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THE IMPACT OF THE ECONOMIC AND MONETARY UNION ON THE HOUSING MARKET

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The housing market in Portugal has notched up a remarkable growth since the early 1990s, in line with the development pattern of the overall construction market. The new residential housing sub-segment has been the one that experienced the highest growth in this period. One of the catalysts of the impressive outcome in this segment of the construction market was the transformation operated in the financial system, which intended to be consistent with the process of European convergence. However, in the last two years the pattern has shown signs of flagging owing to excess supply, particularly in the owner-occupied housing tenure.

This paper discusses the impact of the Economic and Monetary Union- EMU on the housing market. Secondly, it analyses the development of the housing market from the early 1990s. Finally, it attempts to establish future trends and discusses the ways to tackle the unfavourable conditions pertinent to the housing market.

The paper argues that in order to face the demands of the Economic and Monetary Union, policy changes pertaining to the housing market and related economic sectors are needed.

Keywords: Construction market, EMU, Housing market, Portugal

INTRODUCTION

The Portuguese economy has notched up seven straight years of impressive economic performance. Output growth has averaged 3.5 per cent per year on a GDP basis in the period 1994- 1999. This development is in line with the positive economic conditions that commenced in 1986 – the integration of the country into the EEC-, bringing GDP per capita, measured in Purchasing Power Parities, to 69.4 % of the European Union average in 1997 from 53.2 % in 1985 (Banco de Portugal, 1999).

Growth has been reflected in considerable employment gains and increase in labour productivity. Growth in exports has been remarkable and investment has increased significantly, stimulated by both government spending and private investment.

The construction sector has played an important role in the country's economic performance, representing 6.7% of GDP and contributing 11.2 % to total employment, with 64,308 either small or large enterprises in the industry in 1999.

The period from mid- 1980s onwards has witnessed several changes, within the construction industry and the related property sector, at both national and international

levels. As pointed out by several writers (Dehesh and Pugh, 1998; Magalhaes, 1999), one major feature of the international economic change has been the globalisation in financial markets. In Portugal, these developments, coupled with step-by-step reform measures in the financial system (to a large degree spurred by EU directives, OECD, 1999) and EU transfers, had a major positive impact on the construction and property sectors. As regards the latter, the changes in the general environment, increasing per capita income, urbanisation in the metropolitan areas (particularly the developments of the EXPO 98, in Lisbon) spurred the development of a more modern property sector similar to those prevailing in the more advanced markets of the European Union. These have also influenced the changes in the management policy and organisational structures of the construction companies to cope with the requirements of international investors, and the changing pattern in the demand for residential housing.

This paper discusses the impact of the Economic and Monetary Union- EMU on the housing market. Secondly, it analyses the development of the housing market from the early 1990s. Finally, it attempts to establish future trends and discusses the ways to tackle the unfavourable conditions pertinent to the housing market.

THE IMPACT OF THE EMU ON THE HOUSING SECTOR

In 1985, a gradual reform of economic policy began in Portugal, which ultimately led to the participation in the Stage Three of the Economic and Monetary Union in 1999. This development took place in two periods, with different impacts on the construction and housing markets:

- i) the period from 1985, one year before the admission of the country to the then EEC, to 1992 - the participation of the Portuguese Escudo in the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS);
- ii) the period between 1992 and 2000.

The first period is characterised by a gradual shift in resource allocation from state control to the market mechanism, and the recognition of macroeconomic stability as prerequisite for sound economic growth, reflecting the European and national consensus on these views (Banco de Portugal, 1999). According to the requirements stipulated in the European Union Treaty, the fulfilment of the conditions for the adoption of the single currency should be based on two fundamental elements: i) the compatibility of the national legislation of a participating member, including the statute of its central bank, with the treaty; ii) the achievement by each member state of a 'high degree of sustainable convergence' based on four criteria: the achievement of a high degree of price stability; the sustainability of the government position regarding public and fiscal deficits; the observance of the normal fluctuation margins provided for by the ERM of the EMS; and the durability of the process of convergence reflected in the nominal interest rate levels.

The Portuguese authorities adopted a monetary policy strategy in which exchange rate stability was a key component in achieving price stability. Thus, the depreciation of the Portuguese Escudo was progressively reduced and the exchange rate of the Portuguese currency started being defined, since 1990, in relation to a group of currencies participating in the ERM of the EMS. As can be seen in Fig 1, the nominal exchange rate of the Escudo appreciated significantly from 1990 onwards despite some turbulence

in 1992-1993, which coincided with the EMS crisis and a fall in output in the Portuguese economy in 1993.

On the other front, a progressive programme of privatisation was started at the end of 1980s, in parallel with a reform in the financial sector. The significant changes in the financial system, with a progressive liberalisation in the capital markets, played a major role in the country's economic performance and impacted directly and indirectly on the housing sector.

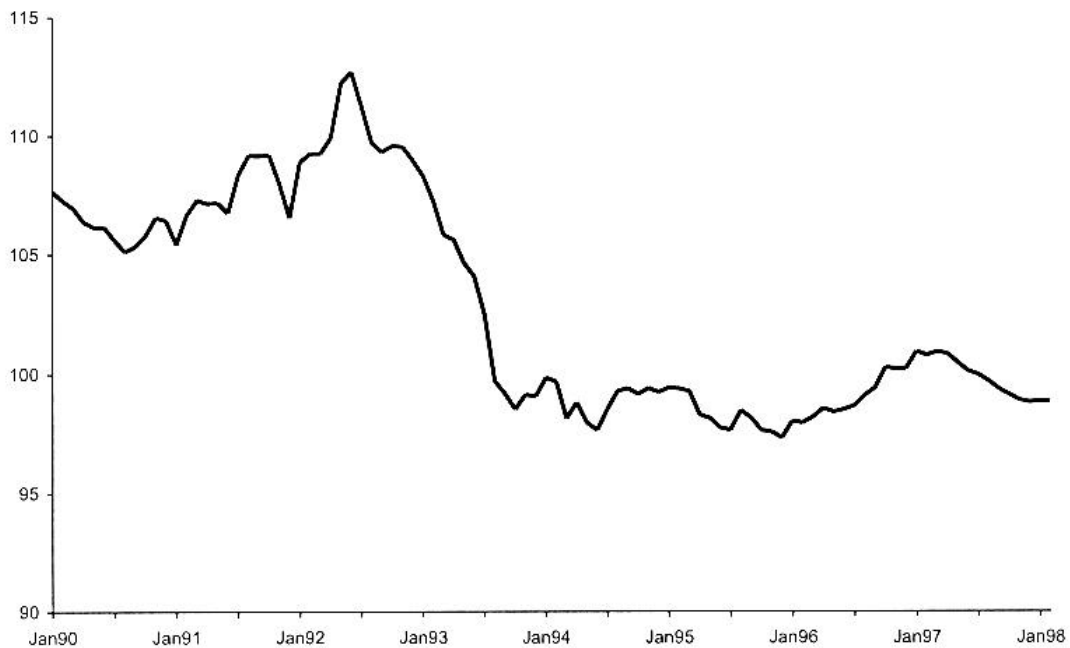


Fig. 1: Nominal Exchange Rate of the Escudo against ERM currency

Source: Banco de Portugal, 1999

However, the important effects of the EMU on the construction and housing sectors in this period were mainly felt at the supply-side. Indeed, the increased international competition for construction works particularly those that stem from the national public sector and international investors, added to the decrease in the rate of inflation, had an important effect on construction costs and on the organisation of the national construction enterprises. On the other hand, the development of the country's infrastructures financed partly by European Union transfers, within the First Community Support Framework 1989-1994, created the necessary conditions for the establishment of a modern property market in the metropolitan areas of Lisbon and O'Porto.

In the period 1993-2000, the concern of Portuguese authorities as regards economic policies were aimed, mainly, at the achievement of a low level of interest rate with a simultaneous low level of inflation. This was undertaken to ensure a steady movement towards the participation of the country as a full member of the EURO region. As an indication of the country's performance in this area, Fig.2 shows that the mortgage interest rate decreased sharply to the lowest levels prevailing in the European Union

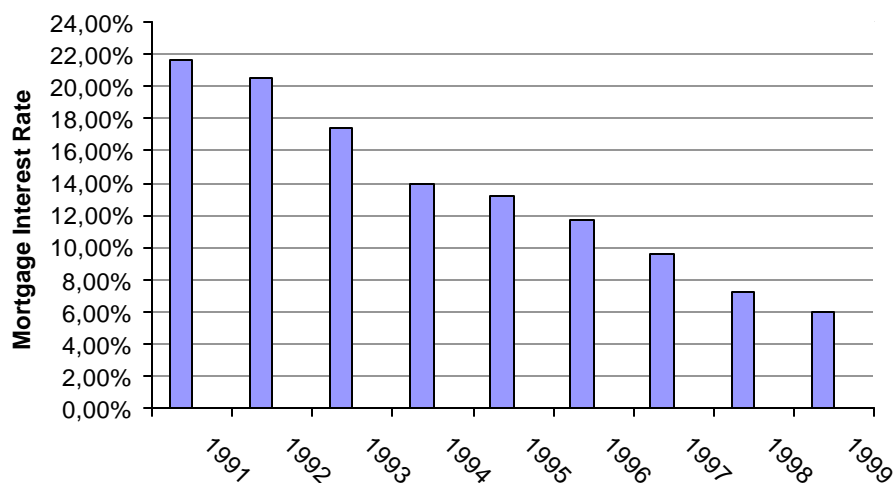


Fig. 2: Evolution of the Mortgage Interest Rate

Source: INE (Monetary and Financial Statistics)

With regard to the deflation process, according to the figures provided by the National Institute of Statistics (INE, 1998), the rate of inflation measured by the national CPI decreased 11.2 percentage points in the period from December 1990 and December 1997. At the end of this period, these figures translated to the Harmonised Index of Consumer Prices (HCPI) led to the under 2% limit stipulated by the European Union. Furthermore, the ambitious privatisation programme helped to improve the indicators of the government financial position (privatisation revenues averaged more than 2% of GDP per year, OECD, 1999). This programme also stimulated product market competition and productivity gains, particularly on the booming financial sector services.

These positive developments coupled with the fierce competition between banks and other financial institutions as regards mortgage credit had a strong impact on the development of the housing sector in this period. The participation of banks and other financial institutions in the capital of, or joint venture with, major construction companies boosted the market diversification of the latter onto the property sector. At the demand-side the impact of the EMU on the housing sector was also significant, particularly in the later years of the period. The non-residential segment experienced a strong increase owing to the booming in the capital market and a sharp fall in interest rates, coupled with the surge of international companies in the Portuguese market. The new residential segment was the one that grew at the fastest rate in the period 1992-2000. The easing of monetary conditions and intense competition between different financial institutions made the mortgage credit very attractive, particularly for low-income households and young people, who were eligible for mortgage subsidies provided for by the government. Mortgage credit in 1999 totalled PTE 2,508 billion (1 Euro = 200.42 PTE- Portuguese escudo) for 235,000 contracts, an increase of, respectively, 17.4% and 6.5 % over the 1998's values (SEH, 2000). The number of building permits increased from 52,705 in 1994 to 62,930 in 1999 (INE, 1993-2000).

THE EVOLUTION OF THE HOUSING SECTOR

As noted earlier the evolution of the housing sector (residential and non-residential segments) has been in line with the development of the overall construction market, which, in turn, has been influenced by the process of European convergence. The structural funds channelled from the European Union within the Community Support Framework have also impacted positively on the country's global economic performance. Fig. 3 shows that since 1986 (the integration of Portugal into the then EEC), gross domestic product (GDP) and construction value added (CVA) increased significantly in the period 1986-1999 despite a fall in 1992-1993. It also shows that the CVA growth rate was greater than that of GDP, particularly in the late years of the period.

The civil engineering segment was the driving force behind the economy in the period 1986-1997, and since then the residential housing sub-segment has been ranking first in the overall growth of the construction market.

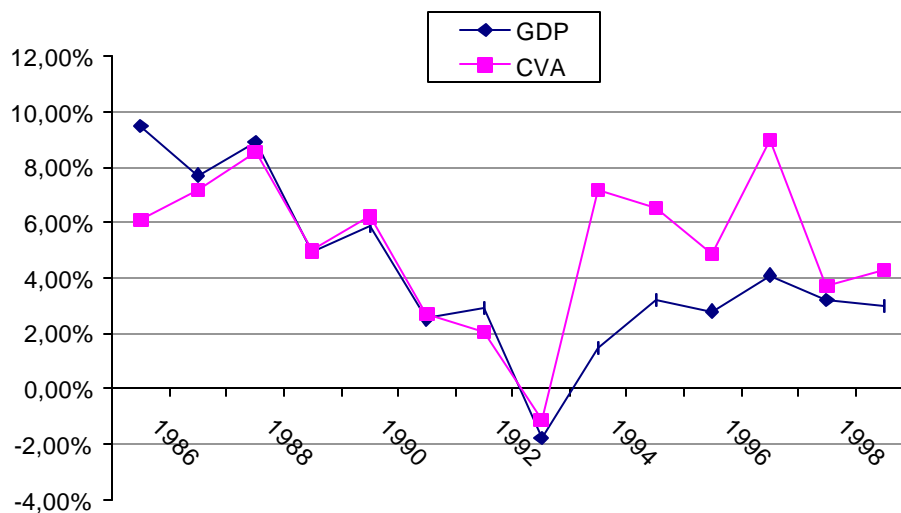


Fig. 3: Evolution of the growth rate of GDP versus CVA

Source: INE (Quarterly National Accounts)

As regards the structure of the construction output, Table 1 shows that new residential housing was by far the fastest growing sub-segment of the construction market. No one EU member country (even Ireland) has been able to match this outstanding performance in this market sub-segment. On the contrary, the R & M sub-segment (7.2 % of total output) was the worst performer among the Euroconstruct countries (Table 2). Although the R & M figures from Portugal might be under-reported (AECOPS, 2001) they reflect somewhat the structural imbalance of the construction market, let alone issues concerning the availability and reliability of data. It is also worthy of being mentioned that the R & M data from Euroconstruct concern only the building segment of the construction market.

Table 1- Gross Production Volume in Construction (% change over preceding year)

	1996	1997	1998	1999	2000
Residential Housing	3.0	11.6	9.0	9.0	7.0
Non Residential Housing	3.7	10.4	0.3	0.6	2.3
Civil Engineering	5.9	15.5	5.0	0.0	2.5
GPV Sector Companies	3.9	12.4	6.0	4.8	4.9
Other construction Works	18.7	23.2	4.9	3.5	5.4
Total	6.4	14.4	5.8	4.5	5.0

Source (AECOPS, 2001)

Table 2– Structure of Gross Construction Output in Portugal and in Euroconstruct Countries (%): 1998 - 2000

	Residential Housing	Non Residential Housing	Civil Engineering	Repair & Maintenance	Total
Portugal	49.2	17.2	26.4	7.2	100
Euroconstruct (average for 15 countries)	23.9	19.5	20.6	36.0	100

Source: AECOPS (2001)

The evolution of the housing market sub-segment can be better perceived using data on building permits issued by local councils. It can be seen that the number of building permits increased significantly in the period 1990-2000, particularly since 1992. The number of licence permits on new dwellings was the one that experienced a more marked growth in the period. Table 3 also shows that there was a decrease on licence permits both on new construction and new dwellings, as well as in total buildings in 1999-2000, and according to the latest figures available, this is also the trend for 2001. Taking into account the Portuguese housing stock (3, 2 million dwellings for habitual residence), a supply of more than 100 thousand housing units per year is unsustainable for the near future.

Table 3- Evolution of Building Permits ('000)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Total	59.05	62.92	47.22	48.57	52.71	50.93	51.76	54.71	59.57	62.93	59.59
New construction	34.93	36.66	27.19	27.77	31.56	31.62	32.52	35.54	40.03	43.99	42.18
New Dwellings	-	-	-	-	73.40	77.48	84.99	95.83	108.83	119.38	113.21

Source: INE (Housing and Construction Statistics)

FUTURE TRENDS AND CONCLUSIONS

There is a prospect of a decelerating pattern in the rate of growth for the overall construction market in the near future. The brightest prospect is for the civil engineering segment, as the development and upgrading of major infrastructures will be undertaken in the next few years. For example, the stadia and related infrastructures for the EURO 2004, the O'Porto METRO, the new Lisbon Airport, the conclusion of the Alqueva dam, the renovation of the railway network and the development of motorways in the concession regime. Some of these infrastructures will be financed partly by the structural funds received from the EU within the Third Community Support Framework 2000-2006. This macro-programme envisages a total investment of PTE 8,460 billion, spread over a seven-year period. Construction investment will represent an important share of this amalgam of programmes and projects. At the national level, the POLIS programme -urban renewal programme - consists of the urban renewal of 18 major towns. This programme will contribute to the to the growth of the civil engineering segment as well as to the non-residential housing segment. Further development of the latter market segment will depend on the country's overall economic performance and the behaviour of the capital markets. As regards new residential housing, there is a prospect for a decreasing growth in this segment due to excess supply and the rising house prices, coupled with the recently (1999) tightened eligibility requirements for mortgage subsidies. As regards repair and maintenance, the prospect is for an increasing growth, as this market segment represents only 7.2 % of the total construction market compared with 36% for the average of the European Union (AECOPS, 2001).

The impact of the economic and monetary union on the housing market in Portugal has been positive, and the process of monetary integration has influenced both the demand for new housing and the organisational structure of the construction companies. Despite the somewhat bright prospects for the period 2000- 2006, the challenges facing the housing market in Portugal are enormous due to the Government's commitments regarding public and fiscal deficits, and excess supply in the new residential housing sub-segment, which is unsustainable for the near future. These problems are aggravated by the fact that the responsibilities for exchange rate and monetary policies, as in any country in the EURO area, have shifted to the European Central Bank. On the other hand, the recent legislative measures with the aim at stimulating the initiatives

concerning the rehabilitation and modernisation of specific ageing residential parks, in particular in the metropolitan areas, added to the lowering of value added tax in R & M construction works, will undoubtedly contribute to the development of this sub-segment of the housing market. Another important measure envisaged by the Government to enhance the development of the property market is the abolishment of the conveyance tax on property, and its substitution by a reduced VAT. It remains to be seen, however, whether the European Union authorities approves the latter measure.

The Government effort to promote an efficient housing policy has resided on the demand side, and particularly on its preference for a policy based on subsidies (AECOPS, 2001): fiscal and loan subsidies for the owner-occupied housing tenure; and subsidies for the social rented housing. It appears that a more markedly market driven approach, particularly an integrated approach that sees the construction market as a “complex” of varied and inter-related segments, and the regulation /clarification of different participants in the industries pertaining to the built environment is a primary step to overcome some of the drawbacks of the housing sector.

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