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INDUSTRIES AND SECTORS: CONCEPTS AND POLICIES

**THE INFLUENCE OF NATIONAL ECONOMIC
DEVELOPMENT ON THE REAL ESTATE MARKET
OF LATVIA**

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Abstract: This article reviews the real estate market development dynamics over the last decade in Latvia. The article describes the influence of various economic factors on the real estate market. These factors are gross domestic product, unemployment, crediting amount, retail sales turnover, and others. The article provides insight into the most critical development periods of economy and property market in Latvia and explains their regularities.

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Introduction

Development of real estate market in Latvia over the last decade has been rapid and dynamic. It attracted great attention from local people as well as from foreign investors. Various activities in real estate market changed the attitude of people in Latvia towards real estate as they realized that real estate had value.

During the last decade there was observable significant increase of investments in real estate, especially after Latvia became a member of the European Union on 1st May, 2004. It was the time when majority of most foreign commercial banks struggled for market share by giving out mortgage loans and, thus, contributing to the growth of demand in real estate market.

The market price in certain segments of the real estate market grew by more than 50% per year, which in its turn caused unbalanced development of the market, namely, salaries grew much slower than the prices of real estate. However, since 2007 the real estate market is experiencing considerable changes which mostly appear as decrease of prices with many resulting consequences.

This article sets out data about the real estate market development since 2000; it discusses details of macroeconomic situation in this period. The segment of real estate market analyzed in this article is serial apartments in Riga. Following economy describing factors were examined: gross domestic product, unemployment, inflation, retail turnover, and others.

The article reviews the study which is concentrated on finding correlation between different macroeconomic factors and the development of real estate market, and considering these correlations trying to predict possible development of real estate market in future.

Real estate market

During the last decade the real estate market in Latvia has developed very dynamically. Until the first half of 2007 there was observed a very high activity of the market, which was combined with rising prices; unfortunately, it changed to price decrease in the second half of 2007. So was the situation with serial apartment market in Riga. Serial

apartments occupy the major part of the housing market facilities in Riga and, although they were built mostly before Latvia regained the independence in 1991, they are in demand.

In 2000 serial apartment average price per square meter was about EUR 250, comparing to the average price EUR 1720 for one square meter in April 2007. In the period until 2007 there were several months when the price increase per month was 5% and more. "The prices increased in fact equally in all districts; also hitherto inactive districts were becoming active". Of course smaller apartments comparing the price per square meter were more expensive than comparatively large apartments.

Over time the prices of the advertised apartments raised and people were of the opinion that the prices will never drop again, although many of them waited for the price stabilization. There were common expert opinions that the prices will become stable and they do not comply with the real market value anymore nonetheless the market indicated the opposite.

After April 2007 the market price constantly reduced and the process continues up till now. In September 2009 serial apartment market price was EUR 487 per one square meter, which actually means that the market price has fallen by more than 70% from the highest point. The major problem of Latvia's real estate market is related to the fact that the price was too overestimated and currently it is, possibly, underestimated. The market has experienced very rapid fluctuations in the relatively very short period of time, which in some ways has undermined the values of the population.

Since the greatest decline in May 2009 there have been observed first indications of serial apartment market stabilization and currently the average price several last months ranges around EUR 500 per square meter. While the price continues slightly to decrease the dealers are no longer willing to sell for that price and remove the apartments from the offer, thus limiting the overall supply. Consequently a situation arises when despite the negative signals from the economic sector, its negative impact on the real estate market is small and unable to strongly affect it in short term. However, observing the development of main factors describing the economical situation in the previous periods

there can be indicated some regularities of the factors impacting the real estate market.

Characterization of economics

The gross domestic product of Latvia in recent years has increased very rapidly by more than 10% per year which, of course, was too fast for the economy of Latvia. Economy developed unevenly, there was high inflation and high domestic consumption at the same time, which is mainly the cause of the high GDP.

Currently Latvia is not able to keep positive GDP increase; since the second quarter of 2008, when the first negative tendency was recorded, Latvia's gross domestic product decreases. In the first quarter of 2009 the economic decline was 18% comparing to the same period last year, which leads to the conclusion about the situation of economics. This finding was unpleasant surprise remembering the high and stable development of last years. The decline of GDP is only summarizing complex situation of economy. The population at the same time is very confused about the possible developments of economy and the pessimistic predictions consequently respond to the real estate market, namely, people choose to defer their purchases, even those who can afford the buying. The impact of price drop is the same as in the case of overall price deflation, that is, purchases are delayed and money is spent only for the very necessary goods, that is, everyone is waiting for the price drop. Although this situation can change positively, if the fall in prices will continue next months, that will show the very lowest point reached and that could alter the mood of the population.

Drop in GDP is accompanied by the rise of unemployment rate which is a common problem in Europe but in Latvia it has become very serious. When in May 2008 unemployment rate was only 4.8% which is fairly low, in August 2009 already 12.3% of economically active inhabitants were unemployed, besides the rate tends to increase. The example of Latvia reaffirms the described situation in economical theory that employment rate is a lagging factor of economic cycle fluctuations: in the period when the decline of economics already started, unemployment rate still decreased, and only after approximately six months it started to increase rapidly. Also the official data of average wage approves that salary is not very elastic in the period of crises, unlike the number of work places which is very sensitive factor. "Also the lagging indicators - employment and inflation contribute to the prognosis of economical cycles." (Gods, p.182).

However after examining the real estate market it can be concluded that the decline of the market mostly corresponds with the periods when the unemployment rate increases.

The Figure 1 depicts the dynamics of serial apartment market and unemployment rate in the period from 2000 until 2009. As it can be clearly seen - both factors develop in opposite directions, namely, when the unemployment rate decreases, the prices in real estate market increase and vice versa. In the period after April 2007, when the real estate market was experiencing a decline, the decrease of unemployment rate continued for some time. But the period of rapid unemployment rate increase corresponds with equally rapid drop of price level in serial apartment market.

Realizing that the transactions in this market segment, as well as in the apartment market in general are mainly made between private individuals, it is self-evident that the increase of unemployment rate negatively affects the prices of real estate market facilities. Of course, unemployment rate is not the only negative factor of fall in prices in this real estate market segment. This decline period is accompanied by negative expectations of the future, instability of the government, which delayed reforms of the real estate market tax policy, inactivity of commercial bank crediting, as well as the global crisis in other countries.

One of the indicators that very precisely describe the public attitude towards economic activity is retail sales turnover. Retail trade turnover has more direct impact on commercial market, which experiences a similar scenario as the serial apartment market, with only a slight lag, but it indirectly affects or indicates also the public mood and with it also the potential apartment market activities.

The Figure 2 shows the regularities between the increase and decline periods of serial apartment market and retail turnover dynamics. Attention should be paid to the fact that retail turnover in this diagram is the relative figure, in this case increase rate compared to the respective period in the previous periods. The diagram shows that while the serial apartment market is increasing, also retail turnover mostly maintains positive increase, that means the retail turnover increases. About the same time when the serial apartment market starts to decline, also the retail turnover increase start to slow down, which later changes to the turnover decline or decrease comparing to the respective period last year.

After joining the European Union investment amount in Latvia increased and that was mostly done by crediting, namely, credit institutions were very interested in crediting the purchase of estate property by offering very favorable conditions and this was largely caused by the competition among the banks. During last years the attitude of inhabitants towards crediting was largely changed. The demand in this market segment and other real estate market segments were increasingly affected by mortgage loans. When in the beginning of 2000 the total mortgage loans issued to the residents amounted to almost 60 million lats, in the second half of 2009 the total amount of issued credits exceeds 8 billion lats.

The macro economical problem is that the most part of those credits were received at the time when the prices were higher than they are currently and credit remaining amount is greater than the possible value of real estate properties. This considerably limits the possibility to sell the property.

Conclusions

The real estate market in Latvia has seen a sharp increase in prices and an equally sharp drop in prices, which have caused macroeconomic problems in Latvia. Economic development of Latvia significantly affects the real estate market and vice versa.

Latvia's economy shows correlation between various economical factors and the development of real estate market. This relationship can be clearly seen when comparing real estate market data with GDP, unemployment rate, retail turnover and mortgage lending statistical data.

FIGURE 1. SERIAL APARTMENT MARKET AND UNEMPLOYMENT RATE

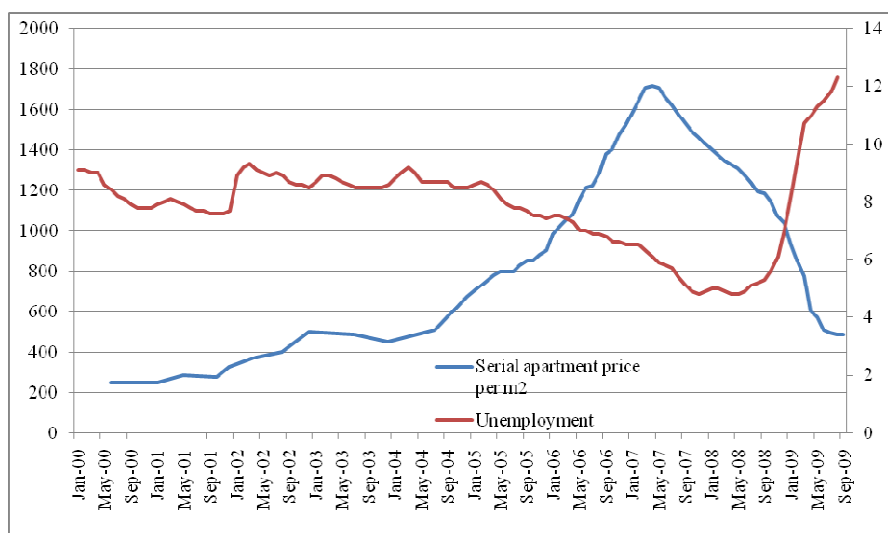
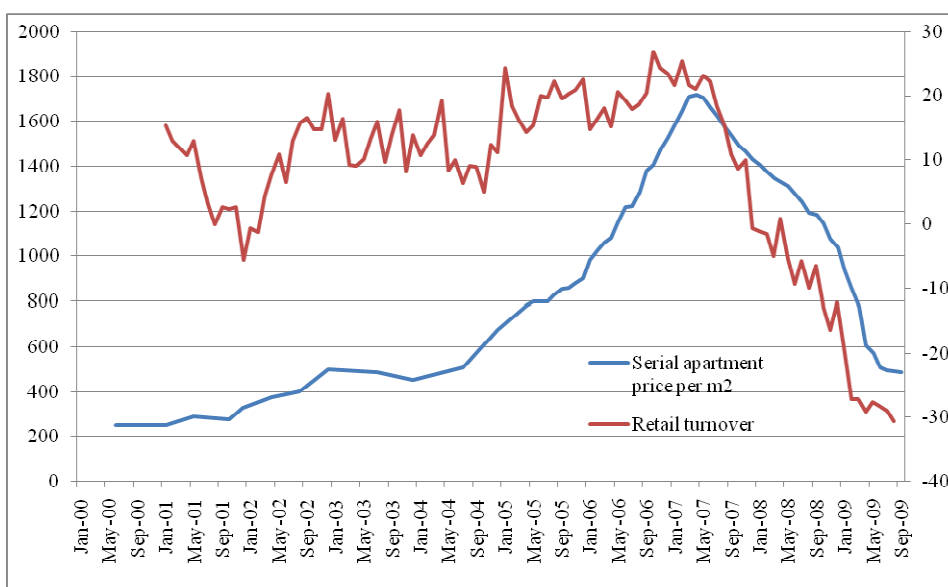


FIGURE 2. SERIAL APARTMENT PRICE AND RETAIL TURNOVER



Currently Latvia is experiencing heavy economical crisis. Similar situation is in real estate market which has been developing jointly with the economics. Latvia is an example of how irrational and too rapid and unbalanced development in past can negatively affect the development of national economy and real estate market in future. Mortgage loans received by Latvia's residents and spent for real estate purchases will have to be paid for many years. But the real problem is that the prices most likely are not going to reach previous levels, which means that the credits are spent for properties with artificially exaggerated prices.

The future development of real estate market to a great extent will be affected by the economical factors. At the same time it is possible that the real estate market may recover before the overall economic recovery, caused, for example, by such previously not mentioned factors as investor activities, government policy, demographical factors and other.

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