004). Banking sector acts as a 'financial accelerator' to accelerate the boom and bust of asset bubble (Herring & Wachter, 1999). Low interest rate is an instrument in banking hands to increase the number of mortgage credit. Low real interest rates and global business cycles are named as important determinants of house price cycles as well (Otrok & Terrones, 2005).

Demographic changes, emigrant needs to invest into property in motherland also promoted increase of real estate demand as well as real estate price level. Some researchers were exploring the impact of demographic trends on the demand for housing (Poterba, 1991; Cerny et al., 2005; Krainer 2005). These factors stirred other real market participants such as construction companies and encouraged them to develop real estate and to accelerate constructional work (*see* Relationship between 2 & 3). Statistical results indicate that employment growth and unexpected employment growth have a stronger impact on residential housing markets than state income growth and national changes in construction costs (Edelstein & Tsang, 2007). The same authors find that interest rates positively related to housing supply and supply 'anomaly' may be explained, in part, by the rapid structural changes of mortgage and construction finance. "The evolving market brought about by globalization, world economy restructuring, rapid changes in project procurement and implementation process, and the pervasive utilization of information and communication technologies (ICT) has brought a new era in the construction industry. C&S firms are free to compete internationally to get project from various resources. Thus C&S companies should seriously think about how to succeed in business by emphasizing the quality and supervision of the projects." (Jaafar et al., 2008)

Relationship between mortgage credit numbers increase and activated construction sector objects is related with an increase of employment level in construction sector, descending countries general unemployment level, increasing real estate production share in GDP. In scientific literature may be found conclusions that residential investment "causes", but is not caused by, GDP, and nonresidential investment does not "cause", but is caused by, GDP (Green, 1997). Economic growth implies increase in an economic variable, which is normally persistent over successive periods (Black, 1997). When people start accumulating real estate, this accumulation describes the growth of assets. It is competition in the market that drives capitalists to accumulate, that is to invest part of their profits to expand the existing capital, labour force and production (Edvinsson, 2005). Real estate accumulation involves either accumulating cash (e.g. broking real estate, selling and getting broking fee) or building equity and wealth (e.g. buying property, waiting for the certain period of time and selling at higher price; buying property, developing estate and managing it for rent or selling). Relationship between 4 & 5 demonstrates that increase in consumption and optimistic expectations of market participants let them lessen their saving habits. Economic slowdown might cause panic among consumers giving uncertainty about future events and concern about keeping working contracts as well as repaying credits. Any changes in real estate sector would have impact on the asset quality and profitability of the banking sector. As they are closely related to each other, the increase or decrease in the price of asset would influence the stability and efficiency of financial system (Ching Ngai, 2006). Sharp downward corrections in housing markets can impact the banking sector, which in turn may adversely affect public finances and macroeconomic stability at large (Girouard & Price, 2004). Banking restrictions in giving mortgages are imposed enlarging interest rates and other lending conditions. Households even willing to take mortgage credit are enabled to do so and wait for real estate price decrease. Descending number of mortgage credits could lead to receding expansion of construction sector. The result of receding expansion of construction sector is unemployment as well as decrease of average wage in construction sector, slowdown of the growth of construction sector (Snieska & Venclauskiene, 2008). Relationship between 7 & 8 demonstrates that slowdown in construction sector leads to real estate market recession. Economic crises are often related to real estate market busts. Economic crisis entails a breakdown or interruption of some of the operating principles of the economic system for a certain period and as the basic operating principle of capitalism is steady accumulation and growth, not only outright fall in production, but also stagnation and slowed down growth over a certain time period, can be considered as a crisis situation for the system (Edvinsson, 2005). Therefore to reduce recession or prevent financial crisis, real estate market must be monitored and supervised.

Impact of real estate market cyclical behavior on countries whole economies

Lithuania is taken as an example of transition country due to its unique historical and financial situation. The data used for the research is taken from the Department of Statistic under the Government of the Republic of Lithuania, except data for number of mortgage credits, which is taken from the Bank of Lithuania database. The data is taken from 2000 to 2008 year, because earlier data, e.g. number of mortgage

credits, is not declared in database. The real estate price research is limited to residential property, as number of persons borrowing mortgage money is bigger comparing to the number of other investors to real estate. For the analysis the two room's apartment's average price of 1 sq. m. in the second biggest town of Lithuania Kaunas was taken. because the living fund in Lithuania consists of mostly two rooms apartments (39% of all the stock of apartments), three rooms share is accordingly 29,3%, one rooms – 14,2%, four – 10,1%, five and more rooms – 7,4%. The data is taken from one of the biggest and the most popular advertisement journal in Lithuania "NORIU" and reflects a 1 sq. m. supply price which might not coincide with the contract price (Snieska & Venclauskiene, 2008).
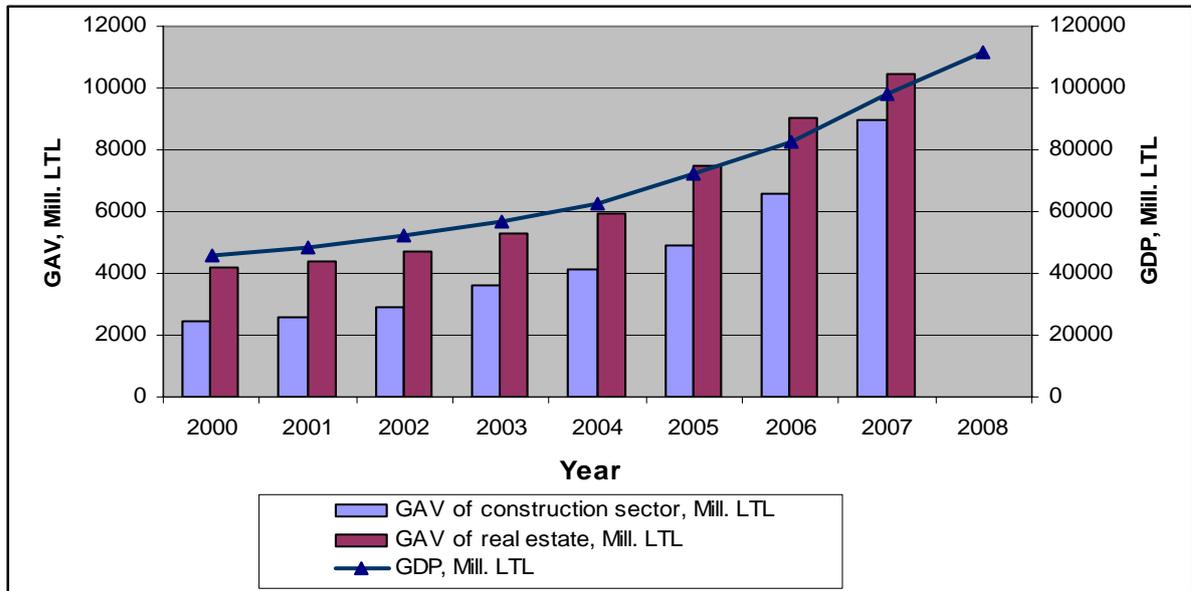

Figure 2. Relationship between GAV and GDP in Lithuania, 2000-2008

Figure 2 represents relationship between gross domestic product (GDP) of the country and gross average value (GAV) of construction and real estate. Both real estate and construction sectors kept growth tendencies during this period. Gross average value for the construction sector in 2000 year was 2 439,021 Mill. LTL, for year 2008 data is not declared yet, but for comparison, in 2007 increased to 8 992,264 Mill. LTL; real estate in 2000 year was 4 182,426 Mill. LTL, in 2007 year was 10 483,431 Mill. LTL.
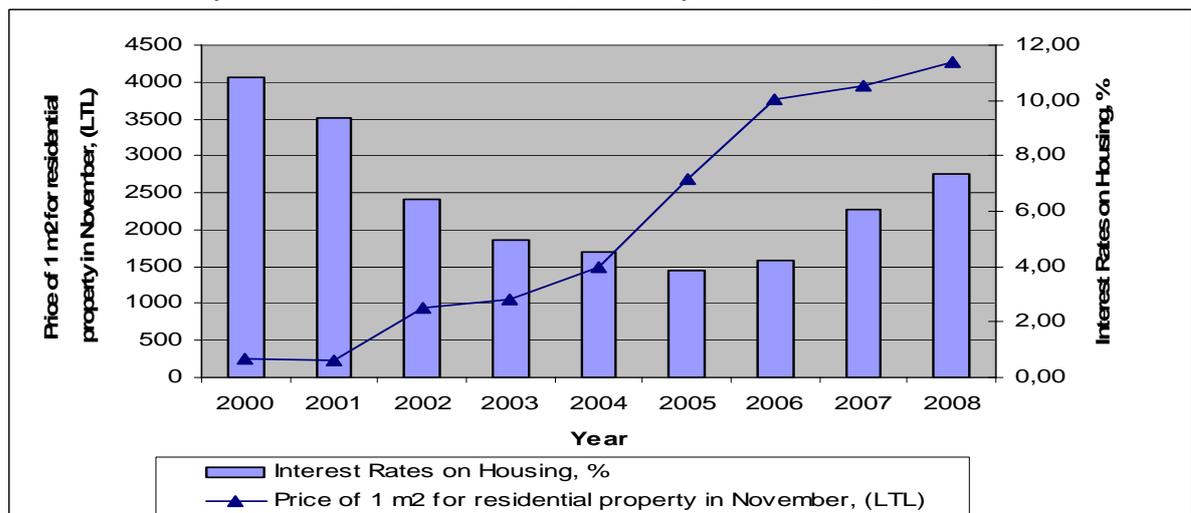

Figure 3. Relationship between interest rates on housing and real estate prices in Lithuania, 2000-2008

Partly such growth of real estate market can be explained by the increase of foreign investments (Figure 4) and favourable banking conditions. One of real estate market growth determinants - employment in construction sector in 2000 year was 83,1 thousand people and in 2008 was 169,2 thousand people.

As banking sector composed favourable conditions to take mortgages by lowering interest rate, the real estate market was visibly activated (Figure 3). Highest interest rate was in 2000 and real estate 1 sq. m. price was at it's lowest level. The highest price jump was in 2004, after Lithuania has joined the European Union. Possibly optimistic expectations, emigrant savings investments into real estate in motherland enhanced the demand of real estate what forced the real estate prices increase fast. Bust of real estate price was slow downed by the increase of interest rate for housing in 2006 year (Figure 3), which lowered the number of taken and given mortgages in 2007 and significantly in 2008 year (Figure 5).

The lag of 2 years between increase of interest rate and number of taken credits on housing can be explained by inertia of changes in attitude of people towards economic issues, and qualitative aspects of banking policy – more barriers for acquiring mortgages in terms of stricter requirements for the income and perspectives of the applicant.
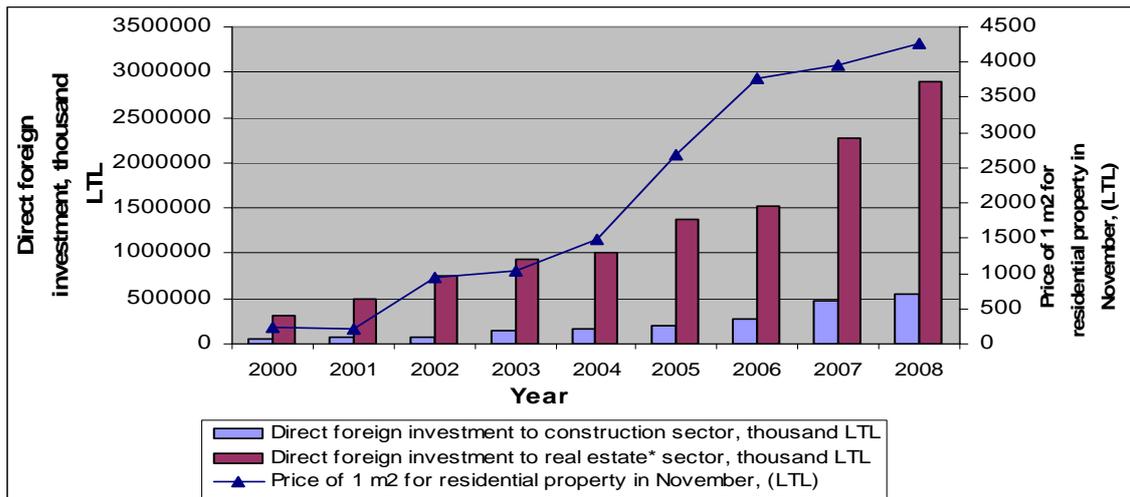

Figure 4. Relationship between direct foreign investment and real estate prices in Lithuania, 2000-2008
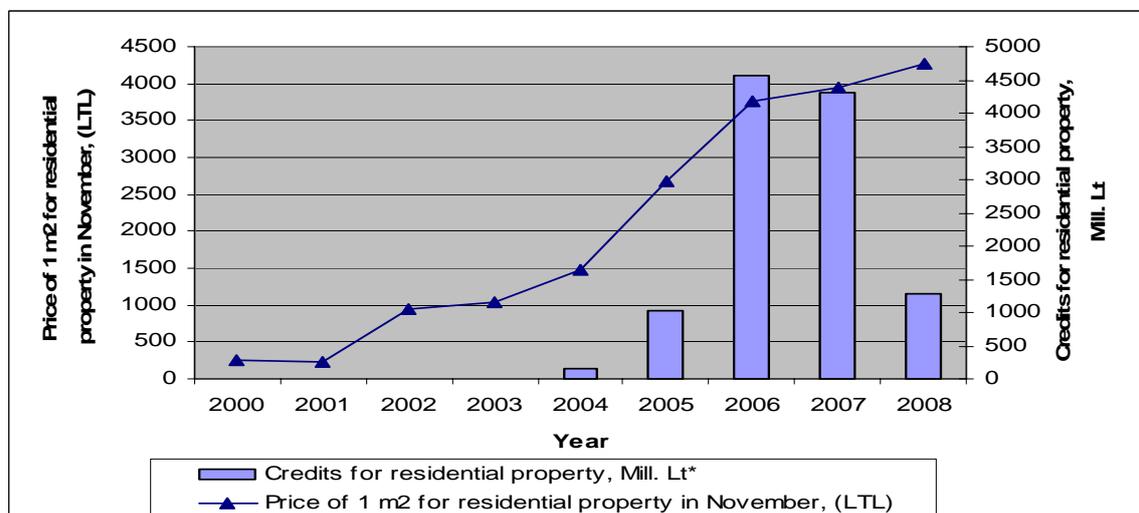

Figure 5. Relationship between the volume of credits for residential property and real estate prices in Lithuania, 2000-2006

Despite the growth of GDP in 2007 and 2008 year (Figure 2), banking policy predetermined the contraction of the constructor sector and the sequel of events should be decrease of employment in construction sector, the reduce of average monthly earnings, as demand for real estate slow downs.

After the performance of comparative analysis of scientific literature and of the real estate growth and recession chain (Figure 1), and analysis of macroeconomic data, we may conclude, that the real estate market and the economic slowdown are closely related. Any economic shock may evoke economic slowdown or financial crisis. Therefore slowdown of accumulation in real estate market and slowed down growth in construction sector leads to real estate market recession as well as to economic slowdown.

Conclusions

1. The living fund in Lithuania consists of mostly two rooms apartments (39% of all the stock of apartments), three rooms share is accordingly 29,3%, one rooms – 14,2%, four – 10,1%, five and more rooms – 7,4%.
2. The lag of 2 years between the increase of interest rate and number of taken credits on housing can be explained by inertia of changes in attitude of people towards economic issues, and qualitative aspects of banking policy – more barriers for acquiring mortgages in terms of stricter requirements for the income and perspectives of the applicant.
3. Real estate accumulation involves either accumulating cash (e.g. broking real estate, selling and getting broking fee) or building equity and wealth (e.g. buying property, waiting for the certain period of time and selling at higher price; buying property, developing estate and managing it for rent or selling).
4. Slowdown of accumulation in real estate market and slowed down growth in construction sector leads to real estate market recession as well as to economic slowdown.
5. Partly the growth of real estate market in Lithuania in 2002 – 2008 may be explained by the increase of foreign direct investments in the real estate and favorable banking conditions, which were created in this period.

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