

# THE MOST SIGNIFICANT FACTORS THAT WILL AFFECT THE DEMAND FOR REAL ESTATE MARKET OBJECTS IN LATVIA IN THE NEAREST FUTURE

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**Abstract.** *This paper describes the factors that influence and will influence in the future the demand for dwelling space in Latvia. The real estate market and its various segments develop cyclically. The length and deepness of these cycles is influenced by factors like the country's economic situation, employment, income level, commerce bank crediting, country's demographic situation and its development, as well as other factors. This paper outlines the possible link between these factors and the dwelling space market. Qualitative and focused identification and determination of these connections gives an opportunity to forecast the possible directions of development in this sector and can help inhabitants, real estate developers and the government in decision making.*

**Keywords:** *real estate market, real estate economics, real estate market forecast, real estate market cyclical structure.*

## Introduction

The real estate market in Latvia has developed very rapidly already since the end of nineties. During this time real estate market has gone through different scenarios of development including rapid price growth, rapid price drop, development of new real estate objects and increasing activity of commercial banks, and other activities. In the last decade the real estate market in Latvia has gone through a full cycle of real estate market development starting from growth phase, then reaching the peak, followed by recession phase which led to the lowest point and then returned to the growth phase again. The cyclical development of the real estate market, the length and depth of these cycles depend on the actual environment in which the real estate market operates. This environment determines the market price as it influences where the demand and supply equilibrium is located.

The real estate market is a significant sector of the national economy. Real estate objects are used daily by all inhabitants, thus the latest developments in the real estate market affect the society as a whole, as well as the economic situation and business environment in the country. In year 2010 real estate transactions constituted to 18.9 % of GDP, which only partly shows the significance of this sector.<sup>1</sup>

This paper examines the market of dwelling space or dwellings in Riga. Although, the dwellings market also could be further divided into segments like flats in apartment houses, private houses, and terraced houses, for the purpose of data analysis authors have chosen only block apartment market in Riga. However, the market price and development trends are similar in all the segments.

Authors describe the possible effect on the dwellings market of various factors including income level, employment, crediting, demographic situation and the government policy.

The aim of this paper is to draw attention to the factors that influence the real estate market dwellings sector, and to the fact that understanding these influences could facilitate a qualitative and sustainable development of the dwellings market, and be useful in decision making both in private investing, and at the state level, as well as could increase the understanding of the Latvia's real estate market among stakeholders.

This paper is a scientific report of the studies which were performed during doctoral thesis about the factors that are influencing the real estate market in Latvia.

<sup>1</sup> Latvia Central Statistics board [interactive]. Riga: Centrālā Statistikas pārvalde, 2011 [accessed 2011-03-25]. [www.csb.gov.lv](http://www.csb.gov.lv)

### 1. The cyclical structure of real estate market and factors influencing it

The real estate market includes different market segments one of the most important of which is dwelling space market. The real estate market has a tendency to develop cyclically which is also the case with the dwelling space market. However, a more important aspect than cyclical development is a tendency to react to changes in the macro environment. Such changes can cause this cyclical development in the real estate market. Cyclical fluctuations can be influenced either by one factor or a group of factors which suppress or on the contrary reinforce each other. The cyclical fluctuations in the real estate market draws attention with the fact that price fluctuations can be significantly more volatile than changes in the factors that influence these fluctuations. Prices in the real estate market have a tendency to overreact: in optimistic circumstances they tend to be noticeably higher than the optimal price while in pessimistic moments they tend to be much lower than the optimal price.

The optimal market price can be taken as the fundamental price or real estate replacement price which would ensure demand and supply equilibrium. In reality the real estate market can not react fast enough to changes in demand that cause price fluctuations. Real estate market participants can not react fast enough to these changes because developing a real estate object can take years. Hence, there is no supply and demand equilibrium during this time and it is likely that insufficient supply will be replaced by overheated supply.

Many researchers of the real estate market have tried to determine the factors that influence real estate market prices, though there is not a one right formula or answer to this question as each region has its specific features, which can influence supply and demand factors. To determine which factors will influence the real estate market in the future one can analyse the factors that have influenced real estate price fluctuations in the past. However, there is a possibility that historical factors can have little or no influence at all in the future. Possible scenarios of the real estate market development have to be considered in a context with the overall economical development as well as the fact that economics at the state level develops as one whole and changes in one of the factors to some extent will definitely affect the overall situation.

By investigating the development of the real estate market in Latvia together with the factors that influence it, conclusions were drawn that the most significant factors that influence the prices in the real estate market in Latvia were the amount of issued mortgage loans, income level, employment, government decisions and policy, inhabitants' expectations and others. Although, in the previous years no direct correlation between the real estate market prices and demographic situation in the country can be observed, it does not mean that demographic situation does not affect this market. It shows that other factors have been stronger. In the future the influence of this demographic factor can become more apparent.

The economic and demographic factors that affect the level of demand are as follows:

1. Net household formation;
2. Age composition of the household;
3. House hold income;
4. Credit conditions;
5. Prices of substitute units;
6. Ownership costs;
7. Expectations about the future;
8. Seasonality.<sup>2</sup>

The real estate market is not influenced only by the factors that are connected with country's economic situation. Another very important factor which affects acquisition of real estate is the mood and future expectations of inhabitants. Real estate is a durable and essential good at the same time, but unlike with other essential goods people buy it only when they have positive expectations about their future income. The real estate market depending on its type and value can be also a luxury good. Different real estate react differently to the macro environment but in the long run the real estate market can be influenced by the society as a whole, culture, climate and also other factors which are not directly connected with the economic environment.

In a way the decision making body influence of the government and local authorities is unpredictable or at least hardly predictable on the real estate market, as their decisions can be completely unexpected as well as restrictive or on the contrary growth stimulating with an aim to adjust or change completely the direction in which the sector is developing. It can be unpredictable because the previous possible directions of development where forecasted using the policy of the government and local authorities at that exact time. Impor-

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<sup>2</sup> Carn, N.; Rabianski, J.; Racster, R.; Seldin, M. *Real Estate Market Analysis*. New Jersey: Prentice Hall, 1988, p. 125.

tant decisions at the state level that are incorrect can strongly damage sector's growth opportunities and have a significant impact on the industry's profitability indicators.

It can be very useful to know which factors and in what way influence the development of the real estate market for various stakeholders in the real estate sector. It can be beneficial for developers who have to decide where to invest based on forecasted investment profitability indicators. Prices of objects in the real estate market are very important for consumers, the main users of these objects because they directly affect the amount of money spent on acquiring some particular real estate. If we look at one individual, the price of a particular real estate object will not affect the sector overall, however, the average price in all real estate market can leave a significant impact on the national economy. If we look from a perspective to have a sustainable development of the national economy, it is desirable to have prices in the real estate market close to their fundamental values. Too high volatility can lead to bankruptcy of some households or increase the probability of insolvency. However, real estate market investors earn from these price fluctuations, hence high volatility ensures good profitability. All stakeholders in the real estate market benefit or on the contrary are made worse off from these price fluctuations, thus they all will be interested to know how the sector will possibly develop.

## 2. Real estate market in Latvia

Latvia as well as other Baltic countries does not have a long-lasting tradition in the real estate market. It has been just twenty years since they regained their independence and only in this time one can talk about the development of the real estate market which had a more rapid growth since the late nineties. During this time restarted its development filling the market with new dwelling spaces, yet it is still just a small part from all real estates.

Since the end of nineties and more actively since the second half of 2004 after Latvia entered the European Union, Latvian real estate market was flooded with additional financial resources. The strong competition between commercial banks and activity in mortgage crediting provided citizens in Latvia with cheap loans which ensured an increasing demand for dwelling spaces. Dwelling space supply could not absorb the rapid demand growth, hence prices increased. In some months they increased by around 5% summing up to a 60% yearly price growth in several real estate sectors.

Real estate prices grew in all dwelling space market sectors. For example, block apartment market prices in the period from 2000 to April 2007 when this market segment peaked, increased sevenfold from 250 euro per square meter in 2000 to 1720 euro per square meter in 2007. After they peaked real estate prices dropped again and reached the lowest point in September 2007 starting to gradually grow again. In September 2009 the average price of block apartments in Riga was 480 euro per square meter, now it is around 600 euro per square meter. In other real estate market segments the price development was similar.

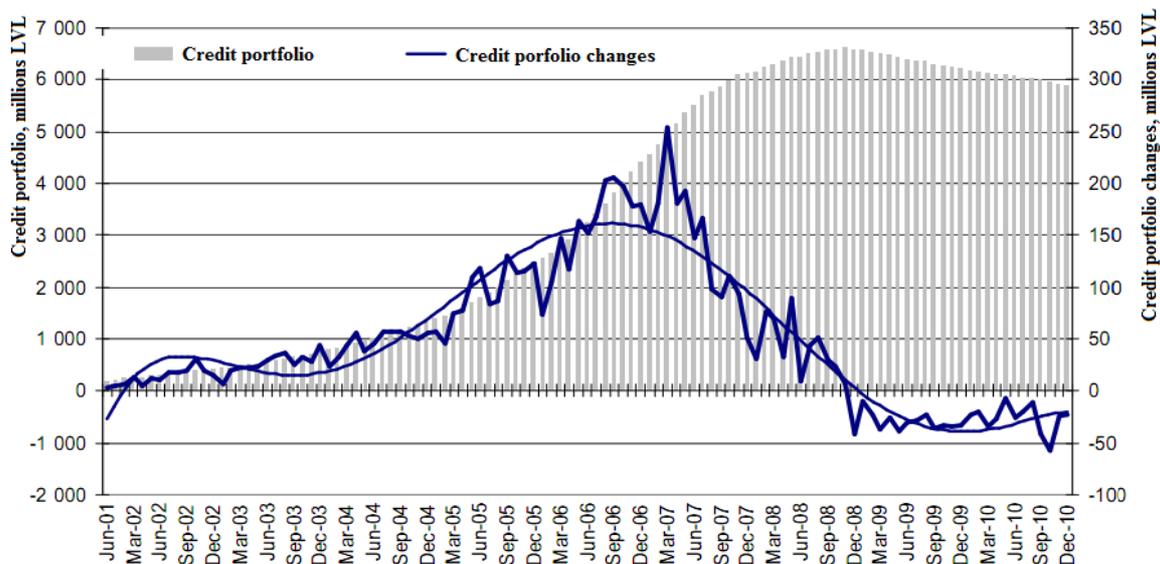


Fig.1. Commercial banks' credit portfolio given to households, credit portfolio changes<sup>3</sup>

<sup>3</sup> Local Real Estate company "Latio" [interactive], Rīga: Latio, 2011 [accessed 2011-03-19]. [www.latio.lv](http://www.latio.lv)

Mortgage lending development in Latvia cannot be seen as the only factor that influenced dwelling space market prices and demand in the sector; mortgage lending was more a tool that allowed it to happen. Of course, without mortgage lending it would not have happened. The main reasons that created demand for dwelling space were improvements in the standard of living, increase in the average salary, which only partly shows in the official statistics as at the same time happened a sizeable income legalization, decrease in unemployment rate, more optimistic expectations about the future as well as overall improvements in the economic situation at the country level.

The desire to improve life conditions was well grounded when the income level increased and crediting became more accessible as large part of all dwelling spaces consisted of deteriorated buildings that did not meet the preferred level as well as the average level in the European Union by their standards and dwelling space per square meter. In Latvia there is around 27 m<sup>2</sup> of dwelling space per inhabitant. That is 30% less if compared to the old EU member states where dwelling space per inhabitant is around 40 m<sup>2</sup>. In order to increase the average dwelling space to 40m<sup>2</sup> per inhabitant the total dwelling space in the country should increase by 50% which is around 30 million square meters. To compare, from 2000 to end of 2009 total dwelling space increased by 7.6 million square meters.<sup>4</sup> However, the amount and quality of dwelling space in old European Union member states is not a factor that stimulates demand for additional dwelling space. The emphasis is on the fact that people in Latvia live in relatively smaller dwellings which is marked by the desire to increase life conditions in the previous years. Still, the recent economic crisis has changed priorities of inhabitants which reflect in the real estate market prices.

A study made by Eurostat shows that 57.7% from all inhabitants in Latvia live in narrowness, comparatively 49% in Lithuania and 41.2% in Estonia, while for example in Ireland this indicator is 3.7% and in Germany 7%. Relatively high number of people living in narrowness is also in Rumania 55.3%, Poland 49.1%, Bulgaria 47%, Italy 23.3%, and Greece 25%. A satisfactory dwelling space standard is set to be: one shared room in the household, one room for each couple living in the household, a separate room for each person that is of full age, and a separate room for each child (though, it is also allowed that children of one sex that are younger than 12 can share one room). In Latvia 25.7% of all inhabitants live in a dwelling with inappropriate hydro isolation, 10.9% live in dwellings with insufficient lighting, 16.6% do not have flushable toilets, and 18.2% dwellings do not have a bath or a shower at all.<sup>5</sup>

If we look in European Union context, in Latvia more inhabitants than anywhere else live in apartment houses – 66% of all inhabitants, 29% live in private houses while 4% live in terraced houses or twin houses. The most similar situation in this aspect is in Lithuania and Estonia where around 65% of all inhabitants live in apartment houses.<sup>6</sup>

The relatively high number of people that live in narrowness together with the relatively lower indicators of life quality is one factor that in the future could positively affect the demand for dwelling space when income level and future expectations will improve.

### 3. Factors that influence the real estate market

As mentioned beforehand the cyclicity of the real estate market and the turning points as well as the length and deepness of these cycles can be affected by various economic, social, and other factors. The influence of each of these factors at every single moment depends on how the real estate market reacts.

#### 3.1. Income of inhabitants

Objects in the real estate market and their dwelling space are among the goods or services that are bought by households or certain individuals. Household income consists of wages, social benefits, pensions, and other payments from the state budget, as well as dividends, percentage payments and others. All these types of income together form distributable income that each household possesses. However, we have to remember that there are also unregistered flows of money and also shadow economy. A large part of inhabitants still earn their income on hand without paying taxes but still allocate them for buying consumer goods and real estate or paying rent. When evaluating the real estate market as a whole an important factor is the amount of money that inhabitants are ready to spend for usage of dwelling space and acquisition of real es-

<sup>4</sup> Latvia Central Statistics board [interactive]. Riga: Centrālā Statistikas pārvalde, 2011 [accessed 2011-03-25]. www.csb.gov.lv

<sup>5</sup> Visciešākā kopdzīve – Latvijā. *Lietišķā Diena*. 2011, No. 11 (201)

<sup>6</sup> Eiropieši dzīvo – vizuālais stāsts. *Lietišķā Diena*. 2011, No. 9 (199)

tate. The total amount of money can affect the overall demand, hence an increase or a decrease in the income level have inverse effects on real estate objects.

The income level and changes in it currently is and will continue to be a significant factor that will affect demand for dwelling space because acquisition of real estate is a substantial purchase which is usually done when a person is sure about his/her income. The person also has to consider whether it will be possible to financially maintain the obtainable object. Such factors as public utilities payments, real estate taxes and other expenses connected with maintaining a property also affect the demand. By analysing income level relation with the real estate object price one can see a clear relation between the average market price of one square meter and the average salary in the region. The income level is connected with the ability to obtain a mortgage loan as well as the maximum amount that one can borrow. In this way average income level in the society affects the amount of money that is invested in real estate objects through mortgage loans which are provided by commercial banks. There is a significant correlation between the average wage and block apartment prices in Riga approving the influence of this factor on the real estate market.

### 3.2. Employment and unemployment

Unemployment is a notable social and economical problem of the national economics. Unemployment can affect economic and social processes in the country; hence it is an important factor which can affect people behaviour under certain circumstances. Unemployment affects decisions and actions of individuals as well as the society as a whole. Inhabitants connect employment and unemployment with their welfare. Unemployment also affects the social state and mood of inhabitants.

When people make decisions in everyday circumstances they base their decisions on their beliefs and the unemployment level or employment of an individual can be the key factor in making a decision. The desire to buy goods that would require a considerable amount of individual's financial resources depends on the individual's psychological state. High unemployment rate in the country psychologically negatively affects people mood, hence they could avoid purchases of expensive and unnecessary goods or considerably delay the acquisition of these goods as well as base their decisions on other aspects using price as the main factor in determining demand. Such pessimistic economical state that results from unemployment can lead to decreased demand for a certain group of goods in the country.

"Unemployment is the main problem of economics that causes widespread social and political resonance. Unemployment affects production volume. The direct costs of unemployment can be determined but it is rather hard to measure the social, psychological or moral consequences of unemployment."<sup>7</sup>

Unemployment is not just the economical and social state of a certain individual. It is a country level problem that affects processes not only for an individual but also for the national economy as a whole. When unemployment increases as some individual loses his/her job the demand is affected in the industries in which the particular individual consumed goods and services and also in the whole national economy, considering the fact that economic development acts as one entity and changes in one industry can influence other industries. The real estate market is not an exception here as unemployment affects it much more heavily than most other industries. Increase in the employment rate will have a positive effect on demand for dwelling space, while it is the other way round when employment rate decreases.

During the economic crisis unemployment problems affected Latvia severely. On average unemployment rate in the country increased from 4.8% in April 2008 to 17.3% in May 2010.<sup>8</sup>

In the beginning of 2011 the unemployment rate was around 14%. Unemployment is not only a problem by itself; it is strongly connected with a decrease in the welfare of the society, high emigration and emotional state of inhabitants. State economics do not operate effectively when there is unemployment because human resource capital is not being used to the full extent, hence the gross domestic product is not being produced in its maximal possible amount which damages the national economy. Unemployment and employment are two of the most important factors in macroeconomics that have the biggest influence on the demand for real estate objects. In Latvia's dwelling space market lowest prices have been recorded when unemployment rates were high.

<sup>7</sup> Gods U., *Makroekonomika*. Rīga: Biznesa Augstskola Turība, 2002, p.190.

<sup>8</sup> *Latvia employment agency* [interactive]. Rīga: Nodarbinātības valsts aģentūra, 2011 [accessed 2011-03-19]. [www.nva.gov.lv](http://www.nva.gov.lv)

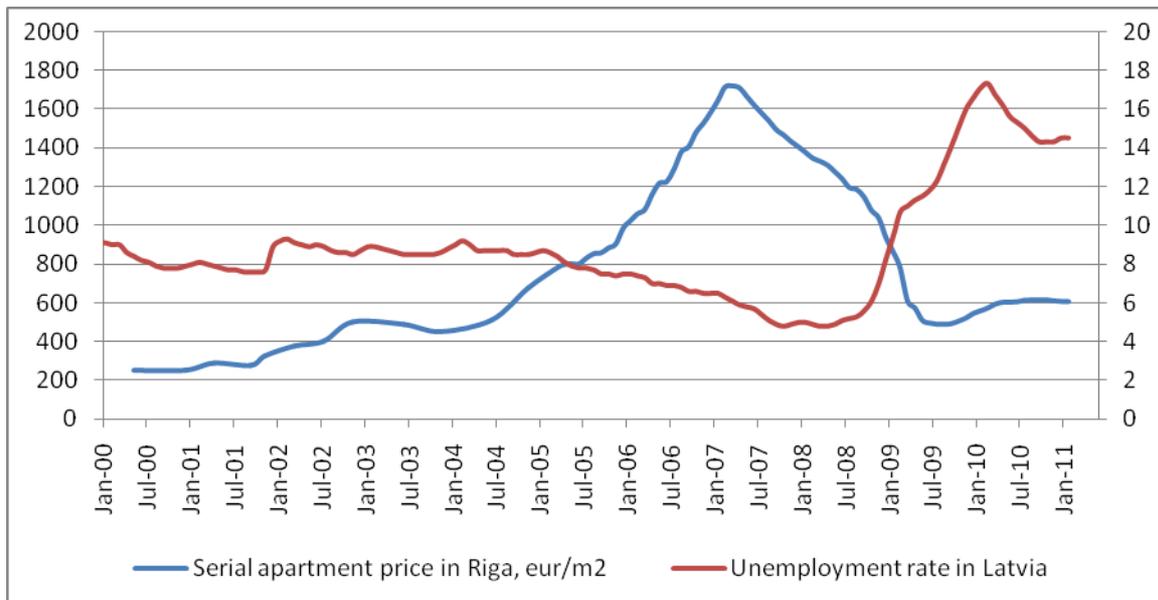


Fig.2. Serial apartment prices in Riga and unemployment rate in Latvia.<sup>9,10,11</sup>

### 3.3. Demographic situation

Real estate is used, sold and bought by inhabitants. They affect the demand for objects in the real estate market and also the supply of objects in the real estate market. Demand for habitable and uninhabitable premises, which are needed for ensuring various processes, is dependent on the inhabitant situation in a particular area which is characterized by the region's demographic situation. The demographic situation is one of the most influential factors that affect the real estate market, processes and forecasts in the real estate market. Also it has to be analysed as one of the influential factors when making a forecast for the possible development scenarios of some real estate sector.

To determine the effect of demographic situation on the real estate market one has to study the specifications of the particular region: the decrease or increase in urbanisation level, population's age structure because people from different age groups may have different dominant actions towards the real estate market. The demographic situation is also connected with migration, which is a strong factor that in a relatively short period can considerably influence demand in the region. Emigration is one of the problems in Latvia. In 2009 more than 4700 people officially emigrated from Latvia, while the real number of emigrated people is much higher.<sup>12</sup>

Latvia's case is specific because the number of inhabitants is decreasing which is not typical for EU countries. As a result, the real estate market has to adjust to this situation. In 2009 the natural growth of population was -8220 people. In the last two hundred years the number of inhabitants in Latvia has decreased by more than 420 thousand. It has continuously decreased every year since 1990. The decrease in population could be explained by lower birth-rates, which were very common in the nineties, as well as negative migration balance.

Without inhabitants and a certain density of population the real estate market will not be able to develop in the long run, thus the development of the real estate market has to be adjusted to match the demographic processes in the region. If the real estate market will not be commensurable with the demographic situation in the country, real estate owners who will want to sell their properties can bear losses as the demand will be rather low. The positive aspect of this is that compared to other factors that influence demand in the real estate market demographic situation is the easiest to forecast. That should be put to use when creating real estate market forecasts. In the previous years there was not a significant correlation between changes in the

<sup>9</sup> Latvia employment agency [interactive]. Rīga: Nodarbinātības valsts aģentūra, 2011 [accessed 2011-03-19]. [www.nva.gov.lv](http://www.nva.gov.lv)

<sup>10</sup> Local Real Estate company "Latio" [interactive], Rīga: Latio, 2011 [accessed 2011-03-19]. [www.latio.lv](http://www.latio.lv)

<sup>11</sup> Local Real Estate company "Arco Real Estate" [interactive], Rīga: Arco Real Estate, 2011 [accessed 2011-03-19] [www.arcoreal.lv](http://www.arcoreal.lv)

<sup>12</sup> Latvia Central Statistics board [interactive]. Rīga: Centrālā Statistikas pārvalde, 2011 [accessed 2011-03-25]. [www.csb.gov.lv](http://www.csb.gov.lv)

number of inhabitants and real estate prices. However, such relation will exist in the future and will more and more affect operations in all industries because economy cannot function without people.

### **3.4. Crediting**

A significant part of deals happen with the help of mortgage loans, thus there is a reason to believe that a mortgage loan with its expenses, terms, and proposals can influence deals of purchasing and selling real estate. During a time when there is a sufficient supply of mortgage loans and also an adequate demand for them, the real estate market is being positively stimulated. In a normal situation without rapid price increase or decrease the existence of mortgage loans is a factor that ensures price stability. At any given moment prices in the market already include the fact that money from crediting is flowing in the market. The real estate cycle fluctuations can be affected by actions that increase or decrease crediting. The real estate purchase and sale market is being stimulated when a loan is given to a person who previously could not acquire a loan or did not want to have it, while the same signals are negative signs for the real estate lease market. Negative signals for the real estate market can also arise if credit institutions for some reason limit or completely stop issuing loans. In such circumstances there is a money outflow from the real estate market that can result in a decrease in the real estate prices. Credit institutions can decrease the amount of issued mortgage loans based on many factors, for example, when the economic situation in country rapidly worsens or in a situation when the real estate prices in the market are considerably exceeding their fundamental price. Correlation between block house prices and increase in the amount of issued mortgage loans can be seen in figure 1.

### **3.5. Government decisions**

When evaluating inhabitant demand for dwelling space in a country one has to take into account all the factors mentioned above that influence the demand. Another factor that has not been previously mentioned and can significantly affect the real estate market is government decisions and regulations directly relating to the real estate market. The evasion from them at least on an individual level is near to impossible. It is a positive sign if these decisions have economic grounds and they are really necessary, however, when looking at the speed and specifics of decision making, one can see that the bureaucracy can do more harm than good with unreasonable interference in the real estate market. An example is the government's decision in 2007 as part of the plan to decrease inflation to introduce a mandatory first payment of 10% if one takes a loan in a commercial bank to acquire real estate. It is not a bad decisions but it was made when the real estate prices had already started declining. In Latvia real estate owners have faced also significant changes in the real estate taxation policy. In 2010 government introduced a dwelling tax to supplement government's budget not to fulfil some regulatory role. That definitely resulted in a negative pressure on the overall demand. Moreover, in 2011 this newly introduced tax rate was doubled. We have to add that it all happens at a time when the average dwelling space per inhabitant is relatively low compared to other EU countries and also the quality of these dwellings is quite low.

Taxes and various regulations are very cumbersome factors in the development of the real estate market. However, an even more cumbersome fact is that these decisions in Latvia are completely unpredictable. Exploitation expenses as well as the quality of these properties for real estate developers, for potential buyers, and also for current owners can significantly change when affected by various regulations and taxes. As a result, the total demand and total supply can change their equilibrium and with that influence the average market price of real estate objects as well as change the direction in which the industry is developing.

### **Conclusions**

The economic situation and the real estate market in the last years have developed very dynamically. There have been rapid price increases and decreases. The swift changes in the real estate market have largely come from the changing external economic environment because such factors as unemployment, gross domestic product, inflation, and commercial bank crediting activity during the past three years have been exposed to changes. These and other factors affect the real estate market resulting in further changes in both the number of transactions and the amount of money that circulates in these real estate market transactions. However, the real estate market can be affected also by political and social factors not only economic ones. The real estate market is subject to various government regulations and laws.

Understanding these factors that affect the real estate market and their effect can significantly improve forecasts about the direction in which this industry is developing and also the direction in which it should

develop. This understanding would also give an opportunity to ensure a sustainable real estate market development that would be compatible, for example, with the current demographic situation.

If the cyclical development of the real estate market is too severe, it can negatively affect the development perspectives of the industry and also the overall economic situation in the country as this industry is very significant in the national economy. The recent events with threefold price drop in some real estate market sectors act as a proof about what can happen if the real estate market development is not compatible with the macro environment and other important factors.

The main conclusion in this paper is that prices in the real estate market are affected by the existence of various economical, social and political factors and changes in them. The understanding of these factors and further usage of this knowledge in setting and forecasting the preferable direction of development can significantly improve the profitability of this industry and can facilitate a reasonable and sustainable development.

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