Speech

Second Deputy Governor of the Riksbank Eva Srejber

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The property market and economic developments in Sweden

SABO Byggnadsförsäkrings AB

Introduction

To begin with, I would like to thank you for the invitation and opportunity to talk about the Swedish property market. On the part of the Riksbank, there is good reason to follow developments on the Swedish property market both from a monetary policy perspective and from a financial stability perspective.

The property market is interesting from a monetary policy perspective, inter alia because house prices and the value of households' property ownership affect household consumption and savings. Just over 1/3 of household sector wealth is comprised of single-family dwellings. Saving in property is the largest type of asset for households. Property also serves as collateral for loans, which is why, for example, rising property prices increase the scope for households to take loans and this affects demand on a national basis. A well-functioning residential property market is also important to mobility on both the residential property and labour markets, which in turn is important to avoid subduing economic growth.

From a financial stability perspective, developments on the property market are important because the banks, which play a central role in the payment system, are exposed to the property sector both through lending with property as collateral and through lending direct to property management companies.

Telefon	Telefax	E-post
08-787 00 00	08 - 21 05 31	registratorn@riksbank.se

The information supplied by the major Swedish bank groups with regard to their credit stocks shows that approximately 20 per cent of lending to the general public consists of lending to property management companies and the construction industry. If one adds mortgages to this, lending to the property sector comprises almost half of the bank groups' lending to the general public. These circumstances, plus the fact that bank crises around the world have often been preceded by rapidly rising property prices, combined with a large credit boom, motivate a special analysis of the property sector.

As you know, the property market consists of several sub-markets. In addition to the single-family dwelling market, we have the market for apartment blocks, which consists of tenant-owner apartments or rentals, plus the market for commercial property, which consists of shops and offices. Although apartment blocks and commercial properties have completely different types of tenants, the developments in prices and rents on these can serve as examples to illustrate the difference between a market with market rents and a market with regulated rents.

The rents on the property market are regulated by rents set on the basis of utility value and by the Tenancy Bargaining Act (SFS 1978:304). Property rents set on the basis of utility value and large subsidies on residential construction have been the primary means used to achieve the government housing policy's objective of ensuring that everyone has access to housing of a specific desirable minimum standard.

As regional growth in metropolitan regions comprises a dominant part of the growth of the economy as a whole, and as developments in prices and rents on the property market have fluctuated greatly in these regions, I will focus on these regions.

Developments in prices and rents

The price of a property reflects the current value of the property's expected yield, consisting of a net operating cost and an expected future change in value that is discounted with a nominal yield curve. The net operating cost consists of the difference between the rent income and the operating costs. An increase in the price of the property today can thus be caused by an increase in the net operating cost, by increased expectations of the future price of the property or a reduced nominal yield curve. Although rent levels develop on a par with property prices, expectations of future changes in property prices or a change in the nominal yield curve can trigger corrections in property prices.

The development of real prices and rents for apartment blocks and commercial properties between 1987 and 2000 shows that property prices on both apartment blocks and commercial property greatly exceeded rent developments up to the outbreak of the property crisis in 1990. Extensive subsidies to the property market in the form of housing allowances, rent allowances, generous opportunities to deduct nominal interest costs and lower VAT on construction, combined with a strong growth, led to soaring property prices and increased expectations of future price increases. Something similar to a price bubble had arisen on the property market.

Between 1990 and 1993 there was a drastic adaptation of property prices. At the same time as the Swedish economy was beginning a downturn, a comprehensive tax reform was implemented, which included reduced subsidies to the property market. During this period GDP growth declined by between 1.1 and 1.8 per cent a year, while subsidies to residential construction were reduced and VAT on construction was increased from 13 per cent to 25 per cent.

This leads to a situation where it becomes more expensive to construct and utilise properties and the demand for both housing and commercial property declines. Prices on both apartment blocks and commercial property fall. The market rents on commercial property also fall, while the rents based on utility value in apartment blocks increase. As a result of the regulation on rents based on utility value, the cost increase makes a full impact on housing rents, while the decline in demand has no impact at all. However, property prices and market rents on commercial property are corrected immediately.

With effect from 1993, the economy began a slow recovery and GDP growth was once again positive. Demand began to rise and property prices on both apartment blocks and commercial property increased again, as did market rents on commercial properties. The rents based on utility value in apartment blocks, on the other hand, did not react to the increase in demand, but developed at an unchanged rate. This reflects the fact that rents based on utility value maintain an even, long-term development over the business cycle, while market rents show temporary deviations from the long-term level as a result of disturbances on the demand and cost side.

The principle of rents based on utility value has certainly contributed to evening out rent levels across the business cycle, but it has also contributed to apartment blocks with rental apartments being transformed into tenant-owner apartments to an increasing extent. As the system of rents based on utility value limits the income generated by a rental property, the market value of rental properties is also limited and both the owner of the rental property and the future tenant-owners benefit by the property being transferred at a price somewhere between the market value for rental properties and the market value for tenant-owner apartments.

The value of tenant-owner apartment blocks can be seen as the total of the transfer prices for the tenant-owner apartments in the building. These transfer prices are determined by the market and reflect the current value of the net difference between the value of utilising the tenant-owner right and the costs the individual tenant-owner has in connection with owning the apartment. The cost of the tenant-owner right consists of the individual tenant-owner's share of the tenant-owner association's joint costs for management of the tenant-owner apartment block that are covered by a charge to the association, and of the costs individual to the single tenant-owner. The costs common to the tenant-owner association include, for instance, property tax, maintenance and running costs for the property. Interest costs after tax for financing the tenant-owner purchase are borne by the individual tenant-owner, as are certain maintenance and running costs connected with the apartment.

The development of prices and rents in metropolitan areas thus indicates that the price increase on commercial property from 1993 onwards has developed in line with rent increases, while the price rise on apartment blocks exceeds rises on rents based on utility value. Prices for apartment blocks do not reflect changes in income flows from renting apartments, as sales of apartment blocks are mainly comprised of sales in connection with the formation of tenant-owner associations.

Today's prices for commercial property are in real terms approximately 25 per cent lower than the price level applying in 1990, which was the year immediately preceding the property crisis. At the same time, today's rent levels for commercial property lie in real terms approximately 14 per cent above the peak level for rents that was noted in 1990. This indicates that the large price increase on commercial property with effect from 1994 appears to be motivated on the basis of fundamental factors and that price levels have developed in line with rent increases. This is a considerable difference, compared with the four years prior to the property crisis in 1990, when the price levels on commercial property doubled, while rents rose by only 20 per cent.

Dividing metropolitan areas into the three major cities Stockholm, Göteborg and Malmö, Stockholm shows the strongest fluctuation in real prices for commercial property. Today's prices comprise approximately 70 per cent of the peak level before the property crisis in 1990. The corresponding figures for Göteborg and Malmö are 80 per cent and 90 per cent respectively.

A picture of whether price developments on the property market are sustainable in the long term or not can be obtained by studying how investors' nominal yield requirements relate to properties' direct yields.

The direct yield of a property states how large a running surplus - the difference between rent income and running costs - a property is expected to generate in relation to the value of the property. The difference between an investment's total yield and its direct yield can be assumed to comprise the compensating increase in value an investor requires to implement a property investment at a given market price. By comparing the property's direct yield with the investors' yield requirement, it is possible to obtain a rough measure of the investors' expectations of the properties' future increase in value.

A glance at how the direct yield for commercial properties has developed over time in metropolitan areas shows that direct yield fell relatively heavily prior to the property crisis in 1990, as a result of soaring property prices and largely unchanged rents, as we saw earlier. After this, direct yield rose during the property crisis as property prices fell.

In recent years the property market has recovered again and direct yield has also shown a slight decline during this period - property prices have shown a higher growth rate than net running costs.

Direct yield on commercial property based on the Swedish property index amounted to an average of 5.8 per cent during 2000. The direct yield on commercial property, calculated by SVEFA, amounted in January 2001 to between 6.25 and 7 per cent in Stockholm, between 6.5 and 9.5 per cent in Göteborg and between 6 and 8.5 per cent in Malmö, depending on the location. A better location provides a lower direct yield, which indicates a higher price level in relation to the rent levels for the properties in the more attractive locations.

The expected future increase in value of commercial property required for the total yield to be on a level with investors' yield requirements is currently relatively low, which indicates that the investors do not base their investment decisions on exaggerated expectations of future property price increases.

New production of properties

A glance at investments in properties in relation to GDP, the gross investment ratio in properties indicates that investments in the property sector lag behind developments in the rest of the economy. The gross investment ratio for both housing and other types of property has remained at an unchanged level from 1994, despite the fact that the economy as a whole has grown.

After the property crisis in 1990, investments in properties declined considerably, particularly investments in housing. Since then, construction has lain at an unchanged, low level. Construction of rental properties in growth regions such as Stockholm has more or less completely come to a standstill. The new production of housing that is nevertheless underway mainly comprises tenant-owner apartment blocks.

The situation is described well in Bengt Turner's article in the second edition of Ekonomisk Debatt this year. The surplus demand for housing in Stockholm is reflected in the rising prices on tenant-owner apartments. The average price for tenant-owner apartments in central Stockholm lay at around SEK 32,000 per m^2 during 2000, which is 33 per cent higher than in the previous year, despite the fact that new tenant-owner apartments have appeared, in that around 4,000 rental apartments have been transferred into tenant-owner association apartments. With a population increase of approximately 20,000 individuals in Stockholm during the year 2000 (net immigration approximately 14,000 individuals), the demand for housing is increasing. Despite rising house prices, only 1,074 apartments were completed in Stockholm municipality, 185 of which were made available for rental in 1999.

Changes in costs and demand are allowed to have an impact on market rents for commercial property, as we have said earlier. Increased growth and increased demand have led to rising rent levels for this category of property and new production of commercial properties is increasing throughout the country and especially in Stockholm.

At the same time, the number of building permits issued is increasing, which is an indication that new production will probably continue to increase. Here, however, it is likely that the forecasts that were revised down with regard to economic growth will have a slightly subduing effect on new production. Some of the construction projects granted permits will not be implemented, or will be postponed until there is less uncertainty over economic developments.

The investment level for commercial property is still far below the levels prevailing at the end of the 1980s and at the beginning of the 1990s. Then there was a peak level of around 1.2 million m^2 of commercial space produced per year throughout the country, compared with just under 600,000 m^2 during 2000. One indication that the property market is more healthy today than it was prior to the property crisis in 1990 is that construction projects in the Stockholm area today are not begun until contracts have been signed with tenants for between 50 and 75 per cent of the spaces.

Conclusion

In conclusion, I would just like to say that this was a taster of our analysis of the property market. If you would like to read about the property market from a financial stability perspective, you can read our Financial Stability Report, which will be published in a couple of weeks' time.