

Dutch housing market scenarios

Risks for the housing market
and potential policy options



Summary – May 2012

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Introduction

In December 2011, the directorate Knowledge and Foresight of the Directorate-General Housing, Building and Integration (WBI) asked De Ruijter Strategy to create a number of different future scenarios for economic development and to outline the housing market policy issues arising from them.

What gave rise to this assignment was the growing awareness that the situation of the financial markets is of increasing importance for the realisation of the objectives of WBI's policy – affordability and availability of sufficient housing – and that the funding of the housing stock can influence financial stability. The objectives of the assignment were on the one hand to obtain more insight in the current developments in the financial markets and create a set of future scenarios for the benefit of the policy agenda of WBI, and on the other hand to improve contacts WBI has with players in the financial sector.

Ten experts from the financial sector and the housing sector were interviewed and two workshops were conducted. The results of the workshops and the input from the interviews were incorporated in a report.

Characterisation of the current state of the housing market

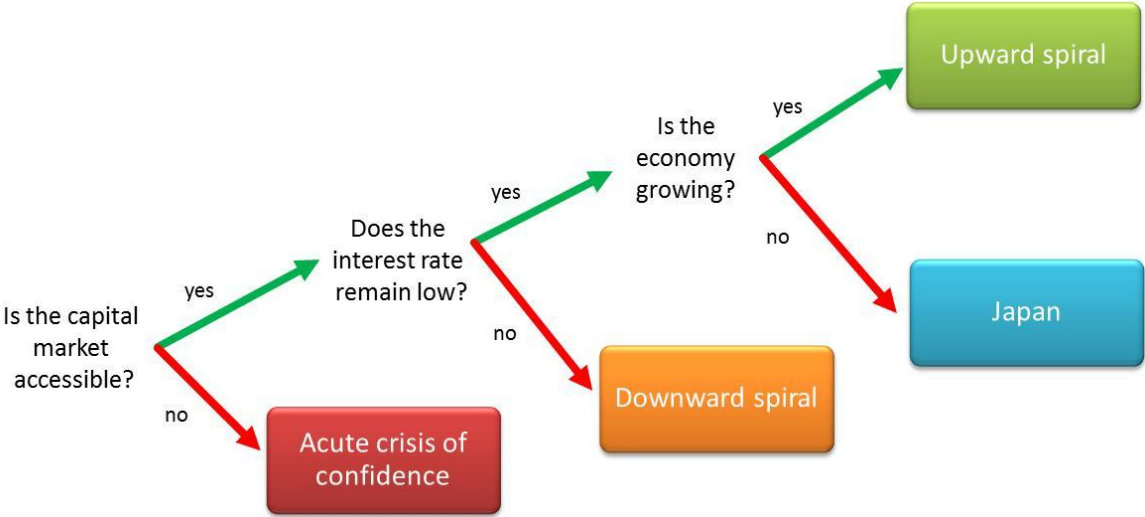
- The housing market is experiencing a downward trend, which reinforces itself through the fact that consumers are adapting their expectations of price developments to the price reductions as realised since 2009. This is the exact opposite of the preceding period (1985-2008).
- The downward trend is reinforced by the procyclic policy of the government, banks and supervising authorities as regards loan conditions and credit volume, in the same way that the upward cycle was reinforced by the relaxation of loan conditions and new financial products.
- The situation of the property market contributes to low consumer confidence and low consumer spending, which reduces economic growth. The stagnation of the housing market can influence the mobility of the labour market.

Scenarios

During the interviews, the Euro Scenarios of the Ministry of the Interior and Kingdom Relations were discussed. These scenarios have been built on different possible directions of development of the debt crisis in the Eurozone. Because of the specific problems of the current housing market, the interviews and the workshops led to the conclusion that for the purpose of WBI, more specific scenarios for the housing market would need to be formulated than the more general Euro Scenarios of the Ministry of the Interior. The most relevant scenarios for the housing market can be

characterised by the levels of interest rate, inflation and unemployment and the confidence in financial markets.

The report distinguished four scenarios, each one of them named after an historical analogy. Although history never repeats itself exactly, the current situation shows characteristics that could give rise to each of the scenarios.



The table below shows a summary of the scenarios. Following that, the scenarios are explained in detail, an estimation is made of the chance of each scenario occurring and its effects on the housing market are outlined.

Scenario	Upward Spiral (analogy 1990s)	Downward Spiral (analogy 1980s)	Acute Crisis of Confidence (analogy 2008)	Japan Scenario
Interest rate	Low	High	Indefinite (no availability)	Low
Inflation	Low	High	-	Low (incl. deflation)
Unemployment	Low	High	Increasing	Moderate
GDP growth	High	Low	Negative	Low
Confidence	High	Low	Negative (distrust)	Low

Scenario A: Upward spiral (analogy 1990s)

Scenario description

As a result of the successful reorganisation of public finances in the Eurozone and the monetary policy of the ECB, the confidence of consumers and companies recovers. Growth picks up, the unemployment rate decreases and because of shortages in the labour market, due to the effects of population aging, wages increase.

Probability of occurrence

The workshop participants and interviewees do not think that this scenario is likely to occur anytime soon. The growth is believed to remain low for some time, due to the reorganisation of public finances and the reduction of their indebtedness by families and banks.

Effects on the housing market

In this scenario, the number of transactions and the prices of the housing market would rise again. Buying a house will be considered more attractive than renting.

Scenario B: Downward Spiral (analogy 1980s)

Scenario description

When we will see high interest rates, and high levels of inflation and unemployment (comparable to 1978-1985), this will lead to a strong price fall in the property market. This in itself will reinforce a negative spiral.

Probability of occurrence

In the short term, the probability of a high interest rate is low. If the ECB decides to keep the policy rate extremely low for a couple of years by means of credit expansion (LTRO1 & 2), inflation can eventually rise, making an increase in the policy rate necessary to restrain inflation. As a result of the demographic development the probability that high unemployment arises is limited. Due to possible shortages in the labour market wage developments could be positive. This moderates the effects of the high interest rate.

Effects on the housing market

If this scenario occurs, house prices will drop drastically and in case of interest rate reset owner-occupiers will face higher housing costs. If the social housing sector pursues an inflation-based allowable rent policy, housings costs and the rental subsidies will increase. If the real wages do not increase, the housing quotes will rise. Because of the high interest rate, the demand for rental homes will grow.

Scenario C: Acute Crisis of Confidence (analogy 2008)

Scenario description

Debt crises in the financial markets comparable to the Lehman crisis in 2008, for example a default in the Eurozone, political instability in the Middle East, or an increase in the price of oil, could lead to a decrease of the GDP and an increase in unemployment. This scenario could also bring about a decline in the public's confidence in banks (bank run).

If the cause of the crisis lies in the South of Europe, the Dutch interest rate could drop as a consequence of capital flight to safe countries. If, however, the debt crisis also concerns the Netherlands (or if the Netherlands show a great deal of care for the situation in the rest of Europe), the Dutch interest rate may rise. Depending on the cause of the crisis, the inflation rate could either be high or low in this scenario.

Probability of occurrence

At the time of writing this report (mid April 2012) the probability of an acute crisis in the Eurozone seems to have been decreased thanks to ECB measures. Nonetheless, a danger still remains that EU countries which are not able or willing to bring their budgets under control, and which realise insufficient growth, will face a strong increase in interest rates. The rescue plan may be insufficient to be able to help these countries. In that case, problems in the European banking sector are to be expected.

Effects on the housing market

If this scenario occurs, it will lead to a decrease in consumer confidence, a fall in demand in the housing market and a price drop of houses. Less sources of funding will be available and investment in the housing stock will fall. The expulsion of owner-occupiers from their homes and migration from the South of Europe may lead to a strong and acute additional demand for social housing. For the government, this can give occasion for unorthodox measures to meet the housing needs.

Scenario D: Japan Scenario

Scenario description

The combination of a low interest rate and economic stagnation in the Netherlands is reminiscent of the situation in Japan in the 1990s. Ever since the collapse of the stock market and the real estate market around 1990, Japan has seen low inflation alternate with periods of deflation, a very low real interest level and low economic growth. Besides, there is a population decline and low to moderate unemployment. The banking sector is kept alive artificially by the central bank. A similar development could conceivably take place in the Netherlands.

Probability of occurrence

An important difference between the Dutch and the Japanese situations since 1990 is the demography: the Dutch population is still growing slightly, and there is a chance of increasing immigration from Southern and Eastern Europe, which might have a positive effect on future economic growth. The other elements of the Japan Scenario are easily imaginable. The vital question

is whether the Netherlands (and Europe) will experience sufficient economic growth to keep the debt burden manageable.

Effects on the housing market

If deflation occurs in combination with stagnating incomes, the real debt burden of both owner-occupiers and the state will increase. Unlike in Japan, it is not likely that the debt burden can be refinanced endlessly, unless the free movement of capital is curtailed and banks, insurers or pension funds are forced by the government to invest in the national debt and mortgages. Without this kind of financial repression, banks will restrict credit facilities and house prices will decrease. Sooner or later, a default of both the state and a substantial number of owner-occupiers is to be expected.

In case of an inflation-based allowable rent policy, deflation is favourable for renters in the social housing sector, but the financial position of housing corporations will be under pressure.

Principal conclusions from the workshops and interviews

- Currently, a Downward Spiral scenario is expected to occur rather than an Upward Spiral scenario.
- The ECB policy – low interest rate, extra liquidity for the banking sector – seems to have cast aside the acute threat of a crisis, but the threat can become a burning issue again any moment (see also Spain).
- In the long term, ECB measures lead to the risk of inflation, which will influence the housing market (inflation-based allowable rent policy) and can lead to an increase in interest rates. The side effect of the low interest rate is that the value of pension rights decreases – which is bad for the confidence of consumers and for the housing market – and that housing corporations face problems in case of the misuse of derivatives.
- The demand for affordable rental houses will increase further, due to the risks of proprietorship in a downward market. At this moment it is hard to say whether this extra demand for rental homes would have a structural or a temporary character.
- Difficulties regarding payments of renters and owner-occupiers will increase, although the payment morals of the Dutch are rather good compared to the situation abroad. The biggest danger for banks is not unemployment and incapability of paying the mortgage repayments, but the unwillingness to pay the mortgage repayments due to discontent with the fact that banks, which are held responsible for the crisis, are saved by the government whereas owner-occupiers are not. In such a climate, opinion leaders could call for citizens' action against banks (bank bashing).
- Because of the slow feedback of measures on the market, there is a risk of over shooting in policy measures. The participants expressed their concerns about insufficient coordination and poor predictability of the policy pursued by government and supervising authorities. In

the short term, it is important that the government removes uncertainties to create clarity in the market.

- The funding gap poses a risk to the availability and price of credit. In addition, the sharpened capital requirements of Basel III put pressure on the availability of capital for the housing market. The fundability of house mortgages by banks would benefit from more simplicity and transparency of mortgage products.
- For the long term, paying off mortgages (and encouraging good payment practices) is a no regret measure that will improve the risk profile of both families and banks. Additionally, the interviews and workshops confirmed that, irrespective of the scenario, the reform of the housing market is a precondition for sufficient investments in the housing stock and for ongoing transactions in the housing market.
- The government labour market policy, combined with the trend of flexibility of labour, influences the housing market at the particular moment that it is vulnerable because credit facilities are restricted. Therefore it is necessary to develop an integral, whole of government approach of the housing market, the labour market and the capital market.



Whole of government approach