European housing review 2008

Executive summary
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While every effort has been made to ensure that the data and other information in this report are accurate, some errors may remain. In addition, it should be remembered that information in this field is variable in content and quality. The purpose of the Review is to provide information, analysis and background to Europe’s housing markets and housing provision systems. It is not intended for use directly either in market forecasting or for investment decision purposes. The full report is available at www.rics.org/ehr
Foreword

I am pleased that Savills is supporting the tenth edition of the European Housing Review. The review provides detailed coverage of the key trends impacting on European housing and mortgage markets over the past twelve months.

Most notably, the upward trend in interest rates since 2006 has lead to lower price growth in many European countries. In addition, towards the end of the year, the turmoil in the financial markets following the collapse of the sub-prime mortgage market in the US has increased the level of uncertainty in many markets. Within this context, the European Housing Review 2008 is an important publication for the property industry.

There is a lack of information on many European housing markets, especially countries in Central and Eastern Europe. This report fills an important gap in providing comparable data and information on the prevailing economic conditions in individual countries.

I feel confident that the 2008 European Housing Review will provide key information about housing market conditions in mainland Europe and in the UK and will be a reliable source of information for businesses active in the residential property sector.

Yolande Barnes
Director Residential Research
Savills

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Key messages

- House price growth has slowed substantially across Europe with falls during 2007 in some countries, such as Germany and Ireland.

- Housing markets across the continent experienced marked falls in activity from summer onwards.

- Rising interest rates rather than the post-autumn credit crunch were the prime causes of the slowdowns, as mortgage availability remained good. Housing market prospects in 2008 depend on what happens to interest rates.

- High year on year price changes in countries like Poland reflected developments in the first half of 2007 only, as early gains were trimmed from late summer onwards.

- There are prospects for some house price falls during 2008 but the scale of any housing market downturn is likely to be far less than the last downturn in the early 1990s.

- The UK housing market looks much better placed than many others in Europe. Interest rate cuts are likely to stabilise prices in 2008.
European markets slow and falter

2007 will probably go down in history as the year that the great European house price boom ended. The year started so strongly on a wave of optimism but ended bleakly for housing markets in virtually every country.

The finger of blame has been pointed at the worldwide credit crunch in existence from summer onwards in the aftermath of the US sub-prime mortgage crisis. However, the most important factor was probably the more prosaic one of rising interest rates. Purchasers could no longer afford to buy at ever rising asking prices. Housing markets either froze as a result or prices started to slide. Interest rate responses by monetary authorities and capital markets to concerns about escalating general price inflation brought the housing boom to an end. A common event in European housing market history of inflation-induced increases in interest rates was being acted out once again, although on a much smaller scale than in previous downturns. This gives optimism that the current ‘correction’ will not be too great.

The credit crunch has, however, had significant effects, especially in certain housing markets and parts of others. At the time of writing, the end was by no means in sight and the situation brings with it heightened risks. Even when loans start to flow more easily, the aftermath might be higher risk premiums on mortgage lending and stronger rationing criteria for a much longer period, which will depress housing demand. Mortgage lenders inevitably tend to tighten up their lending stances when housing markets fade but the impact this time round might be greater than it would have been without the mortgage fiascos originating in the USA.

Banks, monetary authorities and other commentators have all pointed out that mortgage finance procedures are different in Europe from the USA. So, a similar mortgage crisis to that in the USA is unlikely, although Europe will still pay for some of the excesses across the Atlantic. A problem might be that wary markets take a long time to be convinced that there has not been widespread lending to people who could never hope to repay.

On an optimistic note, the available evidence gathered together by the European Central Bank (ECB) in December 2007 suggested that credit standards for residential mortgage loans had not been tightened that much, if at all; far less so than on lending to large firms. Lending to households also remained robust in the last months of the year throughout most of Europe, although there were signs in Ireland, the UK and a few other countries that borrowing levels were moving down from their 2006 peaks.

Moreover, the European economy is still in good shape. Economic growth in 2007 was strong and growth rates for 2008 in the Euro zone are forecast to lie within the range of 1.5% and 2.5% and to be strong elsewhere in Europe as well. The risk of a sharp downturn in economies, though ever present, is small. So, the combination of markedly higher interest rates and a sudden, sharp recession, which last sent Europe’s housing markets tumbling in the early 1990s, is still remote.

The often repeated dilemma currently facing monetary authorities is that slowing economies - and housing markets - need lower interest rates but higher inflation necessitates raising them. How Europe’s housing markets fare in 2008 depends on the way that tug-of-war develops.

Countries in central and eastern Europe are experiencing the greatest general inflationary surges. In addition, exchange rate movements have recently been benign for them and currency pegs have been easy to maintain, despite deteriorating macroeconomic indicators, partly because of a surge of inward real estate investment. If exchange rate movements turn adverse, the high proportions of domestic mortgage loans denominated in foreign currencies, which have helped to fund some extraordinary house price booms, will suddenly become expensive to service while the pressure would also be on to raise domestic rates. Therefore, housing market risks have clearly risen substantially in that region, especially in the countries that have experienced massive house price rises.

Within the Euro zone itself, inflation rose to 3.1% in November 2007, well above the ECB’s 2% target. The increase is expected to be temporary, resulting from oil, food and other commodity price rises, but the rise in inflation is lasting longer than expected. If it starts to be reflected in wage settlements during 2008, the ECB will have little choice but to raise interest rates further. ECB rate movements have a direct impact on mortgage interest rates only in countries where variable rates are common, such as Spain and Ireland, but longer-term mortgage contracts will also be adversely affected by the inflation premiums priced into capital markets. So, the risks of falling house prices in at least some countries during 2008 and possibly beyond have risen as a result.
The inflationary situation looks more promising in the advanced economies outside of the Euro zone, that is Denmark, Sweden and the UK. The Danish economy was one of the few actually to experience a fall in GDP (in the second quarter) caused by a decline in consumption, and its housing market was moribund in the second half of the year with few transactions. In any case, if necessary, the monetary authorities of these countries have the flexibility to adjust interest rates in light of local economic circumstances, of which housing market conditions are a part. Denmark looks particularly vulnerable because of the extent of its recent price rises, combined with relatively high rates of housebuilding and a weakening economy, particularly in up-market inner-city apartments, which on a large-scale are a recent innovation for the country.

The interest rate option is not open in individual Euro zone countries, such as Ireland and Spain, where housing markets look particularly vulnerable and where housebuilding has been a major component of the economy as a whole. Yet, even there, fiscal options remain open and the Irish government in its December 2007 budget has already cut transaction taxes by reducing stamp duty charges.

**House prices in 2007**

House prices are at best only indicative of how much any individual property will trade at. But on occasions the signals they give may be particularly unreliable. At market turning points, year-on-year analyses of house prices may give confusing messages of apparent boom even after market sentiment has radically shifted. This was the case for a number of European housing markets in 2007. Prices rose in relation to 2006 but froze beyond the normal seasonal cooling towards the year end in relation to either the earlier summer or spring periods.

When demand stops rising, there may exist a long period of hiatus when sellers tend not to accept that market conditions have changed and buyers hope that they have changed more than they actually have. Properties sit on the market or are withdrawn from it and sales fall through, compounding the problem by disrupting linked chains of buyers and sellers. Buyers may even decide to wait for some time to see how market trends evolve. Furthermore, the houses actually traded may give an undue rosy picture of market conditions, because only the best existing properties tend to sell and developers start to offer added inducements to shift homes at prevailing prices. So, recorded prices fail to reflect the true state of the market.

There is a lagged price reaction and, if the downswing persists, then the subsequent price fall may overshoot as a flood of properties come onto the market once a new level seems to have been reached. To interpret the messages from 2007, it is necessary to dig a little deeper than usual to investigate market developments. The underlying pattern of annual price change overall was similar to that of 2006. Smaller countries outside of the core heartlands of the EU had the highest price rises (Figure 1). But, overall, Europe’s housing markets noticebly slowed. The majority of countries experienced price rises of 5% or less, and some even experienced falls, a far cry from previous years.

Countries in Scandinavia, the Mediterranean region or that were recent EU member states experienced the most rapid house price increases. Yet, even for most of these countries, the summer heralded a marked slowing and often a virtual cessation of activity.

Denmark was amongst the first to experience the turnaround in Spring, from being a country with one of the fastest price rises in 2006. By the second quarter of 2007 price falls were already being recorded there and the general economy also dropped slightly as well.

One of the EU’s smallest member states, Cyprus, was a rare case of a country shrugging off the gloom. In fact, price rises actually seemed to accelerate during the year. Its market may have been boosted by the prospect of joining the Euro and an associated influx of foreign investors.
The worst performing country price-wise in 2007 was Ireland, where house prices fell by an estimated 7% – or nearly a tenth in real terms. It had been one of the continent’s price leaders only a short time before. The cutback is having knock-on effects throughout Europe, because Irish buyers used rising housing wealth back home and attractive tax breaks there (via remortgaging and pensions) to invest substantially in real estate elsewhere, out of all proportion to the relative size of the country.

The Baltic States were other previous stars in the house price firmament, with reported real price rises of 200% or more between 2000 and 2006. Yet, in 2007, early year price rises were wiped out subsequently from the summer onwards with, for example, the second homes market in Tallinn reported to have experienced a 6% drop since the summer. Land prices for individual properties in some Estonian towns apparently fell by as much as 40%. Inflation in Estonia is high at over 9%, so even if prices only stagnated the real fall matches that of Ireland. Much depends on whether an over-extended economy can be brought to heel without further damage to the housing market. The Latvian market, at least in terms of Riga, fared in a similar way to Tallinn’s, but with price falls focused on apartments in old-Soviet style properties. In Lithuania, prices have yet to weaken but sales are down and unsold new properties abound.

Poland recorded the highest rate of price increase in the 2007 league but in many respects post-summer market conditions there are similar to those in the Baltic States. Sales of newly built apartments were few and far between in Warsaw from the autumn and an overhang of unsold property was carried over to the New Year. The foreign investors who flooded into the market, buying off plan, are no longer

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1 House price data are of variable quality, coverage and timeliness. Those countries with better quality year end data are shown with an asterisk. Sources: National Statistics Offices; Central Banks; Housing Ministries; FNAIM, France; Hypoport, Germany; Permanent tsb, Ireland; Scenari Immobiliari, Italy; NVM, the Netherlands; BPE, Estonia; BuySell, Cyprus; Otthon Centrum, Hungary; and UPE forecasts.
doing so but instead trying to sell, adding to the supply of new vacant property, or they are hoping to rent out properties onto what unfortunately for them is a limited market.

Germany was the one major EU economy which missed out on the long house price boom. So, there have long been expectations by some pundits of major price growth just around the corner. Yet the opposite seems to have happened in 2007 and it seems that prices fell noticeably. This was partly due to the common European theme of rising interest rates but also to changes in fiscal policies which caused buyers to bring forward purchases into 2006, leaving 2007 bereft of demand. Rising inflation also ate into landlords’ yields further depressing already low returns in many areas.

France was another country that relatively early on in 2007 began to feel the chill of a market slowdown, with the apartment market even experiencing minor price falls. By contrast, though predicted by many to be in line for a major correction, Spain actually saw no price falls during the year, although record housebuilding levels were leaving swathes of unsold property in primary and holiday locations alike, and developers were prepared to negotiate deals.

The UK market remained strong throughout most of the year, yet once again an autumn chill descended and some slight price falls recorded. A similar story of winter stagnation could be found in countries such as the Netherlands and Sweden.
Recent market performance: country summaries

Eleven countries are surveyed in detail in the European Housing Review. Brief overviews of current market conditions are presented here.

Cyprus

Although there is no official house price index, indications are that house prices rebounded strongly from a dip in growth in winter 2005/6 to surge into double figures in the autumn of 2007, one of the highest rates of increase in Europe. Domestic demand is strong on the back of a surging economy and inward migration. Another key driver is heightened interest in second homes from outside the traditional source of demand in the UK. Russian and other purchasers are said to be becoming more prevalent and are currently less affected by borrowing constraints than western Europeans.

Housebuilding is booming with the country now having the highest housebuilding rate per 1,000 population in the EU. Market prospects look good but overseas’ interest in second home purchase may prove fickle and any slowing of the UK economy, in particular, will affect demand. There is also a surge of new supply coming on stream, which may dampen prices.

France

The long housing boom ground to a halt in the summer of 2007. The prices of existing dwellings were unchanged or even experienced slight falls after June. Existing house prices just about held up, while apartment prices fell slightly. The end year outcome for 2007 was estimated to be 4%, though regions varied, with the Paris market being stronger. Confidence in further house price growth seems to be ebbing away.

The extent of the price slowdown is perhaps surprising in view of the relative strength of the economy and the demand boost that President Sarkozy is offering as part of his fulfilment of election pledges through the partial reintroduction of mortgage interest tax relief. However, a slowing economy, rising interest rates, greater credit constraints and weakening consumer confidence have offset this fiscal boost.

Recent high levels of housebuilding are also dampening price growth. Furthermore, the relative cost of owning has been rising relative to renting, because rents have only risen moderately in recent years. So, with around 40% of households living in rented property, it might be the case that more people are opting to rent than to buy whilst house prices remain so high in comparison to several years ago and future values seem uncertain at present.

In recent years governments have been offering generous allowances to encourage private investors into the rental sector, and the current government is adding more tax breaks as well. Yet, investor demand does not seem to be underpinning house price growth at present.

Germany

The housing market in 2007 was not as strong as a revived economy would have led many to expect. In fact, the prices of existing houses and apartments gradually declined during 2007: by around 5-8% in the first nine months of the year, while the prices of new dwellings rose by 1%.

There are other signs of continuing housing market weakness. Aggregate new mortgage advances to home owners and buy-to-let investors fell to a very low level. Worse still, building permits, the only available indicator of recent and near-future housebuilding, dropped on the previous year by nearly 40%. Subsequently orders for new residential construction did start to revive in the latter part of 2007.

The long awaited housing market revival has still yet fully to happen. However, in some places – like Hamburg, Nuremberg and Munich – local markets are much more active than the overall national pattern. Munich recorded the highest price rises for the major cities in the first half of the year at 6%. In other places, excess supply and weak local economies keep the housing market flat or depressed. In particular, the East is still suffering from substantial oversupply, which is contributing to frail prices and rents.

A national house price upswing does not seem to be in the offing and the housing market remains oddly distinctive in its recent performance from those in the high house price inflation countries of Europe. Expansion of owner occupation in a country with a majority of renters is also likely to remain a gradual process at best.

Two key short-term factors have recently been holding back demand. First, as elsewhere, rising interest rates are increasing mortgage borrowing costs. The costs of funding mortgage debt rose by 10% in the first nine months of 2007 because of higher
interest rates and, by then, were over a quarter higher than those in 2005. Second, 2007 was the year that VAT was increased by 3% to 19% and the standard rate of VAT is charged on new housing.

Rental returns generally remain low. The IPD German residential index showed a return of 6.5% in 2006. This was made up of a 3.8% cash flow return and 2.7% capital growth. These results may flatter overall returns because there is a high (35%) weighting of Munich properties in the index and Munich has been the most buoyant market in the country at present. There have been some substantial sales of rental homes in the past few years by non-profit organisations, industrial firms with residential estates, and the public sector. Portfolios with a total of around 1.3 million properties have been sold to domestic and foreign investors. However, public sector and municipal bodies still own around 4.5 million dwellings. Some cities, such as Berlin, are currently refusing to sell their public housing stocks. In general, funds aim to make returns through renovations, sales to tenants, other disposals, managerial and financial efficiencies and hoped for future rent and price rises. Some recent purchasers have already sold out as returns have been lower than expected, particularly because of slower rates of tenant purchases. REITs are being launched in Germany following legislation in 2007 but housing has generally been excluded from REIT activities.

Hungary

In nominal terms, the new build condominium market in Budapest, which is the sector that has been exhibiting the strongest price growth, recorded a 6% rise in 2007, roughly the same as the year before. More widely, national prices – though there is no official measure – probably fell by 1-2%. Real prices are falling and nationally they seem to be down by over 15% since 2004.

Over the last few years, borrowing in foreign currencies has eclipsed domestic borrowing because of the much more attractive interest rates on offer. The amount of outstanding household loans denominated in foreign currencies has now risen to over 40% of the total. This represents an exchange rate risk to some households’ finances and to the housing market in general.

Low housing market activity can be attributed to continuing economic problems as a result of large public sector and trade deficits. An austerity programme of increased taxes and expenditure cuts caused personal consumption expenditure to fall slightly in 2007 and there was a spike in inflation, peaking at 9% in 2007.

Hungary has not had the rises in house prices experienced in some other central and eastern European countries in recent years. Prospects for the housing market should rebound as the economy does.

The existence of substantial transactions in the existing homes market and the relatively good supply of existing dwellings relative to demand have contributed to the lower level of recorded price increases in the Hungarian housing market compared with those in several other central and eastern European countries, where the new build market dominates recorded transactions and/or prices even though it represents but a narrow segment of the housing stock as a whole.

Ireland

The great Irish house price boom has finally ended. Nationally, outturn price rises for 2007 are estimated to be -7%, with month-by-month price falls occurring from March onwards. Prices were even softer in existing home markets by several percentage points. High-priced Dublin has also been hit worse than the rest of country.

The house price boom had been the strongest in Europe. By 2006, real house prices were 2.9 times higher than they were in 1996. So, the change in price performance in 2007 marks a dramatic shift in market sentiment.

The market has turned around rapidly. As recently as autumn 2006 annual house price inflation was rising at 15%. Then prices were starting to fade only a few months later, with the number of new mortgages in the third quarter of 2007 down 25% in number in comparison to the previous year. Sales times have lengthened noticeably as well. A fifth of houses put up for sale in January 2007 were still on the market 10 months later.

Buy-to-let borrowing is a substantial proportion of the housing market, currently representing a quarter of all borrowings. Continued interest by buy-to-let investors may have kept demand in the housing market stronger than it would otherwise have been. If this source of demand slows substantially the broader negative impact on market may be large.
Housebuilding has been running at such high levels that it may fall by a half from 2006 levels through to the end of 2008. Unsurprisingly, recent forecasts for the economy have trimmed expected growth rates.

As house prices have already fallen by 10% plus in real terms, the meaning of the term ‘soft-landing’ is beginning to be stretched. The December 2007 Budget cut stamp duty on housing transactions but it is unlikely to have much effect on demand and first-time buyers were already excluded from it. Nonetheless, the risk of a major decline in house prices is still that, a risk rather than a certainty, though the chance of it happening has greatly increased over the past year. Much will depend on how interest rates change and on how cautious lenders become in a fragile market.

**Italy**

The housing market continues to limp along. Nationally, prices in 2007 rose by around 4% in nominal terms, much the same as the previous year, and the number of sales dipped by 4% and by then they were 16% below their 2004 peak. Prices in the major cities have been growing somewhat faster in recent years but are estimated to have increased by less than 5% in 2007. Over the past decade, house prices have not risen by anything like those in many other EU countries, rising by about 30 to 40% in real terms between 1996 and 2006.

The revival seen in the economy over the past two years has not filtered through to the housing market to any great extent. Any economic impetus is being offset by rising interest rates and declining general consumer confidence. It is expected that the market might slow even further in 2008 with continued pressure from interest rates, though no actual fall in prices is anticipated.

**Netherlands**

House prices rose by around 4% in 2007, much the same as in 2006 (5%). Transactions data were mixed with one source showing a slight fall and the other a slight increase over the year. However, there were more pronounced developments in mortgage markets with the number of loans in the first nine months of 2007 a quarter below the previous year, as rising interest rates and tighter lending criteria begin to bite. This may indicate a weaker outlook for the housing market in 2008.

The economy remains strong but the interest rate burden on new mortgages rose by almost 40% on average between the autumns of 2005 and 2007. There was a mini-revival in the housing market in 2005-6 after several years when there were fears of an impending market crash. Economic recovery and lower interest rates were key drivers in that market improvement, but now that era itself is past.

Housing supply remains extremely tight. Private housing completions were a quarter less in 2006 than they were in 1998 and they declined somewhat more in 2007. This reflects tightly constrained land supply, especially for the single-family homes to which many households now aspire, and problems with converting both brownfield and greenfield sites into new developments.

**Poland**

Warsaw and other major cities have in the past few years experienced huge increases in house prices. The square metre price of new apartments in Warsaw rose by 2.3 times during the four years between early 2004 and late 2007. But boom times seem to be coming to an end. 2007 was a year of two halves – soaring house prices and demand in the first half of the year and then stagnation, mixed with signs of decline, in the second half. The year-on-year outcome of a 28% increase in new apartment prices is consequently influenced strongly by the first half of the year, but the real story is what happened in the second half and it makes for a worrying future in 2008 and beyond.

Some commentators, including the central bank, are hoping for a soft landing to a temporary price plateau and resting place in a continued upward movement of house prices. This view may prevail, yet the sheer scale of recent price rises suggests there is now a high risk of a price correction of substantially greater proportions than a soft landing.

The turnaround has been sudden. Although the economy is still growing fast, a number of other factors have contributed to the change. Borrowing costs are rising and credit availability for some is falling. As elsewhere, interest rates have been rising. The central bank raised interest rates in 2007 in an attempt to rein in inflation
and more rises are expected in 2008. At the same time, it has been trying to curb some of the most risky mortgage lending and high loan-to-value ratios, especially when offered on a foreign currency basis with the attendant exchange rate risks.

Foreign investors seem to have recognised prices are peaking. Few are now buying and many are bringing their typically vacant and unfinished properties to market to cash in their gains, competing with new supply for much diminished demand.

An important factor is that the current housing market is a relatively narrow one, which makes it more prone to volatility. There is a relatively narrow group of potential domestic purchasers for middle to upper market properties, so the supply of that type of property may temporarily have saturated the market.

Spain

The housing market continued to slow during 2007 but change has been variable across the country. National annualised price inflation had dropped to 5% by autumn 2007 and was estimated to be 3% by year end, yet some regions were still experiencing up to 11% price growth in the autumn. Even so, there are concerns that 2008 might see significant price falls and the advent of a marked period of market decline.

Rising interest rates have had a strong impact, because most mortgages have variable interest rates and indebtedness is now so high in the aftermath of the housing boom. The rising interest burden raised the charges on a typical mortgage by two-thirds before tax reliefs between the autumns of 2005 and 2007. The burden on household finances is likely to be dissuading potential purchasers from entering the market and may be putting financial strains on many recent purchasers and some others who bought earlier.

During the boom, the Spanish economy became dependent on the residential market and the associated consumer spending. Housing investment alone was 8% of GDP in 2006. A danger is that the downturn in the housing market will spill over to the rest of the economy, denting growth and consumer confidence, which will then further depress housing market activity in a downward spiral.

So far there is little evidence of major retrenchments in new building. Over 4 million new dwellings have been built in the past decade, with output peaking as recently as 2006. Starts are declining but are still at high levels and the stock of unsold dwellings is high. It is early days in the downswing and it is unclear how deep and long it will be but if output does not adjust quickly from now on vacancy rates are likely to rise, with the downturn prolonged and deepened by a supply overhang.

The hope is for a soft landing to the housing boom and several prominent forecasters are suggesting that as the most likely outcome in 2008. The problem is that a number of worrying features of the housing market all have to react in ways that generate such a soft landing – mortgage interest rates, credit availability, foreign investors and housing output. In addition, the general economy has to weather a credit squeeze, a sharp decline in housebuilding and any unforeseen shocks over the next year or two. Consumers also need to sustain confidence in the expectation of the aforementioned soft landing. All in all, it seems that the risks of a sharp housing market correction have greatly increased compared to a year ago.

Sweden

By the end of 2007 house prices were estimated to be 10% higher than the year before, which was the same rate of growth as in 2006. However, the annual data hide what may be a significant slowdown which started at the end of the summer, for there was virtually no price growth at all for the rest of the year, with some moderate falls reported for apartments in some localities.

The economy remains strong, though interest rates are rising and concerns over impacts from the international economy are mounting, so growth may dip somewhat. Housing is still in short supply in high growth areas and recently-announced tax changes are forecast by the central bank to raise property values by around 5% when they have fully worked through the market.
United Kingdom

The housing market was one of the strongest in Europe during most of 2007. Year end prices were up by around 8%, the highest increase of the major EU economies. Mortgage lending also grew strongly in the first three quarters of the year and transactions were high, even though about 10% down on the peak figures of the previous year. Housing starts began to pick in the second half of 2007 after falls in the previous year.

However, there were signs of a slowing beyond the normal seasonal factors in the last months of 2007. The RICS housing market survey reported new buyer enquiries down by 39% in autumn compared to the previous year and mortgage approvals were down by 31% in October. In addition, the previously buoyant London market seemed to be slowing. The price indices from the Halifax and Nationwide even reported slight price falls in November.

Interest rate rises obviously contributed to the cooling, as housing affordability is now stretched. However, the identified drops in market data were from substantial peaks in 2006, so it is still far from clear that the UK market is in for a sharp correction as some pundits are suggesting. The credit squeeze has particularly affected the mortgage market, which relies on the capital markets for around 40% of its funding. The Northern Rock Bank’s collapse in autumn 2007 was the most spectacular event. The Bank of England’s support for Northern Rock also had the paradoxical effect of pumping billions of pounds of liquidity into the mortgage market as retail savers switched their funds from Northern Rock to other mortgage providers. Furthermore, interest rates were cut by 25 basis points near the end of the year and future reductions are expected in 2008. A positive impact on housing demand is likely if these materialise.

Given its relative scale, by far the most noticeable demand surge in 2006-7 was seen in London, which spilled out to adjacent parts of the South East. The London market in the few years up to 2006 had been relatively quiet in comparison to other parts of the country, with real prices even falling slightly in some periods. Then purchaser interest grew rapidly throughout 2006 and 2007 with all the classic symptoms of gazumping, offers above asking prices and sealed bids. Prices in some of the more expensive parts of the city rose by 40% or more. For example, the JLL London prime new homes index showed prices up by 62% in the third quarter of 2007 on early 2006 values. However, by the end of 2007 agents were reporting lower levels of activity, apart from in the £2 million plus properties category.
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