Eastern Europe, EEC and Implications for Finance Worldwide

By Mark Boléat

UNTIL the Gulf crisis Eastern Europe was at the centre of world political attention. One after the other the countries of Eastern Europe have removed their Communist Governments and have started a rapid move from a command economy to a free market economy. Housing and housing finance are part of this process and represent special problems which the Eastern European countries are grappling with.

The countries of Western Europe are watching developments closely, although they are not involved to any significant extent except, of course, in Germany where, within a few weeks, East and West Germany will be reunified. The Western European countries have their own ambitious target, that is the creation of the single internal market by the end of 1992. Developments in Eastern Europe have tended to overshadow this, and, indeed, perhaps it is significant that East and West Germany have gone, in a period of one year, from being separated by barbed wire and mine fields, to a single economy, while the European Community is still a community of individual nation states after over 30 years. Paradoxically, however, it seems that developments in Eastern Europe have, if anything, accentuated progress within the European Community. The nations of Western Europe have realised that they are making only modest changes to their systems to accommodate a single European market when viewed in the perspective of the momentous changes occurring in Eastern Europe.

This paper briefly overviews housing finance in the whole of the European continent, surveying both developments in the European Community, and what is happening in Eastern Europe. The paper begins by examining trends in industrialised countries generally, then examines developments at the European Community level, before considering in detail what is happening in the Eastern European countries, and interaction between Eastern and Western Europe.

Trends in Industrialised Countries

Broadly speaking, in the industrialised countries of Western Europe the same trends in housing finance exist as exist elsewhere in the world. The days of specialist housing finance markets, and institutions with government protection against, in particular, the commercial banks, have ended in all but a few countries. The specialist housing finance institutions have been deregulated, so as to allow them to engage in a wider range of banking activities. In many cases there is now little to distinguish them from the commercial banks, at least as far as the retail markets are concerned. Conversely, monetary policy measures now apply to all deposit-taking institutions, not just banks, and artificial constraints on banks' balance sheets in the name of monetary policy have been removed.

Commercial banks have progressively taken larger and larger shares of the housing finance markets of the Western European countries, although there are pronounced cyclical trends. Conversely, specialist housing finance institutions have diversified and now take a significant share of other retail banking markets in a number of countries.

The role of the government, as regulator and as direct lender, has diminished sharply. Where there have been special bonuses, premiums, or tax concessions on savings accounts linked to housing, or mortgage loans, then these have been reduced, and to the extent that they have not been reduced, it is has been because of political obstacles rather than because of any belief that the previous system was inherently desirable.

These general trends apply throughout the world, but in Western Europe there is the additional factor that the continent comprises a number of nation states in close proximity, with excellent transport links and, in some cases, sharing a common language and a common legal structure. People move between the countries of Western Europe to a greater extent than, say, they move between Canada and America, or Australia and New Zealand, or between the South American countries. An increasing number of businesses now operate in more than one country in Europe, and some American and Japanese countries view the whole of the European market as a single market, and have a single European headquarters.

These trends have made it more difficult for the countries of Western Europe to preserve whatever special status they may have given to any of their industries, including housing finance, although, as will be seen later, housing finance still remains one of the industries that has been provided and will continue to be provided largely on a national basis.

The European Community Influence

The European Community has an ambitious objective of creating a single internal market by the end of 1992. Everyone knows, of course, that there is no way that this objective can be achieved, but, nevertheless, the 1992 objective has had a galvanising effect in its own right. It is probably the case that by the end of 1992 most of the legal obstacles to the creation of a single internal market will have been removed as a result of agreements between the countries of the Community. There will be no legal obstacles to the free movement between countries of people, of goods, or of capital. However, a single market such as, for example, the United States or Australia, will not have been created because of differences in language, in tradition and, also, the fact that one simply cannot move instantly from a grouping of national economies to one single economy. It is, therefore, not the case that from the 1st of January 1993 national newspapers and radio and television services will have been replaced by European services, or that house building will be a European industry or that there will no longer be national food and drink industries. Rather, the trend towards the Europeanisation and the internationalisation of business will have been given a further significant push.

In this context there is much speculation about the effects of establishing an economic and monetary union. About a year ago there were those who seriously believed that it was possible to create a monetary union within a matter of a year or so; they ignored the lesson of history. There are strong grounds for arguing that Italy has not created a proper monetary union after more than 100 years. There is no possibility of inflation rates and economic activity generally converging in the European countries to such an extent that a monetary union can be created by 1992. At the most recent meeting of the Council of Minister of the European Community, this was recognised and there is now an element of reality in consideration of this issue. The notion that exchange rates would be fixed for all time within a few years, and that similarly interest rates between the Community countries would also be fixed, has been shattered; equally those who believed that exchange rates would be fixed, but interest rates could vary, are now learning that this is, of course, impossible. The European Monetary System, which the United Kingdom is likely to join fairly soon, is not a system of fixed exchange rates, but, rather, a system of managed floating in the short term, with provision for significant variations in the medium term. It cannot be anything other than this until there has been much greater convergence of the economies of the European Community.

In the banking field the European Community has now taken the necessary legislative measures. The Second Banking Directive, agreed earlier this year, provides for the single European licence concept; that is, if an institution is authorised to undertake a particular banking activity in its home member state, it may undertake that activity in every other state of the Community without further authorisation. This provision does require a measure of harmonisation of regulatory action, and this is being achieved through collaboration between the regulatory authorities, principally the central banks. In addition, a Solvency Ratio Directive and Own Funds Directive provide for common rules to be applied on capital adequacy, based on the recommendations of the Basle Committee. These Directives are now being implemented in national legislation.

At first sight the Second Banking Directive, when implemented fully throughout the Community, should remove any legal obstacles which now exist to housing finance institutions operating on a cross-frontier basis. In the case of some countries, for example the United Kingdom, there have been no practical obstacles to institutions from other European countries or, indeed, anywhere else in the world, lending on mortgage. The obstacles to British building societies operating abroad have largely been removed, and further secondary legislation on this is anticipated fairly shortly. In countries where there are mortgage schemes, or savings schemes for house purchase, which involve a significant element of government subsidy, then it is anticipated that non-domestic institutions should be allowed to offer these on the same terms as domestic institutions. It remains to be seen whether all countries in the Community will be willing to implement this in practice, even if they do so in theory.

Notwithstanding these developments, it is not anticipated that housing finance will become an industry at the European level rather than at the domestic level. This is because the nature of housing finance is such that it is bound to remain a national market. A mortgage loan that works in the United Kingdom will not work in France or Germany or Italy because land law, tax law, and so on, are different between the countries. Mortgages are unlike any physical commodity that can be sold across national frontiers with minimal adaptation. There are relatively few examples of cross-frontier operations within the European Community, and the greatest activity is from commercial banks which already have a presence in each of the European countries. Among specialist institutions, from the United Kingdom, the Abbey National has established mortgage lending operations in Spain, Italy and France, in two cases by establishing new institutions in conjunction with local partners, and in the third case by buying a French mortgage institution. More recently the Woolwich Building Society has established an Italian mortgage lending company. The three Danish mortgage lending institutions have all diversified into both West Germany and the United Kingdom. By far the most significant institution in terms of cross-frontier operations is the French Compagnie Bancaire, which has established mortgage lending institutions in a number of European countries, including Spain, Italy and the UK.

It remains to be seen how successful these operations will be. No doubt, like other international excursions by banks, some will be successful and some will be less than successful. It might be noted in this context that not only have the British banks recently been disengaging themselves from retail banking in the United States, but there are now reports that Midland Bank intends to sell its French mortgage lending company.

The East European Influence

Turning now to Eastern Europe, one finds a totally different set of problems. In many respects these are nearer to third world type problems, albeit with people of first world calibre available to solve them.

The first East European housing finance conference was held in Budapest in June. This gave a depressing picture for each of the East European countries. The quality of housing is poor, with the housing lacking amenities compared with West European countries. Much of the housing is owned by public sector bodies, and has been poorly maintained. Rents have been held at an artificially low level, which has led to excess demand and contributed to the maintenance problem.

Owner-occupation is at a high level in many of the East European countries, and, as in third world countries, it has to, to some extent, be used as a substitute for more traditional forms of saving or expenditure. This is particularly true in Hungary where much of the proceeds of the informal economy that developed in the 1980s have been used to construct splendid housing around Lake Balaton. In rural areas there is often a high level of owner-occupation with houses having been handed down within families.

Mortgage lending is on a fairly primitive basis, and generally has been at very low rates of interest, often no more than 3%, regardless of market interest rates or inflation.

The one conclusion that each of the East European countries has come to is that they cannot maintain the present system. The budgetary costs of maintaining the publically owned housing stock and of subsidising mortgage interest rates are unacceptably high. Public sector house building has declined markedly, and it is necessary to free the market so that private developers will provide much needed housing. The massive subsidisation of some individuals through cheap mortgage loans cannot be allowed to continue if only on equitable grounds, let alone cost grounds, and therefore it is necessary to establish a normal mortgage market.

While the objectives are clear, the countries concerned face two problems. The first is that they also have to deal with many other problems, and housing and housing finance tend not to be high on the list of priorities. In Hungary, for example, there is probably general agreement that a functioning telephone system is more important in the short term than an effective housing finance system.

The second problem is the political one. Countries have not previously moved from the command economy to the market economy, and there are no lessons to guide them. Changes which, for example, involve an increase in rents tenfold, or an increase in mortgage rates from 3% to 30%, entail many winners and losers, and are difficult to put through a political system that, as yet, is still finding its feet, and where many of those who benefit from the subsidies are still in significant positions of power. For example, in Hungary an attempt to increase rents significantly and to raise mortgage interest rates from 3% towards the market level of 25% suffered severe political obstacles, and eventually was rejected by the constitutional court. The problem is, therefore, how to move to a free market economy, not whether such a move should be made, and in most of the countries there are not the political skills to achieve this. In some cases old style communists, under a different name, are still in power, and believe that what they have to do is to learn from the lessons of the past, recognise that they have built a great deal of unsatisfactory housing, and move towards building more satisfactory housing. In other cases, ministers who perhaps have spent many years being effective journalists, dissidents or academics, find that taking and pushing through painful political decisions is not their strong point.

Many of the Eastern European countries suffer from the basic problems of third world countries; that is, they have no proper land tenure system, and no effective foreclosure procedures. East Germany has a particular problem with, perhaps, three people being able to claim ownership of a particular plot of land. No East European country has an effective land title system similar to that which is taken for granted in Western countries, and, therefore, lenders cannot be certain that they have security of tenure. In most of the East European countries while there might be, in theory, foreclosure procedures available, in practice these are not usable. In Hungary, for example, the law on foreclosure is not used, and lenders therefore have to rely on attachment of earnings as their security rather than taking possession of the property. There is a recognition that effective land laws and foreclosure procedures do need to be put in place, but, of course, this cannot be done either quickly or easily, as complex legal issues are involved. Notwithstanding the difficulties, priority must be given in the East European countries to getting land laws and foreclosure procedures right, because without this basic provision private house building and mortgage lending industries will not develop. Constraints that now prevent private house building must be removed, and indeed, in most cases they have already been removed. Most of the East European countries have now repealed previous legal provisions which prevented families from owning more than one property, and this should allow for the emergence of a private rental sector.

A financial framework has to be developed which allows mortgage lending to exist tapping retail savings. Major problems are inflation and uncertainty as to the tax system. Until these problems are dealt with effectively, significant private sector housing finance institutions will not develop and to the extent that the housing market is to be privatised, this will have to be on a somewhat third world basis, with people using informal methods and their own savings in order to build and acquire housing.

In practice, one suspects that there will not be an easy transformation from public sector housing to private sector housing. A number of radical options are being looked at in this context. In the Russian Republic, for example, there is the suggestion that the problems of public sector housing are so great that the best thing to do is to give the housing to the tenants. Whether, however, the tenants are willing to accept ownership of flats in large tenement blocks with considerable uncertainty as to how the structure of the building is to be looked after, in exchange for no longer paying a minimal rent, is rather open to question. Many Western countries have grappled with the same problem, and found no answer.

However, it should be possible for a private rental sector, and new private house building, to develop very quickly because these require neither a long time scale nor a significant capital investment.

East/West Interaction

There are naturally those who say that it is for the West European countries to help the East European countries in respect of housing and so many other things. In practice, however, there are limits to which this can be done, and in this context one has to leave aside entirely the special position of Germany. Poland, Czechoslovakia, Hungary, Bulgaria, Romania and the Soviet Union do not need a significant investment of Western capital in order to build new housing, and if they had such an investment the chances are it would be as ineffective as some of the old style investment in the third world countries.

What the West can offer is information on techniques used in the Western countries and the way the markets operate. These need to be fully understood in the East European countries where totally new systems are being established. If mistakes are made at the outset, for example, if land law is not right, then there will be a very heavy price to pay in future years.

Western systems cannot be simply transported to Eastern Europe and established; the precedent with trying to do this in developing countries has not been a pronounced success. The East European countries must, where appropriate, build on what they have got, and take elements of Western systems where these are appropriate. As the Budapest conference showed there is no shortage of very able people in Eastern Europe who already seem to have a remarkable grasp of what has been happening in West European countries.

Conclusions

In West European countries, trends over the next few years will be much as in the past few years. In those countries where there are still regulations governing the activities of particular financial institutions and the way in which mortgage loans can be granted, then those regulations are likely to be removed completely, or eased significantly. Transborder operations will continue to develop, although even in five or ten years time they are likely to remain relatively small scale in relation to the size of national markets.

It will be in Eastern Europe where exciting things will be happening. It is already clear that the obstacles are not what has to be done, but, rather, how to do it, and this will require not so much skill in housing finance, but, rather, political expertise on the part of those entrusted with implementing the reforms of housing finance. If anything, there is already far too much knowledge and in some countries there are half-a-dozen different groups all claiming to be developing government housing policy, and, no doubt, in accordance with tradition, they will begin to see each other as the enemy rather than see the existing housing problem.

The success stories will be in those countries where politicians with intelligence and drive are able to see what will work and to implement it against very fierce opposition from vested interests. There will be some success stories, but equally it is clear that there will be many false starts.

The international community, and here the International Union must play a major part, can greatly help the East European countries by continuing to disseminate information about systems, techniques, best practice, and increasingly, also, the experience of the East European countries in establishing their own unique housing finance systems. The Budapest conference marked an important begin-

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ning in this respect, but it is only the beginning, and much more needs to be done in the years ahead. ■

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sustainability and viability of the environment of planet Earth. In a similar conference held earlier in Stockholm, Sweden in 1972, the planning, organization and management of human settlements was the subject of priority discussion and was the occasion where the "poverty is pollution" phrase was first used. While the Conference produced important measures for human settlements improvement and financing unfortunately these have not been pursued. Perhaps Rio in 1992 will produce new sparks for international action for this sector. ■

NOTES

[1] Housing Finance International carried a full report by Mark Boléat in the August 1990 issue .

This is the text of a report presented by Luiz Eduardo Pinto Lima, Chairman, Housing Finance Development Committee of the International Union of Housing Finance Institutions at the Asia Pacific Federation meeting in Bangkok in September.

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nks, has been able to develop very profitable regional operations, with Latin American and Asia being the best examples. Again I believe this reflects its lack of local oligopoly dragging down its competence away from home base.

Another Northern Hemisphere exception might be Deutsche Bank, mainly because it does not seem to be under any great pressure at home due to both the relative strength of its oligopoly its East European opportunities. The main group of banks that I believe will stay can be classified as ones within our region, the Japanese banks, Hong Kong Shanghai Bank, Bank of Singapore, Bank of China. There is some regional logic to these being here and many of them are under less pressure at home when compared to the Northern Hemisphere banks. In addition, Asian banks as a generalisation seem to be more patient than their Northern Hemisphere counterparts. The will need to be! Nevertheless as a group, the foreign banks will be a totally insignificant force in the future.

Did the foreign banks serve a purpose? There is little doubt that they served their role as stimulants to competition, but now that most have fallen by the wayside, it is apparent that there is a danger of the oligopoly increasing its power. This is well illustrated by the posturing by NAB for control of the ANZ prior to the last election and the Treasurer's disapproval of this idea. What the Treasurer seems to have indicated in that matter is that he wants the big 4 incumbents to remain intact. While his dilemma is understandable, it does have the undesirable consequence of taking away the discipline posed by the threat of takeover from a competitor. Banks are already protected by the Bank Shareholders Act and for the big 4 to be immune from takeover really puts them into a privileged class again with some similarity to the pre-deregulation period.

I believe that the foreign bank era is now over, the main hope for competition for the banking oligopoly is competition from the insurance oligopoly. This comes from the fact that banks and insurance companies are able to compete in each other's backyards.

To me this sort of green fields cross competition is the best way to handle the fact that for better or worse, we are stuck with two powerful oligopolies in the financial sector. This competition has worked well, so well that members of each oligopoly seem to have decided to bury the hatchet and combine. Thus the NM/ANZ merger proposal. To me this is hardly conducive to competition and efficiency. I believe it would be far better for both oligopolies to be encouraged to compete against each other via competition; that reflects green fields internal growth rather than anti-competition purchases of market share in each other's patch.

So it seems to me that deregulation and competition have well and truly passed the peaks of their influence. We still have four very powerful, but admittedly much more efficient, incumbent banks plus ominous signs of anti-competitive behaviour between our banking and insurance oligopolies. I believe that these trends pose major policy issues. ■

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