

THE EFFECT OF LENDING ON THE HOUSING MARKET IN LATVIA

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Abstract. This paper reviews *Lending* as one of the most important and influential factors in the housing market of Latvia. Although the housing market is being affected by a variety of factors, lending has had the greatest impact on the market during the recent years. A connection may be observed between the price of the houses and the overall mortgage lending in the country – this paper justifies the observation. The paper focuses on the mortgage lending activities and the possible impact of, on the overall national economy due to the fact that lending and its effect on the housing market was among one of the main culprits of the economic crisis in Latvia thus the paper draws parallels between Latvia and other countries in order to underline the importance of lending. A sound knowledge of housing marketing and adoption of appropriate decisions at the states level may facilitate a long-term economically supported economic development, whereas incommensurable lending velocities and dynamics may lead the country towards recession and cause a crisis in the real estate market.

Introduction

The real estate market is an important industry in any country both from the social and economic perspectives as the objects of housing market may be considered to be an essential. The real estate market of Latvia after country had regained its independence started a significant course of development throughout the previous decade when the objects of real estate market became more of a value as well as they became objects of investment and speculation. Resultant of that certain market segments witnessed substantial price fluctuations which also reflected on the overall economic situation of the country and one of the most influential factors both within the real estate market of Latvia as well as on the overall economy, was the amount of loans issued to households.

In a span of few years over the previous decade the amount of loans issued to households grew from 167 million to 6.5 billion lats, which in relation to the growth domestic product would not be a significant figure; however the velocity at which the relevant credit portfolio grew – a new dynamics of lending approval and the influx of fresh funds in the goods market is accountable for the initial prompt growth of economy, however, after the lending slowed down, it led to a recession.

It was lending that enabled entrepreneurs to implement their project as well as it enabled the improvement of the standard of living, nevertheless the economy was unable to sufficiently accumulate the financial resources that have entered the market via the aforementioned means, which manifested itself as increased inflation, initial GDP increase, but at the later stages such imbalance led to a burst of the real estate bubble and subsequent recession. Certain segments of the real estate market experienced price decreased as low as by 70%, which further underlines the importance of the problem, as well as a connection may be observed between the lending velocities in the country and the development of the real estate market.

This paper reviews the mortgage lending industry in Latvia and its influence on the housing market in the country. The goal of the paper is to focus on lending and the important impact of the lending dynamics it leave on the housing market as well as to prepare a set of recommendations towards an economically supported development of the housing market using mortgage lending as facilitator. The paper presents statistical information, reference literature and results of previously conducted research as well as the information summarized by the author.

The Importance of Lending in the Housing Market

The real estate (RE) market consists of multiple market segments, one of which is the housing market. A house is an essential for every human and it is impossible maintain appropriate living conditions without a place of residence [2]. Nevertheless houses may be considered essentials, but as such they do not resemble most other essentials. The cost of a house is comparatively larger than the cost of any other essential and a price of a house will in most cases greatly exceed person's annual income, it is most probably the biggest purchase in person's life and it is the most valuable asset of an average person. A house has its distinct social and psychological meaning, because it is not only another good in person's life, but rather a place of residence and lifestyle – one may struggle to find another type of service or a product that would affect and characterise person's life in such a profound way.

Looking at the importance of a house in a person's life, one may notice that people have led their lives in a way that they live in houses that are owned by them, rented or the permission to reside in the respective house is given by another person. In line with the Theory of Economics, individuals strive to maximize the benefit the results from the use of resources at one's disposal and a similar situation may be observed in the housing market, although the benefit not always may be converted into financial wealth. In the assessment of such benefits every individual has its own take, however in accordance to the data provided by EU Housing Statistics 85% of Latvian

households reside in personally owned properties, whereas the same indicator in other countries is around 60% [1].

A certain household may obtain ownership right towards a certain house in many ways, nevertheless a substantial part of the houses have been purchased. Conversely, taking into consideration to the high value of houses and comparing it to the average income of a household, many households do not possess sufficient savings to be able to afford a purchase of a property. One of the ways to finance such a purchase is by taking a mortgage, which is the most popular means of house purchase financing in society and economy. With the use of a mortgage, a household may purchase a property without substantial financial saving and achieve in the much shorter term than without the assistance of a loan. In 2010, 16.9% of the households in Latvia had a mortgage, i.e. 152 400 households and in the same year 40% of the transactions in the housing market have been done via the means of mortgage lending [3].

Transaction that have been done with mortgage assistance form a part of, or increase the amount of possible and potential transaction due to the fact that if loans were not being issued such transaction most likely would not take place. However the housing market of Latvia, specifically after the year 2000 has developed in terms of economics, having the availability of lending and mortgage lending, the housing market thus has emerged in the presence of available lending and such lending has constantly affected the housing market both in terms of the demand and offer. The potential house buyers may be divided into two groups – first group includes persons that do not require a loan, but the second group requires a loan in order to be able to purchase a property. Mortgage lending directly effects on the part of potential house buyers that require a loan in order to be able to purchase the house, however the mortgage lending indirectly affects the market as a whole due to the fact that should there be no availability of lending, the extent of the market shall not be as large. Based on the proportion of the groups – namely the amount of persons requiring a loan in order to purchase a property in relation to amount of persons not requiring such loan, one may establish the influence of banking on the entire sector.

Although real estate property is considered to be an essential, the demand for it is not as non-flexible as it is in the case with other essential due to the fact the people do not form the necessity in an acute manner and may plan it, as well as there is a possibility to seek a temporary residence with friends or family. Property rental is the most popular substitute for property purchase and it allows to suit the property more efficiently to ones needs as well as to change it without the risk of losing one's investment, furthermore such change of residence may be executed in a prompt manner. The proportion of rented and owned houses among European Member States is quite a diverse. In Latvia, around 83% of the houses are used by its owner, whereas in Estonia this figure reaches 96%, which is one of the highest ratios Union-wide, however only 36% and 46% of house

are used by the owner in Sweden and Germany respectively, which are in turn among the lowest figures in Europe, resultantly these countries have a large number of rentals [1].

Housing rental is a substitute for a house purchase and it provides person with similar comfort and satisfaction that can be provided by an ownership of a property, however purchase of a house by the means of mortgage is a competitor to a rental. When person or a household is faced with a necessity for a residential area, there are following ways to satisfy the emerged necessity – purchase of the house, purchase of a house with the assistance of a mortgage loan or a rental of the house. The aforementioned types of house usage are mutually competing; the possibility to get a loan and its cost is directly competing with rentals; however income that can be gained from renting a property is one of factors affecting the price of sale of a property.

The real estate industry has been so far heavily studied and analysed in Economics and in the literature of economics. Lending has been announced as an essential factor in determining the market price of the property by a plethora of authors. For instance, in the United States a real estate market investor and researcher has indicated lending interest rate as the most influential among the factors that determine the market value of real estate properties as he gives less attention to the availability of the loans or to other lending related characteristics in this regards [4]. Nevertheless, another group of authors in the book of *Real Estate Market Analysis* underline the lending situation in general as the most important factor in terms of the demand of new houses, as well as authors of the said book mention price of substitutes as additional determination, which in this case may be referred to the rental prices of the houses [5].

Housing Marketing and Lending in Latvia

The development over the past decade in the national scale in Latvia has not been of homogeneous nature, country's economy has both experienced a rapid growth of 12% in terms of growth domestic product compared to the previous year – in 2006, as well as subsequently, a drop of 18% during economic crisis in the third quarter of 2009 comparing to the respective period of last year [6]. Real estate property is a good, market price of which is similar to the market price of other goods - determined by market balance i.e. the balance between offer and demand. The development of the real estate market is affected by the environment surrounding the real estate market; such environment affects the depth and length of the real estate market cycle as well as the market price [7].

In the wake of 21st century lending in Latvia has witnessed a rapid development and a large amount of funds were rendered available to the households via subsequent loans. In the beginning of 2001, the credit portfolio formed by loans issued to households was at 167 million lats; however,

in the end of 2007 the said portfolio reached a figure of 6 billion lats. In the end of 2011, portfolio of loans issued to households by commercial banks had dropped to 5.4 billion lats and around 4.3 billion of the amount was formed by loans to finance house purchases. The total loan portfolio formed by loans issued to the households is set to decline over the last years, it does not however mean that new loans are not being issued, merely the fact that the amount of loans issued was lower when compared to amount paid in instalments. Even in November of 2008, the aforementioned loan portfolio reached 6.6 billion lats [8]. It effectively means that the financial resources drain from the real estate market; however the overall demand for houses is determined by newly issued loans, however a decline maybe also observed in the amount of new loans being issued compared with a period prior to the real estate bubble.

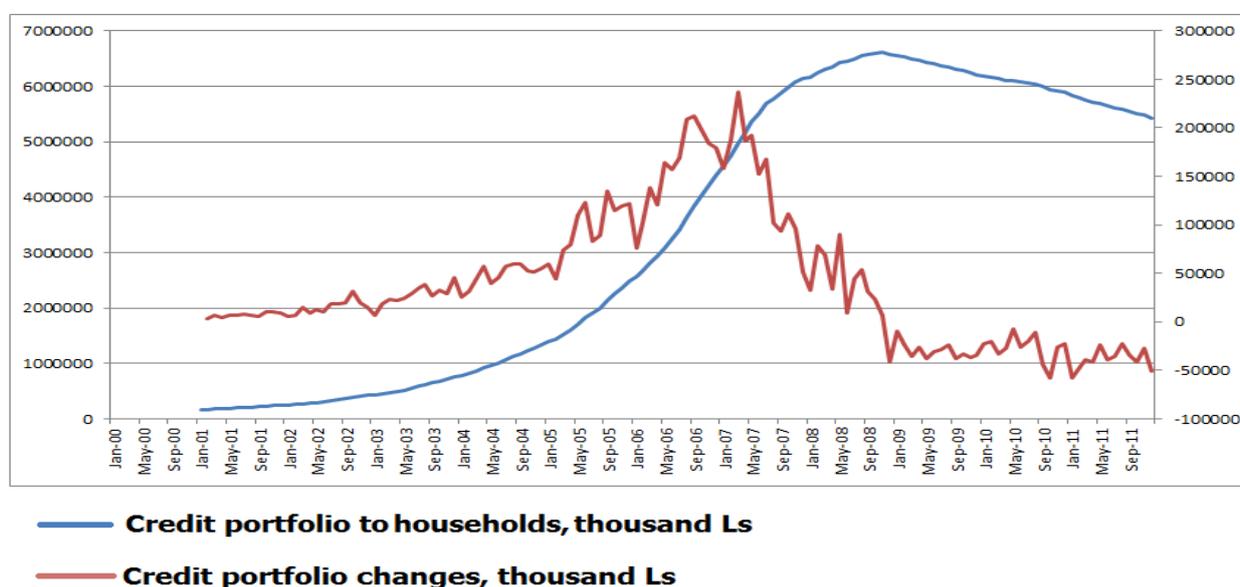


Figure 1. Households credit statistics [11]

The total household loan portfolio in relation to the growth domestic product in Latvia is around 40%, which is a fairly low ratio, considering that in other European Union Member States the household loan portfolio is substantial larger and even exceeds the respective GDP. It indicates towards the fact that households and the economy may maintain a higher loan portfolio than the current one. The loan portfolio per household reached LVL 6100,- which also enables the comparison of the real burden of debt [1] [9].

In the situation of Latvia, although both the loan portfolio per household and in relation to the GDP is fairly low, a major role is assumed by the growth velocity of the loan portfolio. The aforementioned loan portfolio grew from 200 million to 6.5 billion lats in the span of time between 2001 and 2008, which is an increase of more than 30 times. It means that before the 2000's, lending

in Latvia was minor and the loan funds available in the real estate market were fairly low. A rapid influx of loan securities in the economy was observed after Latvia joined European Union. Upon taking into consideration the said circumstances the matter of whether the economy of Latvia was able to accumulate the new funds and the subsequent inflation's reaction to it, including housing costs and prices, are of real importance.

The period of time when the loan portfolio grew rapidly coincides with the price increase in the housing market. The prices of the real estate properties in the beginning of 200 were considerably low comparing to the prices at the peak, even taking into consideration the extent of inflation. In 2000, the average price of serial flat in Riga was 250 Euro per square meter. In 2006, this figure reached 1 000 Euro per square meter which is a fourfold increase in the time span of 6 years. However, after another one and a half year – in mid-2007, the price of serial flats had reached 1 700 per square meter, which was the price maximum and the highest average price that has been ever observed in the serial flats' market. Similar price changes were observed in different real estate market segments – new projects, cottages and exclusive apartments [10] [11].



Figure 2. Apartment prices in Riga, eur/m² [11]

The sharp increase of market prices was followed by a subsequent drop – the price maximum in the serial flats' market in 2007 to price over dropped by more than 70% over the next two and a half years. After 2007 the lowest price was observed in the autumn as the average market price for serial flats had fallen under the 500 Euro per square meter mark. Similarly other housing market segments experienced declines during the period of downturn. This downturn caused a substantial amount of difficulties to the households, both in terms of fulfilling their credit liabilities and in terms of the maintenance. The issue for major part lies in the fact that the real estate cycle in

Latvia coincided with the economy cycle – the downturn affected both the housing market and the economy itself – similar to the prior growth in both areas. The households that had financed their house purchase by loan and providers of whom were employed in industries that experienced turnover cuts and labour lay-offs were exposed to the greatest of risk.

After reaching the market low, the housing prices in the market segment of serial flats experienced a fairly sharp increase – reaching 600 Euros in half a year and subsequently maintaining the price at the level for another one and a half year. During this period the lending had recovered and new loans were being issued, loans were being repaid faster and subsequently the overall amount of the loan portfolio decreased. A sharp price increase in the housing market may only be observed to selected small market segments, for instance to flats right in the centre of the city as well as to properties in the resort area of Jurmala.

Upon analysing the interrelation between lending activities and market price, one may observe a correlation between changes in the loan portfolio and housing prices, which thus indicates towards the fact that lending is one of the most important factors in creating the housing market balance. Such correlation is being analysed between various factors of real estate market, one may observe a statistical correlation between the housing market prices and the changes within the household loan portfolio, such correlation ratio being 0,767, and the strength of the correlation was identified with the use of Pearson's correlation coefficient.

The Role of Lending in the Housing Market and its Problems

Lending is one of the most crucial factors when it comes to determining the average market value, lending mainly affects directly the overall demand for houses. Correlation between the housing market prices and overall increase dynamics of household loans' portfolio reveals that lending is one of the factors affects the housing market.

The real estate market is very specific in the sense that the offer may not promptly react to changes in the demand – it responds with a delay which can be explained with the amount time to create a real estate market object – several years may pass for the moment regarding the erection of the real estate property is born until the time it is fully built and put into commission. In the event of sharp lending increase, grows the demand for properties due to a fact a larger number of households may afford to purchase a house and in the conditions of loan availability there will be additional facilitators to realise the desire, such desire being rendered fairly impossible in the absence of lending availability.

In the case of Latvia, the rapid development of lending led to a sharp rise in the housing prices and the activation of the offer - overall housing fund in the country from 2000 increased by

almost 15% from 53.4 million square meters to more than 61 million square meters in 2011, furthermore, the population in the country decrease about 15%, the population decreased both in the rural and urban areas, including Riga [6]. Lending is the only factor influencing factor, also of equal importance is the increase of population's standard of living and the overall improvement of country's economic situation, as well as the critical status in the housing market, which most likely was the most important facilitator of the housing demand increase, whereas the rest of the factors enabled the demand. Another important factor was loan interest rates, which are considered to be the prices of the loans and generally affect the demand for loans.

The overall growth of the loan portfolio, increase of average credit liability per household, as well as a sharp increase of the real estate market object prices may lead to a real estate market bubble – first the increase would stop afterwards followed by a sharp decline. A sharp decline after an increase forms a situation in which a part of household that have purchased a house financed by a loan and mortgaged the purchased property as a security of the loan, may no longer fulfil the respective credit liabilities. It would not be seen as a problem, if other economic processes in the country maintained their course without significant changes, however, if a crisis in the real estate market coincides an economic crisis, then the value of the real estate property may not cover the credit liabilities which in turn causes an instance in which a household loses a property, but may still have to continue fulfilling the remaining credit liabilities. The situation is worsened by the growing unemployment rate, decreasing overall employment level as well as by the decrease in amount of the income available to the household.

The above described scenario indeed took place in Latvia. From 2004 until 2007, the overall credit portfolio grew 5.8 times and the housing prices in the real estate market segment of serial flats in Riga increase by about 3.5 times. The credit portfolio reached 6.5 billion lats, however the housing prices decreased by more than 70%, which effectively means that the housing prices decreased but the households were left with credit liabilities in the previous level and in many instances the value of the property did not cover the remaining amount of credit liabilities, thus it was in such cases impossible to eliminate the credit liabilities by selling the respective property. It is also indicated by the fact the daughter companies of commercial banks have accumulated a large property portfolio.

The renowned US economist Joseph E. Stiglitz in his book *Freefall*, which reviews the recent economic crisis in the United States, argues that it was the low interest rates; insufficiently regulated activity of commercial banks in relation to the facilitation of lending dynamics led the country into an economic crisis and thus affected the whole world. In his book, the author argues that if banks are insufficiently regulated they tend to fall out from one extreme into another i.e. issue large amount of loans and not consider the resultant consequences in foreseeable future [12].

In this case, one may draw parallels with the economy of Latvia where commercial banks competed with each other offering more favourable conditions in order to maximize their market share and clientele. The responsibility of commercial banks is only secondary and the main role shall be assumed by the government and the relevant ministry.

The well-known Latvian economist A. Plotkans has summarized the conclusions of various famous economists in relation to the recent economic crisis and it is a popular opinion that the excessive greed of banks must be restricted because it threatens the foundation of global economy and even politics [13].

For the most part the opinions of economists and financial analysts match, but the statistical data in Latvia as well as in other countries reveals that an uncontrolled lending development may be provided only in short term, but in long term it may impede the development of economy and may create a situation in which the credit portfolio has grown, prices have returned to the initial levels and the economy stagnates, even worse if such credit portfolio originates in external markets which would effectively mean that the financial resources may flow away from the country's economy even in the subsequent periods.

Recommendations for the Housing Market

There are plenty of examples in the most recent history of global economics that markets do not function and economy does not develop in a way in which they should in accordance with the interests of government and society. Economic crisis, recessions and periods of rapid development that facilitate an imbalanced economic development do not match the long terms interests of the society and most probably such phenomenon is not in the interests of anybody except for the selected few who profit from the reorganisation of the market, which in itself is not a negative. Considering its nature, real estate market may severely affect the direct of an economy in general because a house is a very valuable commodity, an object of investment and speculation, and finally it is also an essential, furthermore this price of a house is a fairly expense in relation to population's average income, thus the fluctuations of the prices in housing market will affect population's attitude towards it.

TH fact that rapid price fluctuation, price bubbles and a depression in the real estate market is not in the favour of the majority of society, however, the economy itself shall develop in the interests of the said society and by saying society it is meant everyone employed in the commercial environment. Equally of importance is a fact that prices in the real estate market are determined by both internal and external factors. Such external factors as the country's overall economic situation,

population's level of income, demographic status, employment rate, inflation and of course lending must be taken into consideration.

It is because of lending that the country's economy may be exposed to a large additional amount of income. In Latvia, most of such funds were provided by foreign commercial banks. In mid-2011 the overall credit portfolio of the four largest Scandinavian banks reached 65% of the overall country's private and corporate loans [14].

Although the amount of loans issued to the households in Latvia is fairly small when compared to growth domestic product among the rest of European Union member state [1], in Latvia of importance was the velocity at which the said credit portfolio was formed and the actual velocity at which respective loans were issued, thus by analysing the real estate market tendencies during the period of time when the amount of loans issued to households grew quickly, it may be concluded that national economy was unable to accumulate a sufficiently large influx of financials. It primarily manifested itself as an excessive demand in relation to the offer in the real estate market and a rapid price increase in the housing market.

Population's desire to improve one's standard of living is self-explanatory and the state of the housing fund in comparison to other EU countries was in a much worse situation, which only escalated the problem. 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. [15]

It is obvious that the trends of the previous decade was a result of the actions of the parties involved, but any legal power to perform substantial changes in the industry of real estate was inherent only to the government and Latvia thus is a very real example that a strong presence of the government is very much desirable, specifically, if the economy is experiencing rapid changes. The amount of funds that in one way or the other finds its way into the national economy, may severely affect its structure and the fact that should there be an increased influx of borrowed funds in the economy of the country, specifically from external market, the country may be seen more as an object of investment and thus becomes dependent from global development. This is not entirely considered undesirable by the authors due to the fact that if the performance of the commercial

banks was regulated more closely and if the population would not be enabled to assume credit liabilities that it cannot fulfil, then such funds would enter the economy at a more moderate speed, thus one would not observe such intense price fluctuations. Even until 2007, citizens and non-citizens alike were able to take a mortgage loan in a commercial bank without a basis of official income.

Government has the benefit of both the fiscal and monetary economy levels as well as the legislative power, such tools shall be used in the interest of the society, companies and the country itself in market as the real estate market because both in accordance with the theory of economics as well as with the practical experience it is obvious that real estate market is far from being an ideal and its uncontrolled development may inflict substantial damage on the national economy. It must be noted that the government intervene in a clever manner not to restrict the interests of the business entities in the market as well as the interests of the society. It is clear that to prevent any periodical fluctuations is almost impossible, but excessive fluctuations may be tempered. It is the obligation of the government to regulate the real estate market from the perspective of offer and demand, focus on moderating the price fluctuations and maintain the adherence to fundamental market policy, in the meantime maintaining the entrepreneurial interest and the interest of commercial banks in the relevant market by providing an adequate level of income, as well as by avoiding considerable price fluctuations and creation of price bubbles.

Conclusions

In the recent years, the economy of Latvia has experienced a significant reorganisation, from rapid development until 2007, followed by the recession in 2008 and 2009 and later re-establishing a moderate increase of economy, nevertheless it must be noted that comparing to 2007, the economy of Latvia still finds itself in a lesser situation. Very similar to fluctuations with growth domestic product and even to a greater extent such fluctuations were experienced by the objects of the real estate market. For instance, the prices for serial flats in Riga were around 250 Euro per square meter in the beginning of the last decade, but already in 2007, the price exceed 1720 Euro per square meter.

Among the significant factors that affect the real estate market, one may mention growth domestic product, employment, demographic factors and populations' level of income. There is also a quite significant correlation between the housing prices and the changes in the credit portfolio consisting of loans issued to the household, which during the last decade grew from 167 million to 6.5 billion lats.

Lending is one of the most important factors when it comes to the generation of housing market values, because the factor directly impacts the level of demand. Regardless of the fact that the said credit portfolio is smaller compared to the growth domestic product when compared to the same figures of other European Union countries as well as the fact that the level of average credit liability is fairly small, the growth velocity and the subsequent slowdown of increase hindered a balanced development of the real estate market and the national economy in general. The focal conclusion of the article is that lending activities in the national level must be balanced with the overall development of the economy, restricting an excessive growing of the amount of loans issued – this may be achieved with both fiscal and monetary methods, which will benefit the society, businesses operating in the real estate market and the national economy in general.

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