Real Estate Markets and Capital Flows in the Context of EU Accession

Lecture Presented by Dubravko Mihaljek, Senior Economist at the Bank for International Settlements

On June 16, 2005, Dubravko Mihaljek, Senior Economist at the Bank for International Settlements (BIS) in Basel, gave a lecture at the OeNB on real estate markets and capital flows in the context of EU accession. Before focusing on a country study on Croatia[1], he addressed some wider implications for Central and Eastern Europe (CEE).

To start with, Mihaljek analyzed the current situation of foreign investment in real estate within the enlarged EU. He discussed the right of EU citizens to buy property in other EU countries without being residents of those countries, recalling the permanent exceptions of Denmark and Malta in this area and providing further details on the transitional arrangements that are in place for the new Member States.

Mihaljek continued by pointing out some general characteristics of CEE real estate markets. In general, these markets are still fairly small: together with the construction sector, they account for 10% to 15% of GDP, compared to 20% to 25% in industrialized countries. As the public sector retreated from housing construction in the 1990s and private construction firms have started off only slowly, the supply of housing in the primary market has been very limited. The secondary market is characterized by high owner occupancy ratios; moreover, as a result of privatization many people own houses they would not be able to afford under normal market conditions. In general, the housing stock itself is in relatively poor condition and maintenance costs are often very high.

Dubravko Mihaljek subsequently discussed the impact of the increased demand for secondary residences by foreigners on property prices in specific regions – such as tourist areas – and examined the potential future effects of foreign property investment on housing markets. Combined with a strong demand by nonresidents, supply constraints may push prices further up and thus create a situation in which local residents may find it difficult to afford housing. Antispeculative regulations (e.g. tax regulations) may partly mitigate price rises, while still existing legal uncertainties should be solved to remove disincentives to supply housing in the secondary market. In view of likely supply constraints in the short run, Mihaljek argued that a gradual opening of real estate markets to nonresidents would allow for a more orderly adjustment than a rapid removal of restrictions would.

Turning to the macroeconomic effects of foreign investment in the property sector, Mihaljek highlighted various macroeconomic challenges for the new EU Member States. Given that real estate prices have risen considerably in the past few years, the wealth of property-owning households has grown, too. This situation may spur domestic demand. In some countries, property sales to nonresidents may generate considerable capital inflows, which may – ceteris paribus – exert appreciation pressure on the respective currency. In a first

[1] *Mihaljek, D. 2005. Free movement of capital, the real estate market and tourism. In: Ott, K. (ed.). Croatian Accession to the European Union. Vol. 3. Zagreb: Institute of Public Finance and Friedrich-Ebert-Stiftung. www.ijf.hr.*

round, state budgets will benefit from the positive effect of property sales on tax revenues while, after that, the overall fiscal effect depends on how this extra revenue is going to be spent.

Finally, Dubravko Mihaljek stressed the case of Croatia, where restrictions on property sales to nonresidents are currently in place. Under its Stabilisation and Association Agreement, Croatia has committed itself to removing the restrictions on property sales to nonresidents by 2009. However, Croatia may seek an extension of this transitional arrangement, or a permanent exemption, during accession negotiations. On the one hand, both Croatian tourism and the national economy will benefit from foreign investment in property, but on the other hand there is the risk of excessive housing and infrastructural development in the coastal region. It will be the responsibility of the Croatian government to prevent overbuilding by ensuring the strict enforcement of existing building regulations and further appropriate adjustment of all relevant legislation.

All in all, the new Member States may have the chance to benefit from allowing EU residents unrestricted access to their property markets, as housing stock will be renewed, the regions in question will become more attractive for other tourists, local communities will be revitalized and, as a consequence, local residents will have the possibility to create wealth. However, without proper longer-term management, this process also bears potentially high risks such as environmental damage and skyrocketing prices.