Before and after the boom: changes in the Estonian housing market

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Changes in housing prices have essential effects on households and their financial behaviour. A sharp rise in prices can generate a situation where households may face affordability problems. Research regarding housing booms and busts has become a topicality in recent years. Nevertheless significant gaps remain in understanding the reasons why boom situations initiate and insufficient analysis of their consequences and impact. Historical background and economic development in emerging markets are different from advanced economies and there is a need to fill the gap in academic writings.

The purpose of this Doctoral Thesis is to assess various aspects of Estonian housing market development, with the aim of identifying whether and to what extent the ratios and models used for real estate market analysis in developed countries can be used in transition economies and if necessary adjust them according to Estonian housing market conditions.

This study investigates housing market developments from three main aspects – market analysis, housing affordability, and quality of housing. The first section presents a theoretical and literature overview about the Basic characteristics of the housing market, the relationship between the financial and housing markets and on concepts of housing affordability, along with housing quality issues. The second part focuses on commonly used methodologies for analysing housing markets and suggests methods for investigating Estonian market dynamics. Part three presents the main results of this thesis.

The practical and methodological problems identified in the paper might be interesting for people studying similar issues in other emerging markets. The theoretical contribution - this thesis offers possible solutions on how to elaborate and adapt frequently used methodologies (e.g. the Poterba model, Tobin q, Price to Earnings ratio, Price to Income ratio, index for measuring housing affordability situation) for investigating developing housing markets using the Estonian market as an example. The Estonian government has made many decisions that have influenced the real estate market, especially the housing market, mostly with the purpose of improving access to the housing market. But no research has been done in trying to find an

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answer for the affordability problem in the housing market in Estonia and also to assess the impact of the regulatory framework. The method worked out by the author can be used for future market monitoring. The HAI (Housing Affordability Index) is new for the Estonian market, as well as use of the aggregated LTV (Loan to Value) ratio.

Different factors influence the average housing price, from the demand to the supply side. Tobin’s q calculations for the Estonian housing market show that the most challenging period for property developers on the supply side was in 2003–2007. The housing boom in Estonia was mostly driven by a large credit supply and favourable loan conditions.

Evolving housing price booms and a worsening affordability situation are strongly correlated. It is very important to monitor the indicators that point out the possibility that prices are far from fundamentals. Even in this situation, it is difficult to find observable fundamentals that are correlated with price movements. We can use some indicators, such as Price to Income ratio (using average monthly data) or Price to Earnings (P/E) ratio (adapted version of Poterba model) for the Estonian market in order to identify a real estate boom and bubble.

The P/E ratio was growing fast until 2006, when it achieved its maximum. Taking into consideration the specific features of the Estonian housing market (the underdeveloped rental market, inadequate statistics on rental earnings and a mostly functioning purchase and sales market greatly affected by loan conditions) the Poterba model was correspondingly developed and the share of owner’s costs in net wages was found. If Estonian housing rental market statistics are more adequate in the future, it will be possible to develop a model similarly to the method provided by Poterba.

Although the real estate quality rating system treats all quality attributes (location and plot, construction quality and management) as equal, this research shows that in practice valuers attach extremely great importance to the attribute ‘location and plot’ and little significance to factors under the attribute ‘management’. From the aspect of sustainability, however, energy, water, heating expenses and waste disposal, which are under the attribute ‘management’, play a significant role. In 2012 repeat research shows that energy consumption and utility service costs became more important. This study also shows the importance of regulatory decisions, which in our case was the waiving of limitations on all mortgage loans in 2002. The recommendation is for the government to change the law of credit institutions and reinstate restrictions on mortgage loans (LTV ratio). It is also suggested that households pay more attention to the household’s credibility to avoid unrealistic expectations.

The problem with data availability and an underdeveloped rental market has limited the use of some well-known methodologies for investigating Estonian housing market developments. Considering the shortage of disclosure research about the housing markets in CEE countries, this thesis proposes new theoretical and practical approaches.

This research has cast different questions in need of further investigation. If a person with an average monthly income cannot afford to pay for an average home (which in the Estonian case is a flat) there is an affordability problem. There is a need for future investigation of housing affordability problems and more research with the purpose of finding solutions for different types of household.