Inflation, Housing Markets and Lending: Emerging European Concerns

by Duncan Maclennan

CONTINUING ECONOMIC CHANGE

It has become apparent over the last five years, at least in Northern Europe, that housing markets have a considerable capacity to shape and reinforce both the boom and the bust phases of the economic cycle. Usually, however, the housing market reacts to rather than leads economic progress and policies. In consequence, both borrowers and lenders now face a constantly changing decision-taking environment.

During the 1980s housing markets and finance systems throughout Europe have had to adjust to capital market changes in the post-oil shock era. Adapting to inflation and then coping with financial deregulation were obvious challenges to mortgage lenders and they were met in a supportive environment for housing markets. The long 1980s boom in European incomes, relatively high household formation rates and rising tax subsidies for homeowners created conditions in most countries for both the ownership share to expand and house price increases to outstrip inflation.

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The 1990s have, so far, been very different. The majority of European markets have been at best sluggish and at worst contracting sharply as fiscal and monetary policies bit deeply into consumer spending and housing activity. For some countries, such as the United Kingdom, Sweden and Finland, the housing market recession has been protracted and painful. In others, such as Belgium and Germany, recession has passed swiftly.

There are few countries, however, where housing market recovery rates have been as fast (in terms of construction growth, turnover and price increases) as in previous cyclical upswings. Does this merely reflect the deep recession of the early decade, with consumers restoring savings balances (for savings rates have increased in all the major European economies since 1989) before resuming housing and other spending? Hangovers may take a little time to cure!

Or is there some more fundamental structural adjustment taking place in national housing markets as the world economy changes? During the 1990s European businesses, then governments and now consumers have become acutely aware of the economic consequences of growth in the emerging economies of the Pacific Rim and Latin America (the NECs).

There is now a recognition that unskilled labor in Europe, at present wage rates, has a reduced capacity to compete with the NECs both in low-skill manufacturing and semi-skilled services. At the same time, growing income in the NECs, and a rising demand for skill intensive imports, offers the prospect of job and income growth in Europe as long as European economies can compete effectively with other advanced economies.

In order to forestall job loss in the unskilled sector and to raise the prospect of skilled job gains, European nations have, broadly speaking, embraced broad economic strategies for competitive disinflation. The implications of this approach have, for the medium term, potentially unsettling implications for European housing systems. The strategy may, however, provide a more robust long-term base for housing and economic progress.

COMPETITIVE DISINFLATION

In order to secure national economic interests, competitive disinflation requires:

- a permanent reduction in inflation rates;
- more flexible labor markets;
- increased efforts in training and education;
- reduction in public deficits and restraint on

tax rates (unless higher taxation is reflected in profit-enhancing investment in infrastructure, education etc.).

In the European context it is apparent that "competitive disinflation" strategies are also consistent with the macro-policy actions required to meet the Maastricht convergence criteria. Although the UK was the only European Union nation to grasp the nettle in the early 1990s, there is now a wider emphasis on raising labor market flexibility, as European unemployment has remained persistently high and more than double the rate of other OECD economies, with Spanish (20%) and French (12%) now at worrying levels.

If competitive disinflation strategies are implemented, then key economic variables which impact the housing sector may change. European GDP per capita may be raised in the long term but is likely to grow slowly in the short term. In the long term, income inequality is likely to increase (as it has already done in the UK) with bottom half wage rates stagnating relative to the average. In all sectors, skilled and unskilled, public and private, more frequent job changes and income disruption are likely. Public and private education/training costs are rising and likely to continue to do so. Public policy expenditures will be scrutinized.

Lower inflation will induce more real decision taking, and real interest rates will be adjusted to avoid boom and bust tendencies likely to damage productivity growth paths. Higher real interest rates are likely until inflation is "squeezed out" of the European economies. This is a broad-brush picture and the extent of strategy fulfillment and specific impacts will differ across countries. Germany and the Netherlands face different challenges from Greece and Portugal and, as always, Britain and France will have a different emphasis.

These changes require adjustments in housing systems. Increased inequality has obvious implications for social housing and housing allowance bills. The latter have already risen markedly in the UK, France and the Netherlands. In due course, redesigning existing systems will become the major housing challenge for housing policies. But at present, housing adjustment to the new economic order is most obviously manifested in owner-occupied markets.

Two key structural adjustment issues arise. First, has housing finance deregulation and housing tax policy change now begun to create a context, unlike the 1970s or 1980s, within which mortgage rates more fully adjust to inflation? Secondly, have housing policies and lending decisions adapted to the increased uncertainty and shifting distributions of income associated with flexible labor markets? Why does competitive disinflation matter for housing markets?

REDUCING INFLATION MATTERS

At present, nominal house prices in Europe are significantly higher in most countries than a decade ago. In 1993 Danish prices were just 2% more than in 1985, but in Greece and Spain the rises were, respectively, 214 and 156 (1985=100). These nominal increases helped homeowner borrowers, as higher inflation generally was associated with non-fully adjusted mortgage rates.

The inflation boost to homeowners, where mortgage rates do not rise fully to compensate savers for inflation, is illustrated, for the UK in Tables 1 and 2.

With mortgage debt fixed in nominal terms and earnings growing with inflation, inflation quickly reduces mortgage payment to household income ratios. (See Table 1.) Similarly, rising nominal house prices quickly reduce the loan/owner equity ratio. (See Table 2.)

In general, rising nominal prices and house prices (which are, unsurprisingly, correlated in most European countries) help lending activity because inflation:

- reduces the prospect of borrower arrears;
- reduces the prospect of lender losses on loan default;
- facilitates trading-up without recourse to current incomes

and this helps homeowners and lenders alike.

Macroeconomists could quickly and correctly point out that in a country higher than average inflation would probably mean increases in unemployment. In a world of complete homeownership, then, inflation would also have raised the likelihood of owner job loss and income loss, leading to arrears and default. However, prior to 1980, job loss was focused on the unskilled and, at least in Western Europe, job losers were concentrated in rent-controlled homes, in social housing or had access to means-tested housing allowances (after the mid-1970s). Public housing ensured the relative stability of owners' incomes in inflating housing markets.

Table 1.
Rising Incomes and Their Impacts on Mortgage Debt Repayments in Household Budgets, UK

Holding Period of Loan	*Initial Mortgage Payment/ Income Ratio*	*Mortgage to Income Ratio at the End of the Period*
1969–72	11.1	8.1
1972–76	12.3	8.0
1975–79	14.7	10.2
1979–83	15.9	10.4
1984–88	15.1	11.1
1989–93	21.8	10.9
1990–95	25.2	17.1

Source: CML Statistics

This housing system-labor market mesh, however, is now changing.

Real house prices matter as well as nominal increases. Their path since 1985 has varied geographically and cyclically in Europe. There is obviously no single European housing market. Real prices in Denmark in 1994 were 20% less than a decade before, Italy reports (from 1984 to 1992) zero gains but real gains of 54% and 39% were experienced in Spain and Belgium respectively.

Real house price increases, by reducing the user cost of capital, boost homeowner demand, and both the volume and value of lending. At the same time, as northern European experience shows since 1989, they may also shift market activity patterns in a cyclically reinforcing pattern. They also obviously influence real wage claims and may shift wealth-reward-effort patterns in ways which do not facilitate export-oriented investment and national economic competitiveness.

CYCLICAL INSTABILITIES

I have now mentioned price cycles several times; it is important not just to consider index changes over a 10- or eight-year period but to consider year-by-year evolution patterns. The charts which follow are based on the increasingly useful EMF Annual Report.

Some countries have experienced persistent nominal increases, both low and high, since 1985. (See Figure 1.)

Others, especially the northern countries, have experienced both increases and decreases. Denmark is remarkable for protracted nominal house price stability. The real price changes for the countries are depicted in Figures 3 and 4.

The 1990s have until now been difficult in most European countries. In many there have been one or two years of falling nominal house prices, particularly in major metropolitan centers which over-heated at the end of the 80s boom. It is the national markets with falling nominal house prices, however, which have experienced most difficulties and questioned past lending and borrowing decisions. (See Figure 2.)

These countries have faced major market disorder:

- loan arrears and management costs rose;
- fiscal support costs for unemployed owners rose sharply;
- default and possession rates increased, with forced sales further depressing prices;
- lenders margins have risen and consumer confidence in homeownership has been damaged.

Table 2. Inflation and Changing Housing Debt/Equity UK

Holding Period	*Initial Equity*	*Loan*	*Equity at End of Period*	*Loan to Equity Ratio, End of Period*
1969–72	857	3240	2845	1.14
1972–76	1131	4954	5227	0.98
1975–79	2257	7292	6845	1.07
1979–83	3632	11286	8227	1.37
1984–88	3388	18786	17021	1.10
1989–93	6798	32950	14647	2.25
1992–95	7759	38801	7120	5.45

The macroeconomic policy scenarios involving higher mortgage rates to reduce inflation and reducing fiscal support for homeowners represented the first steps towards the competitive disinflation path. The higher the rate of inflation, the greater was the required interest-rate rise; but characteristics of housing and mortgage markets also shaped the housing and economy consequences.

Clearly the impact on economies and housing markets depended on:

- the share of residential mortgage debt to GDP (which varies from 6% in Greece and Ireland to 10 times that share in Sweden, the UK and the Netherlands);
- the extent to which post-tax mortgage rates followed general interest rates;
- the proportion of variable- as opposed to fixed-rate debt (contrast the UK and Denmark, for example);
- the ratio of loan/owner equity for new and recent entrants;
- the size of "shock-absorber" rental sectors;
- the extent to which unskilled/semi-skilled owners have mortgage debt.

The UK and Finland, for example, score badly on all of these criteria; Germany and Italy much less so. But for all countries this experience raises the question of how reduced inflation and increasingly flexible labor markets will impact housing and lending choices. Ownership growth means that owner occupation is no longer the preserve of "safe" earners.

LENDING AND BUSINESS PROSPECTS IN THE ADJUSTMENT PERIOD

This poses key questions for the future:

- Have government policies and tax incentives encouraged too rapid a growth in ownership for households whose problem is now insecure, rather than below average, income?
- If labor market flexibility spreads, will it disrupt income flows for all income groups; is this insecurity catered for and appropriately priced in mortgage insurance arrangements?
- As labor market entrants face wages falling relative to established workers, and as mobility and educational costs rise, will owning become less attractive/feasible for younger households?

In the short to medium term, it is likely that housing market activity and lending will grow less rapidly than in previous upswings, as economies adjust to competitive disinflation. In the longer term, of course, rising real incomes will support the market and growing numbers of households. In adjusting countries, however, falling fiscal support for owning, deregulation of and new support for rental markets, reduced real and nominal inflation rates, labor market flexibility and reduced equity withdrawal will all reduce the demand for new loans by younger households (even if ownership grows with aging).

In this context, reduced market instability would reduce lenders' risks but lower inflation and labor market change will increase them. This will involve lenders in:

- more detailed, costly credit screening;
- developing more flexible mortgages and revised insurance arrangements.

In consequence, margins for lenders are likely to be squeezed and subject to acute competition in smaller volume markets.

Figure 1.

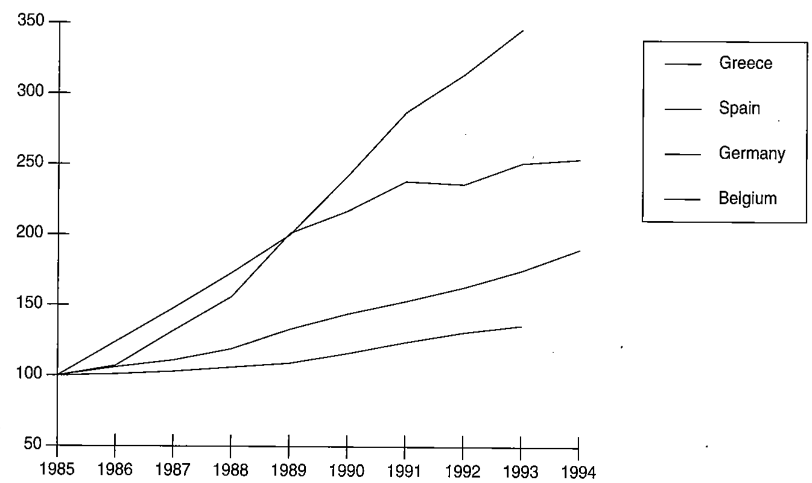
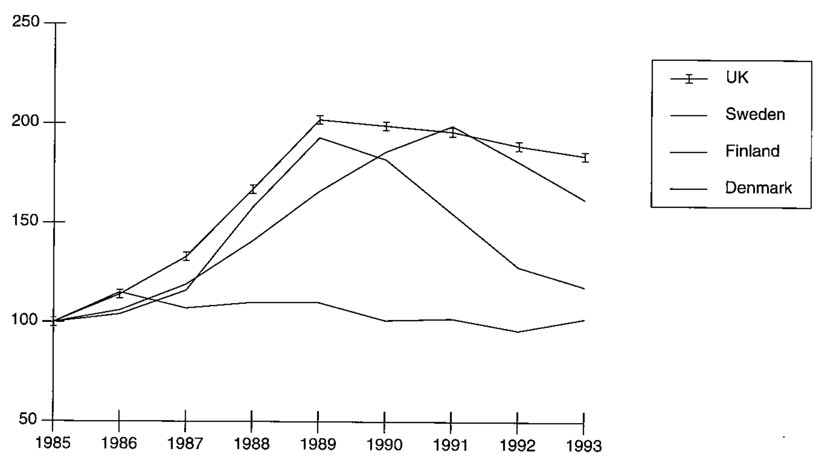


Figure 2.



There are likely to be a number of key elements in lender business strategies over the protracted adjustment period:

- review of credit rationing and "bad-debt" management strategies;

Figure 3.

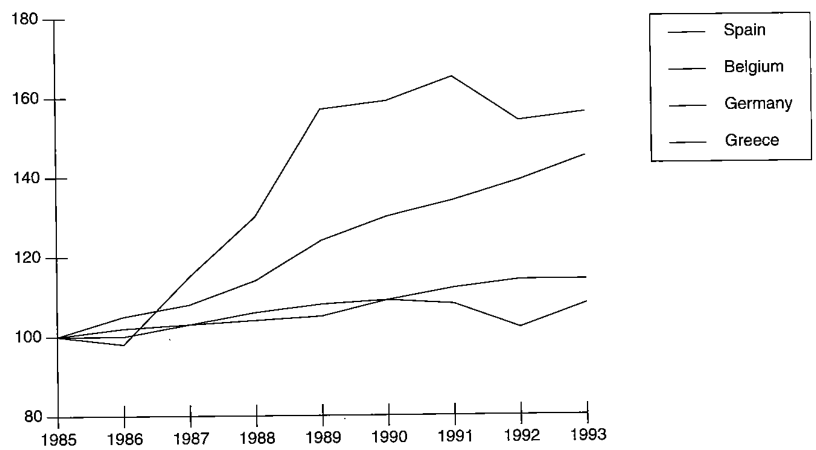
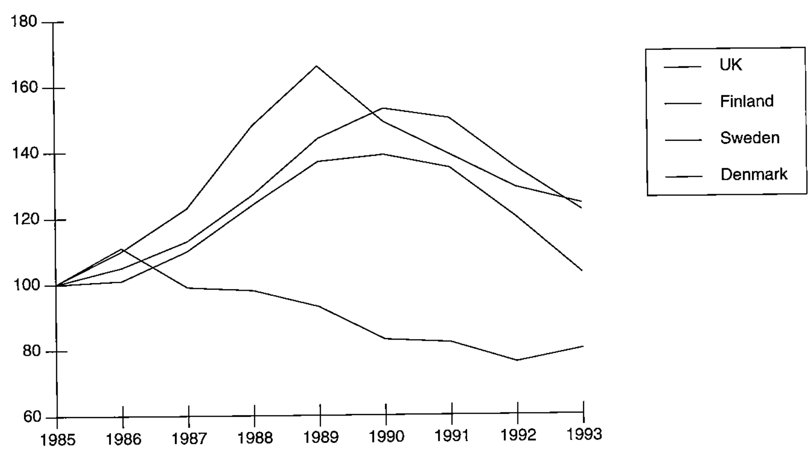


Figure 4.



- domestic mergers to secure economies of scale and portfolio diversification;
- diversification, where it does not already happen, into financing rental housing, including refinancing social housing;
- growth of reverse mortgages as governments reduce old-age support;
- diversification across financial services;
- cross-national mergers and business purchases both within the EU and into the emerging Central European countries.

Any real moves towards a single currency in Europe will be likely to accelerate such tendencies.

CONCLUSION

There is little prospect of a re-run of booming housing markets of the 1980s. With competitive disinflation strategies, there will be no rosy false dawn offering illusory progress. Global competition imposes global economic realities. These can be harsh, but they offer real prospects for economies and individuals that seek adjustment.

If governments hold to competitive disinflation strategies then it can be expected that:

- households will increasingly pay the real, market cost of housing;
- mortgage rates will follow general capital market pressures and have better assessed risk premiums;
- European ownership rates for the under 30's will not grow;
- ownership entry will be slower and later, that is postponed rather than cancelled;
- average national real house price gains will be minimal; economies cannot withstand their negative impacts on competitiveness, but clearly there will be regional/sectoral differences;
- there will be fewer, larger and European-wide lenders.

These conclusions are speculations. They are bound to be wrong in some way. They pose questions, however, to which housing lenders will have to find the correct and profitable answers.