

# UC Berkeley

## Fisher Center Working Papers

### Title

European Housing and the Prospect of a Single Currency

### Permalink

<https://escholarship.org/uc/item/1cd8d32c>

### Author

Maclennan, Duncan

### Publication Date

1996-04-01

Peer reviewed



Institute of  
Business and  
Economic Research

University of  
California at  
Berkeley

---

# **FISHER CENTER FOR REAL ESTATE AND URBAN ECONOMICS**

**WORKING PAPER SERIES**

**WORKING PAPER NO. 96-247**

**EUROPEAN HOUSING AND THE PROSPECT OF A SINGLE  
CURRENCY**

These papers are preliminary in nature: their purpose is to stimulate discussion and comment. Therefore, they are not to be cited or quoted in any publication without the express permission of the author.

By  
**DUNCAN MACLENNAN**

---

**WALTER A. HAAS SCHOOL OF BUSINESS**

**FISHER CENTER FOR REAL ESTATE AND URBAN ECONOMICS  
UNIVERSITY OF CALIFORNIA AT BERKELEY**

**Kenneth T. Rosen, Chair  
Robert H. Edelstein, Co-Chair  
Dwight M. Jaffee, Co-Chair**

The Center was established in 1950 to examine in depth a series of major changes and issues involving urban land and real estate markets. The Center is supported by both private contributions from industry sources and by appropriations allocated from the Real Estate Education and Research Fund of the State of California.

**INSTITUTE OF BUSINESS AND ECONOMIC RESEARCH  
Carl Shapiro, Director**

The Institute of Business and Economic Research is an organized research unit of the University of California at Berkeley. It exists to promote research in business and economics by University faculty. These working papers are issued to disseminate research results to other scholars. The authors welcome comments; inquiries may be directed to the author in care of the Center.

REGENT'S LECTURE  
UNIVERSITY OF CALIFORNIA, BERKELEY

**EUROPEAN HOUSING AND THE PROSPECT OF A SINGLE CURRENCY**

Duncan MacLennan  
University of Glasgow

April 1996

*I am grateful to Mark Stephens (University of Glasgow) for helping me to draw together the material for Section II of this paper and to John Quigley (University of California, Berkeley) for discussing the general ideas.*



# I

## CHOICE AND THE 'MENAGE A TROIS'

### **The Menage a Trois**

The 1990's have been a difficult decade for European countries, both individually and collectively as the European Union. The deepest and most protracted recession for half a century has prompted concerns with three broad themes of economic activity and policy. The first theme has been European 'readiness' for growing 'global competitiveness' and the persistence of high unemployment in apparently inflexible labour markets. The second has deliberated on the 1980's boom, 1990's bust and now near stagnant performance of European housing, land and property markets. And the third, of course has been the sustained discussion of the post-Maastricht convergence process and moves towards full monetary union. They are, of course (and like the 'menage a trois') interrelated and not always in well understood ways.

In previous papers (Maclennan 1994, Maclennan and Pryce, 1996) I have discussed how, in the United Kingdom context, changes in the labour market (towards increased flexibility) and mortgage markets (with extensive deregulation) interacted to refashion housing sector-economy linkages. Failure to recognise these changes resulted in macro-economic and housing policy stances which exacerbated both the 1980's boom and the 1990's bust.

In this Lecture I wish to move the discussion of housing/real estate sector effects on economies and their adjustment upwards from the national to the international scale. I wish

to reflect on how housing and property markets and systems might interact with the development of a single currency in the process of European Monetary Union (EMU).

I have chosen the topic not because I am an English Euro-sceptic, though that debate has become so poisonous that the suffix 'septic' may be more appropriate. I am in fact a pro-European Scot and, in the best tradition of Adam Smith, my choice of subject has been driven by self-interest. Joining or staying out of EMU will probably represent the most important single decision on economic policy by a UK government in my professional lifetime. I wish to understand the issues and assess the likely impacts.

### **Missing Fundamentals**

Reflection has led me to a critical view, not necessarily of further European integration but of the policy and political discussion in moves towards it. In producing economic models of monetary union, academics can legitimately develop relatively abstract and reductionist models, say of optimal currency areas. They all have their point to make. My concern with the conceptual discussion is that the literature stemming from international economics in recent decades has de-emphasised, or often ignored, the role of spatially fixed factors of production. For instance, in their otherwise excellent summaries of optimal currency areas De Grauwe (1995) and Eichengreen (1994) discuss adjustment processes almost exclusively in relation to labour markets. Krugman (1992) may have encouraged 'international' economists to become 'regional' economists now but even his analysis does not consider how markets for spatially fixed factors operate; fundamentals, in the best Latin sense, are missing.

As long as we do not live in a world of mobile homes and Portakabins then the economic features of real estate markets, which require different adaptations of core economic models if they are to be 'realistically' modelled, deserve scrutiny in the 'economic adjustment' process.

Housing markets and systems are major and not minor sectors of advanced economies. In Europe, paying for housing typically involves a fifth to a quarter of disposable incomes. Residential investment usually comprises around a fifth of Gross Domestic Capital Formation. The construction sector provides five to 10 per cent of all European employment. Housing related expenditures, except in the Mediterranean area, typically comprise five to 10 per cent of public expenditure (or one to four per cent of GDP), and this share was much higher in the past. If there are 'stylised facts', to use Kaldor's phrase, about housing and property markets then they deserve an airing in academic speculations about EMU.

### **Partial Choices**

The main criticism of the EMU debate should not be directed at academic models or speculation. Rather it should be directed at the institutions of the European Union, and the Commission in particular. It is my contention that spatially fixed factor markets will play a key role in how European economies will adjust after integration and their change from the status of 'nations' to 'regions'. At the same time EMU will impact the price and output of housing and the housing policy instruments traditionally used by European governments.



The European Union, however, has not faced any of these issues but, I will argue mistakenly, referred the issues to 'subsidiarity'. Important issues for European consumers, producers and financial institutions remain unconsidered whilst discussion focuses on the 'timetable' and on the names and shapes of coins. The cart has been placed firmly in front of the horse and an obvious absence of real democratic accountability in the process of change has created unease amongst the citizens of Europe.

Rationally, individuals and institutions want a better sense of what EMU means for them. And specialist real estate and housing lobby groups have not helped the clarification process either. They have been much more concerned about future 'rent-seeking' and new 'pork-barrel' opportunities than hard assessment, with the possible exception of the major housing finance institutions and federations.

The real issue now, is not whether property market considerations will influence the decision calculus, at the Union level, on whether or not to proceed with monetary union. A single currency by 1999 is a foregone conclusion, at least for some countries. For those that adopt the ECU and those who abstain the challenge is to think through housing related policies which meet 'national' social objectives but also facilitate national or regional economic adjustment in the post 1999 era. The current likelihood is that EMU will start with a small group of Union countries in a single currency area and another group connected to it by a revived ERM (exchange rate mechanism) and a set of convergence rules.

To make the case set out above I propose to divide the remainder of the Lecture into three substantive sections. The next section presents an overview of European housing systems,

especially the financing and performance of home-owner markets. Section three, then addresses how the major 'stylised facts' of European housing markets can be introduced into more conventional discussion of optimal currency areas. With that discussion in mind the fourth part summarises the key impacts that monetary union is likely to have on European housing markets and policies.

## II

### HOMES AS CASTLES

#### **Oceans Apart**

Applied economics discussions of how monetary unions can be formed and operated are, in several senses, rather partial. One approach, which has merit only because of the absence of any recent unions as a basis for comparison, is to assess how Europe (as a set of nations) contrasts with the USA (as a set of regions). This approach has been used, helpfully, by Eichengreen (1994), Krugman (1991), De Grauwe (1994) and others. However, their contrasts rarely move beyond locational specialisation and labour market indicators. However as the housing system plays such key roles in economic adjustment, localisation and migration then it is pertinent to briefly contrast US and European systems.

The US has, by advanced economy standards, an unusual housing system. The vast bulk of homes, more than nine-tenths, are privately owned and allocated by price-signalling market means. Private renting provides a quarter of homes, and private rental housing dominates social renting. The mortgage market is competitive and, through the secondary mortgage market, now well integrated into national financial systems. Similar mortgage products are offered throughout the states and the general legal framework is broadly similar from state to state.

The US housing system is designed to facilitate mobility. The US inter-regional mobility rate, at 2.5 to three per cent of households per annum is two to three times as high as within,

let alone between, European countries. And this difference, so critical in adjustment, is influenced by housing arrangements.

What are the stylised facts of European housing? European countries have housing systems in which significant proportions of provision have been removed from market pressures. The nature and extent of these departures also varies across countries. Within Europe, only Spain and Greece have a tenure structure even remotely resembling the United States, see Table 1. Social rental provision (allocated by local administrative rules) provides more than a fifth of homes (ranging from 0 per cent in Greece to 40 per cent in the Netherlands). Private rental housing provides a lower proportion, just under a fifth (ranging from 43 per cent in Germany, prior to unification, to nine per cent in the UK). Administered price schemes still dominate private rental provision which does exist, though most markets have been deregulated for new tenancies since 1989.

**Table 1: The Growth of Owner Occupation in Europe, 1950-1995**

<b>Country</b>	<b>c.1950</b>	<b>c.1960</b>	<b>c.1970</b>	<b>c.1980</b>	<b>c.1995</b>
Belgium	39	50	54	62	62
Denmark		45	47	52	50
West Germany		35	36	40	42
Germany					38
Spain	50	51	64	69	76
France	36	42	45	50	54
Greece				71	70
Ireland			71	73	80
Italy	40	46	51	59	67
Luxembourg		55	56	59	67
NL	29	30	35	43	47
Portugal		45	48	52	65
UK	31	42	50	58	66
Austria					41
Finland		57	59	61	72
Sweden	38	36	35	42	43
EU					56

Source: Haffner (1991); Hedman (1994) CECHODAS

Aside from distorted pricing, dwelling tied subsidies (though greatly de-emphasised since the late 1970's) have provided gaps of 30-40 per cent between social sector and market rents (MacLennan, 1996). In most countries, with the Mediterranean area as exceptions, housing allowances have become a universal entitlement and in the Western countries are paid to between a third and a quarter of the total population. They usually reduce, along with other subsidies, net rent to income ratios to around 15 per cent for the rental population and generally have poverty-trap features.

From 1950 to 1980 these non-market rental systems attracted a range of client groups (including middle-income households) but disproportionately housed unskilled and semi-skilled workers. And these were precisely the labour market groups increasingly prone to redundancy and long-term unemployment after the oil shocks. In general, unemployment rates in social housing run at two to three times the high national average rate in Western European nations. And since 1980 the profile of new clients has been towards marginal economic groups.

These systems, by providing immediate housing support in situ may effectively redistribute income (that is another question) but they do not create flexible or mobility enhancing housing arrangements when economic adjustment is required. Further they are locally, and not just nationally, fragmented with queues, pricing and investment organised by municipalities and local not-for-profits. Even worse, from the standpoint of future economic adjustment, they are proportionately most important in the poorer cities and depressed regions of Europe. Housing allowance arrangements differ sharply from country to country.

It is unsurprising that cross-regional mobility rates within these sectors are low and inter-country migration is almost non-existent.

But are owner-occupied housing markets any better organised? It is important to examine home-ownership, the growing European tenure, and its financing in more detail. Owner occupation has generally grown throughout the European Union over the past five decades. Today in only three EU countries is less than half the stock owner occupied, and in one of these countries, Sweden, this is because a distinctive co-operative sector is more akin to owner occupation (Table 1).

The comparative level of owner occupation is not well correlated with the per capita GDP of countries: West Germany, for example, has the highest GDP per capita (after Luxembourg), but virtually the lowest level of owner occupation (about 42 per cent, compared to 38 per cent in Germany as a whole). Conversely, three of the four poorer Cohesion States (Spain, Ireland and Greece) have the highest levels of owner occupation. Variations in the level of owner occupation appear to have more to do with factors such as:

- government policies, such as tax reliefs or low interest loans, which have encouraged owner occupation
- government policies, such as private sector rent controls, which have disadvantaged other tenures
- the nature of the housing stock: organising flats into owner occupation is more problematic than houses, both legally and practically (and this may be one reason why rural areas, with more houses, have higher levels of owner occupation);

- the economic climate: high inflation has sometimes lowered the acquisition cost of housing by reducing the real level of interest rates and eroding the real value of the debt; and
- sometimes the extent to which the housing finance system is effective in mobilising funds for mortgages (McCrone and Stephens, 1995, p.19).

Mobility rates within European home-owner systems are relatively low by US standards. In part this reflects the propensity in some countries (Germany, France, Italy and the Netherlands) for first-time buyers to be '30-something'; it also mirrors the very high transaction costs associated with moving home, see Table 2 below.

**Table 2: Transactions Costs and Labour Mobility**

	Transaction Taxes (% of Price)	Total Cost (% of Price)	Regional Labour Mobility (% of population) 1987
France	8-10	16	1.3
Germany	4	12.5	1.1
Italy	10	18	0.5
UK	1	4.5	1.1
Spain	6	14	-
Belgium	17	22	-
Western Europe	6.5	13.5	-
USA	1.5	9.0	2.8
Japan	0.6	5.0	2.6

Sources: Economist, OECD

Only the UK has owner mobility rates and transaction charges/taxes approaching US levels. Owner occupation is important not only as the principal housing tenure in the EU. It is also important in economic terms. For many individuals their house is their largest single asset and their mortgage their largest single liability. Table 3 shows that the level of outstanding

mortgages as a percentage of GDP varies considerably throughout the EU, but averages about one-third. Owner occupation also affects government budget deficits, mainly through tax reliefs, but also through more direct forms of support, such as interest subsidies. Again, as indicated below, the form and generosity of tax reliefs varies markedly from country to country.

**Table 3: Importance of Mortgage Credit in National Economies**

Country	Outstanding residential mortgage debt as % GDP (1992)
Belgium	21
Denmark*	92
Germany	40
Greece	6
Spain	15
France	24
Italy	22
Ireland	6
Netherlands	66
Portugal	12
UK	57
Norway	52
Sweden *	57
Total	33

\* includes residential and commercial mortgages

Source: European Mortgage Federation

### **Housing Finance Systems**

The convergence of European national interest rates with those of their off-shore (Euromarket) equivalents and with each other (in real terms) since the late 1970's has been well documented by Marston (1995). Removal of exchange controls and internal deregulation played a key part in this continuing process. However Marston notes that systems dependent on national deposits may have converged less. This holds true in the



housing finance sector. There is still no single market in European housing finance. Until the 1980's, housing finance systems were generally able to evolve and to develop their own national characteristics.

Boleat (1985) identified three main types of intermediation system in Europe: the mortgage bank system, the deposit-taking system and the contractual system. These are summarised briefly.

*Mortgage Bank System.* This system redistributes personal sector savings into the housing finance system using institutional investors, such as insurance companies and pension funds, or through a stock exchange. Loans are funded by the sale of bonds on the capital markets, commonly at fixed rates of interest. The mortgage bank system is usually characterised by a high degree of matching maturities between a mortgage banks' assets and liabilities. Because funds are gained from wholesale markets, mortgage banks are not greatly dependent on extensive branch networks. The mortgage bank system is most strongly established in Denmark and Germany, but is also important in Sweden, the Netherlands and Italy.

*Deposit Taking System.* This system recycles the retail deposits of individual savers into long-term loans. The system's successful operation is more likely to depend on the use of variable rate loans, since retail deposits are generally relatively liquid and lenders may have to raise interest rates to attract new funds to maintain a balance between assets and liabilities. The reliance on retail funds means that these lenders tend to have extensive branch networks. The deposit-taking system is traditionally the dominant form of

intermediation in the UK, France, Spain and Ireland, but it operates side-by-side with the mortgage bank system in many countries, including Germany. Savings banks are the most common institution to operate this system, although building societies have been dominant in the UK and Ireland, and commercial banks may have entered the market more recently.

*Contractual System.* This system is effectively a sub-category of the deposit taking system, whereby potential buyers contract to save a certain amount for a certain period, usually at low rates of interest. Eventually, they will qualify for a loan, also a low interest rates, but since this must be funded by new savers, there may be a delay before a loan can be financed. This system which is operated in Germany and Austria by specialist organisations called *Bausparkasse*, should not be confused with more common housing-saving schemes, which are not strictly speaking contractual and do not constitute separate finance 'circuits'. The latter exist in many countries including France, Spain and Finland. In both cases favourable tax treatment and other government subsidies are generally needed to make these systems attractive.

While three distinct systems of housing finance intermediation were developed, operated by a wider range of institutions, each tended to be fairly tightly regulated up until the 1980's. Regulations tended to serve two functions, viz:

- the avoidance of institutional failure through imprudent lending practices, and
- the desire to lower and stabilise the cost of funds to borrowers.

An array of regulatory instruments was employed:

- explicit restrictions on the activities of institutions, for example not allowing commercial banks to make long-term loans if they were funded by short-term deposits. For example, Italy's 1936 Banking Act prevented deposit-taking institutions from making long-term loans
- balance sheet restrictions that made mortgage lending unattractive to commercial banks. For example, the 'corset' in the UK made entry into the mortgage market by commercial banks unprofitable by penalising excessive growth in the interest-bearing liabilities necessary to fund mortgages
- differential tax treatment between institutions, giving some (usually specialist institutions) advantages over others (usually commercial banks)
- restriction of specific mortgage instruments to specific institutions. Commonly only mortgage banks were able to issue mortgage bonds; only certain institutions may operate the French housing-savings scheme
- regulation of the terms of funding instruments. For example German mortgage banks can support mortgages of loan to value ratios up to only 60 per cent
- use of compulsory investment ratios to provide cheap finance for owner occupation, such as the system of *coefficients* employed in Spain
- regulation of interest rates on deposits. Interest rates on deposits were controlled by regulation in many countries, including Spain and Finland
- regulation on the terms of mortgages. For example, some countries place legal limits on loan to value ratios. In Finland, mortgage rates were set by a reference rate, and variable rate mortgages were not allowed in Belgium

- restrictions on the geographical scope of institution's activities. Such restrictions applied to Spanish savings banks
- restrictions on the activities of foreign banks or their prohibition occurred in all Member States.

The regulation of mortgage markets limited competition between categories of lenders and indeed between lenders within the same category. Combined with other regulations, generally the objectives of institutional stability and cheap funds were secured. Entry to owner occupation was both encouraged (by lowering the cost of funds), but restricted (by lowering the returns to savings so reducing the supply of funds, as well as through explicit restrictions on mortgage contracts). Consequently, mortgages were, in economic terms, 'rationed', usually through limits on the amounts that could be borrowed and sometimes by requirements for borrowers to wait before they were granted a loan.

### **Deregulation in the 1980's**

Until the 1980's the essentially national or domestic nature of European housing finance systems was largely unchallenged. A number of common international pressures arose in the 1980's which have caused national finance systems to become more exposed to external competition but these pressures have had quite uneven impacts.

The pressure for deregulation arose from the break-down in systems for controlling international movements of capital. New technology allowed finance to be transmitted at a fraction of the previous cost, electronic transmission made transactions more difficult to collect, and an explosion in financial instruments made the system much more difficult to

control. Western governments were faced with a choice between attempting to create a whole new battery of regulatory instruments (which were likely to be constantly outdated and therefore ineffective) or to loosen regulations within a system of international regulation. They opted for the latter course, through the Bank of International Settlements and, of course, the European Union. The most explicit change has been the (virtual) abolition of controls within the European Union since 1990 and between the EU and third countries since 1993.

In many countries currency exchange was liberalised before the EU made it compulsory. Indeed the UK did so in 1979, and this illustrates the way in which the removal of exchange controls could have a huge impact on the mortgage market. In 1979, the UK mortgage market was still dominated by deposit-taking building societies, which operated an interest rate cartel for both deposits and mortgages. The 'corset' prevented the commercial banks from competing against the building societies in the savings market, and the low cost of savings kept potential competitors out of the mortgage market. Once exchange controls were abolished, the corset became untenable because foreign banks were not restricted by this regulation. Consequently, the corset was abolished in 1980. Banks were free to compete for savings, with the result that the interest rate cartel collapsed. With savings set at market rates, wholesale funds also became competitive and the funding base for mortgages was widened. Mortgage rates rose, but the terms of lending became very much more generous. Faced with competition from the banks, the building societies were themselves deregulated to allow them to compete against the banks. The UK mortgage market changed very rapidly in the first half of the 1980's and is still undergoing rapid structural change.

The four key elements in the UK's mortgage market deregulation were:

- market pricing of funds
- market pricing of mortgages
- relaxation of lending criteria; and
- expansion of mortgage credit.

While the nature of deregulation in some other countries was different in detail and timing, the basic pattern was the same. In Spain the system of *coefficients* was wound down, particularly in 1987 until it was eventually abolished in 1993. Interest rates were also deregulated: in 1981 all loan rates were deregulated, regardless of maturity and deposit rate controls were removed in 1987. New funding instruments were created to mobilise funds from the savings market, and, although commercial banks were prevented from issuing them initially, savings banks were allowed to do so. Finally, the onerous restrictions on branching, which had greatly restricted the scope of activity of savings and foreign banks, were loosened and abolished. The terms on mortgage loans loosened and there was an enormous growth in the supply of mortgage credit (McCrone and Stephens, 1995, pp.106-10). Mortgage markets were also liberalised in Sweden and Finland with similar consequences from around 1986.

But mortgage market deregulation did not occur everywhere. Some countries seem to have been much more resistant to change. In France, elements of deregulation occurred that allowed commercial banks to enter the mortgage market after 1987, but restrictions on interest rates remained which removed a vital mechanism for the big credit expansions that

occurred elsewhere. French regulators continued to prevent financial intermediaries from paying interest on current accounts and savings accounts of up to three months liquidity. Attempts by foreign banks, notably the British bank, Barclays, to pay interest were thwarted in the French courts. In consequence the funding advantage enjoyed by the French deposit-taking institutions leaves the wholesale funded mortgage credit companies at a competitive disadvantage.

In Germany, the structure of the mortgage market, created by the regulatory system, has meant that the abolition of exchange controls has had little impact. The mortgage banks continue to enjoy a monopoly right to issue mortgage bonds, which are still the predominant form of first mortgage. The contract-savings scheme, which can be operated only by *Bausparkassen*, remains attractive for some despite the reduction in state support for the system. The market has adjusted to this regulatory regime by becoming vertically integrated, with commercial banks either purchasing or establishing their own *Bausparkassen* and mortgage banks, and themselves offering top-up loans and indeed mortgages when the market conditions are favourable. The funding attractions of *Bauspar* loans and mortgages funded by mortgage bonds gives the state leverage over mortgage products which remain relatively tight. And this makes the market very difficult to enter for outsiders, domestic or foreign.

## **Diversity in the 1990's**

Despite the pressures of deregulation, the Member States of the EU retain a marked diversity in their mortgage systems, as indicated in Table 4. There is no single EU market for housing finance and, importantly, different systems imply different reactions to similar housing market shocks.

*Interest Rates.* There remains a divide between those countries that depend upon mortgages with predominantly fixed rates of interest and those that depend on primarily variable rate mortgages. This generally mirrors the division between those countries that raise funds predominantly by mortgage bonds and those that raise their funds mainly from retail sources. The former system is more adept at raising long-term finance so is more suited to funding fixed rate mortgages. There are some exceptions, notably the French tradition of fixed rate mortgages, even though the main funding source is retail (reflecting distortions in the savings market). *Bauspar* loans are also at fixed rates because they operate within a closed finance circuit. In the UK there was some shift towards mortgages with interest rates fixed for up to five years, which were made attractive by low long-term interest rates in 1993 and part of 1994 and possibly by the use of interest rate swaps to cover the risk of losses by lenders. In other countries, such as Spain, there was pressure to allow people to prepay fixed rate loans to take advantage of lower variable rates. The fall in short-term market interest rates in 1993 prompted borrowers in Finland to switch from mortgages linked to the historically stable (and low) base rate to mortgages tied to the highly volatile (and usually higher) inter-bank rate.



Table 4: Mortgage Systems and Products

Country	Main source of funds	Interest rates: fixed (F) or variable (V)	Repayment period (years)	Loan to value ratio (%)	Repayment (R) or endowment (E)
Belgium		F			R
Denmark	Mortgage banks	F	20-30	80	R
Germany	Bausparkassen, mortgage banks, savings banks	Bausparkassen: F Mortgage banks: F Savings banks: V	Bausparkassen: ave. 11 Mortgage bank: 25-30 Retail: 25-30	70-80	R
Spain	Savings banks, state mortgage bank, commercial banks	F, but growing proportion are variable	15	80	R
France	Retail banks, savings banks, state mortgage bank	F	20	80-90	R
Greece	Direct lending, specialist lender, retail banks	F	6-15	50-75	R
Ireland	Building societies, retail banks	V and short-term fixed	20-30	80	R
Italy	Direct lending, mortgage banks				R
Luxembourg					R
Netherlands	Retail banks, insurance cos., mortgage banks	F	30	75	E/R
Portugal					R
UK	Building societies, banks	V and short-term fixed	25	90-95	E/R
Austria	Bausparkassen, retail banks and state	Bausparkassen: F Banks: V	25	70-80	R
Finland	Retail banks	V	10-15	70	R
Sweden	Mortgage banks	50% F; 50% V	30	85	R

Source: European Network for Housing Research Housing Finance Working Group Survey June 1995; Diamond and Lea (1992)

*Repayment Periods.* These still vary greatly, even though deregulation had the effect of lengthening repayment periods in some countries. They remain shortest in Finland, Spain and Greece where they tend not to exceed 15 years. Repayment periods of 20 years or more are more common, although in some countries repayment periods are as long as 30 years. The length of repayment period is not merely a function of the lenders' ability to supply long-term mortgages or of the degree of competition. In Spain, for example, shorter repayment periods are encouraged by the tax system which favours the repayment of capital.

*Downpayments/Loan to Value Ratios.* The size of the deposit acquired by lenders is one of the key differences between mortgage systems. It is of crucial importance since it determines access to owner occupation according to income (the speed at which savings can be accumulated) and age (the point at which a deposit has been saved). Roughly speaking, small requirements for deposits allow early access into owner occupation. In the 1980's 100 per cent mortgages were common in some countries, notably the UK, but the housing recession has reduced this figure. The largest deposits are required in Austria and Germany - the countries with the lowest rates of owner occupation. Again, the maximum loan to value ratio is not merely a function of competition: the presence of state/municipal guarantees (eg. the Netherlands) or other mechanisms (such as the mortgage indemnity guarantee system which operates exclusively in the UK, protecting the lender from losses arising from default and foreclosure) have the effect of raising loan to value ratios.

The degree of support for government owner occupation varies throughout the EU (Table 5). Some of the key features of government support are:

- mortgage interest tax relief (MITR) is a feature of all housing markets, although the degree of generosity varies. There has been a reduction in the scope of mortgage interest tax relief in many countries. The principal restrictions that are applied are: limits on the number of years for which it can be claimed; limits on the rate of tax at which it can be deducted; and limits on the amount of a loan or interest payments that are eligible for relief. MITR is unlimited only in the Netherlands, but this is the only country that applies a significant balancing tax on the imputed rental income enjoyed by owner occupiers. Germany's main tax relief is a depreciation allowance, rather than MITR. Tax relief has not been cut in all countries: Spain and Germany are notable exceptions, and in the latter case the cost of MITR has grown greatly in recent years
- Capital Gains Tax is not generally charged on principal homes, at least not without roll-over relief. Clearly one reason for this is that it would discourage mobility
- housing allowances are available for owner occupiers in many countries. The main exceptions are the UK and the Netherlands, where the housing allowance is available only to tenants, and the Mediterranean countries such as Spain which have no housing allowances
- interest subsidies are provided in some countries. They are very significant in Spain where the whole direction of housing policy has been on lowering the cost of borrowing. In the 1980's these interest subsidies have become more targeted on lower income groups, although first time buyers, and people with moderate incomes are now also

targeted. Interest subsidies are also a feature of owner occupied housing in France, Sweden and Finland, although the level of support has been greatly reduced

- other measures have been taken to encourage owner occupation. In the UK and Ireland schemes have been run that have enabled tenants of local authority housing to buy their houses, and these have been very popular. The British government intends to introduce a scheme to allow housing association tenants to purchase their houses with the help of government subsidy. The Irish government is also introducing measures to extend its existing schemes. In Germany, the government wishes to raise owner occupation to 50 per cent, and is attempting to meet this target by lowering the cost of housing by relaxing building regulations and increasing competition in the house-building industry.

Table 5: Tax Deductibility and Housing Allowances for Owner Occupiers

Country	Main tax relief	Deductibility	Time limit	Rate	Direction	Housing Allowance for owner occupiers
Belgium	MITR	Not above (high) imputed rent, child allowances				No
Denmark	MITR			50%	Has been cut	No
Germany	Depreciation allowance	5% of property value	8 years, then smaller allowance	Own tax rate	Maintained. Costs have risen rapidly	Yes
Spain	MITR	Interest payments up to Ptas. 800k (single) Ptas. 1 m. (couple)	None	Own tax rate	Maintained	No
France	MITR	Interest payments up to FF40k (higher for families); income ceiling FF21k (1992).	5 years	25%	Payment ceilings uprated but time limit reduced from 8 years	Yes
Netherlands	MITR	All interest payments; no limits	None	Own tax rate	Maintained. Note balancing tax on imputed rent	No
UK	MITR	Interest payments up on first £30k of loan	None	15%	Ceiling not uprated since 1983; maximum rate reduced from 40% to 15%	No (limited social security payments for interest)
Finland	MITR	Interest payments up to FIM20k (single); rising to FIM29k for children	None	Tax credit	Was claimable at own rate of tax; now <i>de facto</i> tax credit	Yes
Sweden	MITR	30% of interest payment within limit of Skr 100k (Skr200k for couples)	None	30%	Rate at which claimable cut progressively since 1982. Cut to 30% in 1991	Yes

Source: Diamond and Lea (1992); Hedman (1994); McCrone and Stephens (1995)

With such diversity in the EU's mortgage finance systems it is unsurprising that their efficiency varies. A study of the efficiency of mortgage delivery systems in four EU countries and the USA was undertaken in 1991 (Diamond and Lea, 1992). The authors attempted to measure the efficiency firstly by comparing the mortgage rate with a hypothetical benchmark rate based on the government bond rate. This gave a gross spread. Secondly, they made allowances for origination fees, subsidies within the intermediation process and the value of options (that is, choices within contracts). This gave an adjusted spread. Thirdly, they conducted a qualitative exercise to assess the efficiency of other aspects of the intermediation process, notably the allocation of risk.

It is important to note that their concept of efficiency is not just confined to factors within lenders' control: for example subsidies and (sometimes) the cost of funds. So no simple judgement can be made regarding the ability of lenders to compete against one another across borders. But neither is their concept of efficiency comprehensive: it does not take into account subsidies outside the intermediation system, such as mortgage interest tax relief. And, as the authors themselves point out, efficiency is only one way in which to judge a finance system: there may be other objectives, such as market stability.

The Diamond and Lea results, reproduced in Table 6 suggest that wholesale funded systems are more efficient than deposit funded systems, with the exception of British building societies which, on the basis of the adjusted spread, were the most efficient institutions examined. It should be noted, however, that spreads have widened in the UK since the early

1990's, partly in response to rising losses on non-performing loans. The French deposit taking institutions appear to be quite inefficient, especially when subsidies are taken into account. The qualitative exercise, summarised in Table 7, consistently indicates that the UK system is the most efficient, with two exceptions, while the French system is consistently the least efficient.

**Table 6: Intermediation Efficiency**

Country	Lender	Period	Unadjusted Spread	Adjusted Spread
Denmark	Mortgage banks	1986-91	1.28	1.29
France	Depositories	1987-91	2.32	2.65
	Specialised	1986-90	2.34	2.00
Germany	Mortgage banks (1st mortgage)	1982-91	1.47	1.46
	Depositories (1st mortgage)	1982-91	2.15	2.07
	Bausparkassen (2nd mortgage)	1982-91	-2.21	1.65
	Depositories (top-up loan)	1982-91	2.76	2.76
	Packaged loan	1987-91	n.a.	1.65
UK	Building societies	1988-91	1.65	1.23
	Centralised lenders	1987-91	1.51	1.35
USA	Securities market	1988-91	2.07	1.23
	Depositories	1988-91	n.a.	1.82

Source: Adapted from Diamond and Lea (1992)

**Table 7: Qualitative Assessment of Intermediation Efficiency**

Country	Funding market	Operating cost	Excess subsidy cost	Credit risk allocation	Interest risk allocation	Liquidity risk allocation
Denmark	4	1	2	2=	4	2=
France	5	5	5	5	5	5
Germany	3	4	3=	4	3	2=
UK	1	2	1	1	1	2=
USA	2	3	3=	2=	2	1

Source: Diamond and Lea (1992)



## **The European Single Market and Mortgage Finance**

One of the key issues at the European level is whether a more integrated mortgage market will emerge and whether the diverse systems of mortgage finance will converge.

In the 1980's the European Commission issued a draft mortgage credit directive, which indicated its desire to see moves towards a more integrated European mortgage market. The draft directive was dropped when it was overtaken by the single market programme. In banking this is based on several principles:

- all credit institutions, whether they operate in other Member States or not, must meet minimum prudential standards established by the EU, including basic capital adequacy standards laid down by the Solvency Ratio and Own Funds Directives
- all credit institutions may operate in other Member States on the basis of the banking licence issued by the home state regulator: the so-called 'single passport' (Second Banking Directive); and
- credit institutions may operate in other Member States only in the same way in which they operate at home (Second Banking Directive).

In principle one might expect that the single passport might lead to a single market in mortgage finance. One might expect systems to become more like the most efficient through a combination of actual cross-border competition and the threat of such competition. However, as the previous sections in this chapter have shown, there is very little evidence of convergence in mortgage markets; indeed, in recent years, there may even

have been some divergence. Although there have been some operations by lenders in other Member States these have been small scale, they have often been unsuccessful, and mortgage markets remain overwhelmingly dominated by domestic institutions.

A number of barriers remain which tend to limit the transfer of mortgage finance across borders:

- *mortgage products cannot be standardised.* For example, the tax system in the UK and the Netherlands favours endowment-backed mortgages, whereas the Spanish tax system favours repayment mortgages
- *security is nation-specific.* Valuation systems vary across Europe and offer varying degrees of certainty to lenders. Foreclosure systems depend on national laws, and again offer differing levels of security to lenders. These factors will affect the amount that lenders are willing to lend, at what price and to whom
- *indigenous institutions may retain regulatory advantages.* The Second Banking Directive prevents discrimination against foreign institutions, but it does not prevent particular types of institution from having certain advantages. So it is quite allowable for mortgage banks to be given the sole right to issue mortgage bonds. Incomers may find it difficult to compete against mortgage banks, unless they themselves establish one. But this prevents convergence
- *market entry is expensive.* Whether through acquisition or establishment of a branch network, entering markets is expensive. Normally, lenders operating in other countries do so on the centralised lending model. On this basis funds come from the wholesale

markets or from the parent institution and loans are originated through third parties. This saves on the cost of establishing or acquiring a branch network. But wholesale funds are not always the cheapest, and the centralised lending model is not suited to the cross-selling of other financial products

- *savings markets remain segmented.* Although exchange controls have been abolished, savings markets remain segmented and savers may sometimes get poor returns. These poor returns give lenders a competitive advantage. Savings have been transferred from one market to another at no risk to the financial institution or the borrowers using derivative instruments. But this practice is expensive and complex. Whilst exchange risks remain, segmented savings markets will be used to the advantage of indigenous lenders. A single currency could therefore be beneficial to savers and would remove one barrier to a more integrated market in mortgage finance.

### **Housing Market Volatility and Monetary Union**

Housing finance systems for owner occupation will remain distinctive for many years to come, and they interact with the wider economic system to produce very different results for overall stability. That is, the external shock to housing to economy transmission mechanisms vary sharply across the Union countries. One of the very notable differences in western European housing markets over the past decade has been the experience of great volatility in some countries, compared to relatively stable situations in others. The contrast between volatile and stable housing markets is demonstrated most clearly through house prices, although transactions and new starts usually vary directly with prices.

Table 8 summarises real house price trends in 14 EU countries and Norway over the period 1985-93. (The missing EU member is Austria). The second half of the 1980's saw a boom in real house prices in some countries, but relative stability in others. The UK, Spain and Finland experienced the largest rises in real house prices, which peaked in the late 1980's at more than 50 per cent above their 1985 level in each of these countries. In contrast real house prices were almost unchanged in Italy and Portugal. Spain and the UK each experienced one year when prices rose by more than one-fifth. In contrast, Italy and Greece never experienced one-year rises of more than three per cent. At the end of the period, following a downward adjustment in some countries, real house prices were still more than 20 per cent higher than their 1985 level in 1993. In some other countries, real house prices ended the period almost unchanged (Sweden, Greece and Italy), and substantially lower in Norway and Denmark. It is important to distinguish between real prices that have been stable throughout the period (eg. Greece and Italy), and those which have been so volatile as to have experienced among the highest rises, yet whose falls have brought real prices back down to their 1985 levels (Sweden).

**Table 8: Trends in Real House Prices in European Union Countries (1985=100)**

	Belgium	Denmark	Germany	Greece	Spain	France	Ireland	Italy	Luxem- bourg	Nether- lands	Portugal	UK	Finland	Sweden	Norway
1985	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
1986	105	111	102	100	98	101	100	97	104	105	99	110	105	101	109
1987	108	99	103	103	115	102	97	97	108	110	97	123	113	110	112
1988	114	98	104	106	130	95	103	98	109	114	97	148	127	124	109
1989	124	93	105	108	157	105	111	97	112	121	96	166	144	137	98
1990	130	83	109	109	159	116	121	99	114	120	98	149	153	139	88
1991	134	82	112	108	165	106	120	100	116	119	101	139	150	135	80
1992	139	76	114	102	154	109	119	...	117	124	...	129	135	120	75
1993	145	80	114	98	156	...	121	...	115	133	...	124	122	103	75

Source: European Mortgage Federation

The common features behind the inflationary surge in house prices in the 1980's were usually relatively large owner occupied sectors supported by generous tax treatment, small private rented sectors unable to act as anti-inflationary shock-absorbers; and mortgage finance deregulation which provided credit for previously unmet demand.

Inflationary and volatile housing markets have several implications for national economies. The competitive position of countries with inflationary housing markets may be undermined. Higher house prices may feed through into demands for higher wages, and these pressures may become acute when prices rise very quickly. Further, rising real house prices may also create inflationary pressures on the macroeconomy through their impact on real personal wealth. Rising real house prices increases overall wealth in the personal sector because all owners of houses gain from higher prices which are sustained by relatively few purchasers who are less wealthy. Particularly in deregulated markets, real house price wealth can be unlocked into higher consumer expenditure which can be inflationary.

Among those countries which experienced house price inflation in the 1980's, the largest falls in real house prices occurred in Sweden and the UK where they fell by one-quarter. Like these countries, Finland experienced a one-year fall of 10 per cent. However, it is unlikely that falls in real house prices simply counterbalance the inflationary effect of previous rises. Most especially, it is unlikely that the previous inflationary impact on wages will be reversed. So in both cases the country may be less competitive. If wages do not adjust downwards, adjustment may take place through the nominal exchange rate by

currency devaluation. In the event of monetary union, this response would not be open to individual countries. The result would be higher unemployment or migration, see next section.

Table 9 shows changes in nominal house prices. These are important for housing finance systems and housing markets because it is usual for mortgage debt to be fixed in nominal terms. Real house prices can fall without nominal house prices falling. In this case the security of the loan is not diminished. But when nominal house prices fall, the value of the house (and security for the loan) can fall below the value of the debt, the situation known as negative equity. Negative equity makes it more difficult for borrowers to trade their way out of repayment difficulties and therefore increases the chances of loan default and perhaps repossession. It also increases the chances of lenders incurring losses because the security behind loans can vanish. This could greatly disrupt the intermediation process. Clearly, the higher the loan to value ratio, the smaller the fall in nominal house prices necessary for negative equity to occur. Finland has been affected most severely by falling nominal house prices, which fell by nearly 40 per cent in the period 1989-93. Sweden and the UK were also severely affected by falling nominal house prices. In each of these countries the government intervened to assist borrowers with mortgage difficulties.

**Table 9: Trends in Nominal House Prices**

Year	Belgium	Denmark	Germany	Greece	Spain	France	Ireland	Italy	Luxem- bourg	Nether- lands	Portugal	UK	Finland	Sweden	Norway	
1985	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
1986	106	115	101	124	107	104	104	103	104	102	110	114	104	106	118	118
1987	111	107	103	148	132	108	104	108	108	106	118	133	116	119	132	132
1988	119	110	106	173	156	104	113	114	111	109	130	167	158	141	137	137
1989	133	110	109	200	201	118	126	120	118	111	145	202	193	166	128	128
1990	144	101	116	242	217	135	142	130	124	113	168	199	182	186	119	119
1991	153	102	124	287	2389	128	145	140	130	116	191	196	155	199	111	111
1992	163	96	131	314	236	134	149	...	136	119	...	189	128	181	106	106
1993	175	102	136	346	251	...	153	...	138	125	...	184	118	162	108	108

Source: European Mortgage Federation except Norway, Sweden and Finland kindly supplied by Rolf Barlindhaug



Housing markets where nominal prices in particular are falling may be difficult to turn around towards recovery because potential buyers defer purchase when they expect prices to fall further. However, devaluation in 1992-93 in some of these countries seems to have helped to stabilise their housing markets, allowing lowered interest rates to ease the pressure on borrowers and paving the way for export-led recoveries. Nor do countries such as Finland and the UK seem to have been unable to contain inflationary pressures resulting from devaluation. Indeed, by 1995, Finland was able to switch from a loose monetary policy and tight fiscal policy, towards a tighter monetary policy, with some currency appreciation. Such flexibility in monetary policy would of course be absent in a monetary union.

It is not clear how monetary policy could work in a Union with very different housing finance systems and housing markets. There is clearly a possibility that some countries (or regions within them) would experience inappropriate monetary policies, and these would be felt most keenly in those countries, such as the UK, where variable rate mortgages are predominant. Some countries may experience strong inflationary pressures from their housing markets, but will be unable to adjust through monetary policy.

There is therefore some pressure to create conditions for more stable housing markets, and reductions in support for owner occupation combined with measures to revive private rented sector in some countries is indicative of a willingness to attempt this. Whether such measures will be sufficient to avoid future volatility is uncertain.

### III

#### NOS PONEMOS EN CAMINO

European countries, or at least some and at different paces, are setting out on a road which will allow little diversion and no turning back without great cost. The single currency is essentially irrevocable unless a currency wishes to leave the Union. The critical question, in this context, is whether the 'stylised' features of European housing systems are likely to exacerbate difficulties in the convergence/post unification short-term or whether, more fundamentally they will impair the effective functioning of the Union as a single currency area.

#### **Lost Options**

Put in concise terms, a monetary union goes beyond fixed exchange rates to replace national currencies by a single currency. In relation to currency issues, nation states then become 'regions' of the Union with irrevocably fixed exchange rates. This arrangement removes the costs of currency conversions for those wishing to trade across former national/currency boundaries, and the EU have estimated this benefit at around half a per cent of EU GDP per annum. Consumers will gain at the cost of financial sector employees and institutions. Creating the single currency also removes exchange rate risks for those trading across national boundaries within the Union. As potential variations in exchange rates induced either cross-country differences in interest rates (with higher premia for those currencies likely to depreciate), (see Marston, 1994), or costs of hedging, unification removes further

costs and promotes equalisation of interest rates. De Grauwe (1995) also argues that such processes begin to remove price discrimination across countries and makes real interest differences more apparent to lenders and borrowers thus ensuring their erosion. Such effects, given the observations in the previous section, may be of great future significance in European housing finance markets but these issues are left to the next section.

Within the monetary union, cross country differences in (risk-adjusted) nominal and real interest rates will also be inevitably curtailed by changes in monetary policy arrangements. As countries can no longer determine the price of their own currencies they are no longer effectively able to control the supply of money (and interest rates) within their nation state boundaries. In consequence, the control of monetary policy within the Union has to be shifted from national to Union level, within the EU context a European Central Bank being formed. That is, nations joining the Union must simultaneously lose sovereignty over exchange rates and monetary policy.

### **No Regrets?**

The loss of national monetary policy control may, at first sight seem a grievous blow. It also raises questions about 'instruments' for housing and land policies. In recent years some countries, especially Denmark (since 1983) and the UK (since 1989) have reduced fiscal policy supports for the home-owner market and increasingly seen monetary policy as the key policy influence on the housing market. On occasions, in the past, monetary policies have been 'softened' to encourage market activities (post the 1987 stock price fall) and in other

periods, as in the UK 1989-1991, specifically 'hardened' to reduce house price inflation and equity withdrawal. Given the debt features of housing, monetary policy has been an important housing/property policy influence.

Within the currency area, embracing all of the 'national' housing markets, monetary policy cannot be made to suit a particular sector or region. However, if it is to design 'Union' monetary policy effectively, the ECB will have to have good information on housing/real estate trends (which the EU presently does not have for all countries). The intra-EU property cycles, see previous sections, which presently differ in amplitude, timing and economic impact are likely to become more synchronous and develop more similar shock absorber capacities (see next section). And housing market cycles induced by different national monetary policies (and mistakes!) will be removed under the ECB regime.

A further, possible, advantage is that a 'hard nosed' Central Bank regime may lead to lower real interest rates, especially in inflation prone political/economic systems. Where countries, with their own monetary sovereignty, persistently create inflation they do not reduce unemployment (except for very short term periods) but rather raise inflationary expectations and, often, real interest rates. If the Central Bank adopts 'hard nosed' monetary policies nominal interest rates will certainly be lower in 'soft' countries and unemployment (in the long term) no higher. This is the familiar vertical Phillips curve model.

Further, if the ECB recognised the long-run vertical curve it will (so the conventional wisdom runs) be less likely to 'cheat', than national, 'election-sensitive' politicians by attempting to reduce unemployment below the natural rate and hence increase the credibility of monetary policy (the Barro-Gordon model). Of course this relies on the Bank Board being apolitical and acting in the aggregate interests of the Union. How this develops in practice within Europe will be of great interest and significance.

One assumption has been that the ECB will essentially adopt the technical and ethical approach of the Bundesbank. But with the majority of Union countries having been distressed by German interest rate policies over the last four years (from British mortgage holders in 1992 to French teenagers in 1996) this is no foregone conclusion. Indeed the recent behaviour of German bond price issues (which will be repaid in ECU's for four year plus bonds) and an apparent shift of German deposits to Switzerland (outside the Union) indicates unease on this issue from inflation averse German citizens and institutions. However, unless the ECB disregards the continuing pressures of global competition, and the need for competitive disinflation strategies then monetary policy will be of the hard-nosed variety. Ultimately that scenario will help mortgage borrowers in the single currency area.

It is important not to overstate the pro and anti arguments for single and separate currencies. Arguably, the removal of exchange controls and the markedly increased integration of global capital markets has greatly narrowed the scope of national monetary authorities to pursue 'discretionary' monetary policies. Bond markets quickly add an inflation and risk premium

to interest rates lowered by expansionary national policies. National autonomy has greatly narrowed in the 1980's. Equally losing exchange rate flexibility may impose few costs on national policy-makers. Where devaluation occurs in response to lax monetary policies or recurrent, structural impediments to competitive pricing then devaluation of nominal exchange rates is likely to have only short-term benefits. De Grauwe, however, notes important European exceptions to this argument, for instance Denmark and Belgium in the mid-1980's. It is also arguable that at present the UK economy is benefiting from the post-EMR exit of sterling in 1992. And part of this gain has been that the devaluation has washed away, in conjunction with sensibly changed housing policies, some of the economic consequences of over-priced land and housing.

The current concern of France and Germany over the effectiveness of the UK and Italian devaluations has, in fact, led to a significant toughening of the proposed 'rules-of-conduct' for EU countries which remain outside the single currency post 1999. Equally the development of sophisticated exchange and interest rate hedging instruments has, in contrast to the early 1980's, reduced the risks of traders and institutions located outside the single currency area.

### **Economics and Optimal Currency Areas**

Countries therefore have to assess whether joining a single currency will mean net gains or losses from giving up exchange rate and monetary policy sovereignty. The economics literature on optimum currency areas offers some rather generalised insights about which

kinds of countries are likely to be net gainers though the literature offers no precise rules, calculus etc. It is useful to review these considerations to establish whether housing and property systems are likely to shape pro or anti single currency calculations.

Small countries are likely to lose little by joining a currency union. For they already have little autonomy in exchange rate and monetary policy but can gain from reduced exchange costs. Mackinnon (1963) noted, reasonably, that for any given size of economy more 'open' economies were likely to gain more from currency union. Savings in exchange cost and exchange risk removal will be proportionately more significant. This pre-supposes, of course, that union will be with intensive trading partners. European economies are, in contrast to North America, relatively open (with exports at 20 to 30 per cent of GDP versus 10 per cent) and the share of trade with intra-Union partners is large and growing (close to 60 per cent of trade).

However, adapting figures from De Grauwe, in Table 10 it is apparent that openness varies considerably across the EU states. Even more important, the share of intra EU trade differs sharply. For instance Belgium and the Netherlands are open economies but facing into the EU and they represent an obvious case for further consideration of currency union. In contrast, Britain and Denmark face outwards into the world economy to a much greater extent and, on these grounds, have less to gain from union.

**Table 10: European Countries, Exports as a Share of GDP and Intra-Community Export Share (1992)**

	Exports as a Share of GDP	Intra-Community Exports as a Share of all Exports
Ireland	68	74
Belgium	69	73
Netherlands	51	78
Portugal	24	82
Germany	22	73
Denmark	35	40
France	23	54
Greece	22	53
UK	25	38
Spain	23	41
Italy	19	37

Sources: European Commission and World Bank

Diverse economies, with economic activity arising from a wide range of sectors are, in the long-term, less likely to suffer from currency union than specialised economies. Kenen (1995), argued that specialised economies are more likely to suffer shocks to demand or supply which are not shared by other union members. That is they suffer from 'asymmetric' shocks which present them with a need for economic adjustment vis-à-vis their currency partners.

There is some very generalised empirical evidence on this point. Krugman (1991) has contrasted the locational specialisation of industries within US regions and European countries. He concluded that European economies are more diverse than US regions and therefore less likely to suffer from asymmetric shocks. However, the limitation of this argument (which Krugman recognises) is that EMU may well facilitate and accelerate single



market effects which sharply increases country/regional specialisation in Europe. That is, EMU will generate more 'asymmetric' shocks (though note the earlier contrary observation in relation to policy shocks) and remove a key adjustment mechanism. Eichengreen and Bayoumi, also, provide evidence on the correlation of supply and demand shocks across the EU and other countries. Their evidence, with some countries in the EU having high correlations and others low, reinforces De Grauwes well argued and detached conclusion that not all of Europe constitutes an obvious, single currency area.

The importance of the symmetry and asymmetry of shocks to a set of economies has to be complemented by an understanding of how economies respond to the same shock. If countries are all part of the same labour or land market or capital market then symmetrical shocks will have similar impacts. But if countries, even facing the same external pressures, have, as a result of individual and institutional differences, different transmission mechanisms then impacts and adjustment requirements may vary.

### **Adjusting Without Exchange Rates**

Until now, with minor embellishments, this section has followed the standard arguments about optimal currency areas. But what if, faced with a symmetric or asymmetric shock, countries differ in adjustment capacities and that these differences arise in property markets or because of them.

Mundell (1961), first developed coherent arguments about how nations, in many respects reduced to the status of economic regions, can adjust to externally originated shocks in the absence of the power to vary exchange rates. His arguments retain force but need, in the European context, to take account of the 'stylised facts' outlined in the previous section.

If countries have joined currencies, then they have to adjust in other ways to asymmetric shocks. Other dimensions of economic flexibility have to be addressed. The weakness of the optimal currency area adjustment literature is that it equates overall economic flexibility with changes in wage rates and migration, that is labour market flexibility.

The standard argument runs as follows. In a currency union if region A suffers a reduction in effective demand for its exports which are now produced by expanded output in Region B then adjustment will take place through labour market change. If wages are flexible, then wage rates in A will fall in relation to B and there will be migration from A to B. If wages do not fall and migration is sticky unemployment will rise in region A and wages will increase even more in B (note that this spatial shift will induce a higher 'natural rate' of unemployment). It is worth noting that even prior to monetary union that European regional differences in unemployment and wage rates are more marked than in the USA. That is, even with present exchange rate arrangements, the system is less flexible. And the onus of 'blame' for this difficulty is laid firmly at inflexible European labour markets.

This argument, as far as it goes is valid but seriously incomplete. Let us introduce 'real estate', in the shape of housing markets and systems into this analysis. And let us assume that these systems are characterised by the stylised facts of Section II. First, we should note that resort to standard regional economic models won't help greatly as few such models adequately model the interaction of housing sectors and local economies (MacLennan, Meen and Tu, 1996). But progress can be made on an informal level.

Housing demand and prices have a positive elasticity with respect to income and employment levels. In Region A, continuing the previous example, reduced exports induce reduced wage rates. These will impact 'fixed factor' prices. Falling wage rates will induce, in the home-owner sector, falling house prices. Falling house prices, will help maintain the real wage rates of new entrants in the housing market (thus sustaining real local consumption). However, a much greater number of existing owners will have to meet fixed nominal long-term mortgage debt commitments from lower wages and they will also suffer capital losses on their main asset. Both of these effects are likely to substantially outweigh benefits to new entrants and hence consumption in Region A will be reduced further than the initial loss in exports would have implied, at least into the medium term. As long as land ownership is not local, however, falling land costs will reduce the need for further downward adjustment in wages as firms will be attracted to A by both low wages and lower land costs (viz the recent success of London's Docklands, essentially paid for by the losses of overseas banks).

In Region B, rising exports will expand employment and property and housing costs will rise. There may, in all likelihood, be an upward increase in consumption in B arising from increased local property wealth. However to induce migration into B from A, wage rates may have to rise to compensate potential movers for asset losses in A, the higher cost of housing in B and the significant level of European home-owner movement costs. These wage rises, and inelastic urban property supply curves are likely to forestall growth in B.

In short, leaving aside owner capital gains and losses and migration costs, the fixity of local property supplies and upward supply inelasticity in the growth region should reduce the adjustment difficulties between A and B (though potentially impairing the inflation trade-off of the Union as a whole). Asset gains and losses and high migration costs exacerbate adjustment problems.

The obvious response is to rely on rental housing which is market priced, has low tenant movement costs and is owned by institutional investors with regionally diversified portfolios. Then fluctuations in property costs would invariably reduce the adjustment burden. But these are not, emphatically, the stylised facts of European rental systems. And this is important because the history of the last 20 years has seen downward pressures on the real wages and employment prospects of renters rather than owners (though this pattern has altered in the 1990's housing market recessions of Sweden, Finland and the UK).

With the exception of Germany and the Mediterranean countries social rental provision dominates private rental ownership. Even where rental units are privately owned prices are primarily influenced by administrative rather than market forces. Continuing the adjustment story for Regions A and B, if non-market renters in A are faced with lower wage rates or become unemployed they may have little incentive to move. If they are subsidised by non-portable dwelling subsidies (with rents 30 to 40 per cent below market rates) then 'net advantages' reasoning may result in a decision to remain in A. And if they do so and become unemployed, social security/housing allowance induced poverty/migration traps come into play. Even if they do wish to move to B they have, often, to re-enter administered housing queues de novo which lengthen as fiscal retrenchment (at the national scale) reduces new social housing starts. And private rental supply invariably remains sluggish.

The key point is an obvious and telling one. Housing arrangements in Europe are likely to preclude effective labour market adjustment across European countries let alone within them. Ignoring these concerns in the theoretical discussion, which so much relies on effective labour mobility, is a little careless. Ignoring them in the real European debate constitutes either gross neglect or stupidity. The European Union, to ease post currency integration adjustment difficulties must take a view on the economic role and functioning of housing systems in cross regional integration. At present housing remains a small and back-door interest of the Social Affairs Division of the Commission DGV. The message is clear,

inflexible housing systems may be as important as inflexible wage mechanisms in preventing required adjustment within the Union.

### **Fiscal Policies**

There is a final dimension of adjustment, inter-regional fiscal transfers, which can accommodate asymmetric shifts (MacDougall, 1977). In a national economy with a progressive tax and benefit system, or with explicit territorial redistribution objectives (for instance through central government ) 'equalisation' of budgets for local government spending, there will be automatic stabilisers helping region A to adjust. In essence fiscal transfers from B to A will boost demand in B and reduce it in A. Interregional transfers are well developed within nations but are rare across national frontiers. At present the European Union budget represents less than one per cent of European Union GDP and this is clearly much too limited to serve as an effective adjustment mechanism (though relatively low cost schemes can be developed, see Eichengreen, 1994).

There are also limits to the extent to which national units can run fiscal policies to 'compensate' for lost monetary sovereignty. The possibility of locational shifting will restrict tax rates on households and businesses, unless such rates are directed at providing widely approved public goods and not, primarily, income redistribution. Borrowing options may also be restricted but there are two possibilities. First, within the Union, arguably, a specific national government may seek extensive recourse to public borrowing, aware that the monetary implications will impact the Union as a whole (that is, there is a moral hazard

problem). If this is likely then the Union will wish to set limits on fiscal deficits for member states and, with more resource equalisation also likely, this will lead to some centralisation of control over fiscal policies. The second proposition is that member states will no longer be able to erode the real value of outstanding public debt by relaxing monetary policy but have to make real repayments. These 'harder' constraints will induce Union members to behave responsibly (and de Grauwe notes the voluntary restriction of State deficits in the USA).

Two aspects of fiscal issues are of particular pertinence to housing issues. Firstly, if there is a move to increasing European budgets, and some commentators have argued that Europe should have a unitary, centrally financed social security system, then such changes will have to be harmonised with the range of tax and benefit schemes which are so important in European housing. Secondly, growing fiscal stringency within countries (already evident in the Maastricht convergence phase) is likely to lead to further downward pressures on housing policy spending.

## IV

### WILL EMU BE BAD FOR HOUSING?

Housing sector discussion of EMU has generated quite a bit of heat and noise, but very little enlightenment. In part this is understandable because the issues are so complex and the real costs and benefits of EMU may differ from country to country. In this debate the 'one-handed' economist isn't really very helpful and economic Shivas are really required. But a number of general observations are pertinent and it is assumed, initially that a relatively extensive monetary union appears within Europe by around 2000.

The convergence 'requirements' of the Maastricht Treaty are already having a significant, negative short-term effect on European housing systems. Restrictive fiscal and monetary policies to achieve 'Maastricht' criteria amidst a deep recession has resulted in flat housing markets in most of the Union with little recovery in market volume and nominal prices in the countries most deeply enmeshed in negative equity and arrears. At the same time, within government spending, housing budgets are being trimmed and reduced. Britain, the Netherlands and the UK have all introduced new housing policy measures to facilitate more flexible housing systems but there are few other major reforms in train.

It can be expected that those countries which do unite their currencies in 1999 (with Germany, France, the Netherlands and Luxembourg likely to be definitely 'in', Britain and Sweden definitely 'out' and the other nine in various stages of indecision) will have mutually



adjusted to a significant extent. But that adjustment may not be complete prior to union, especially if the (arbitrary) Maastricht rules are relaxed to admit more countries. In the short-term after union, the housing markets of the weaker countries will be subject to further negative pressures. Indeed if regional restructuring commences almost immediately, lower productivity regions will feel downward pressure on property prices, and in the converse in growing regions (see above). Lenders will have to pay attention to new lending risk patterns in the mortgage market. And within the inefficient, inflexible housing systems described in Section II, regional shift consequent to EMU is likely to add to unemployment, especially in social housing, and this may occasion a negative dynamic of decay and poverty externalities in non-core regions and cities. The EU is much vexed about social exclusion but it has done little to stop it happening by improving housing system and labour market flexibility prior to the single currency. Hopefully, in this period the Union will finally recognise the economic significance of poorly organised housing and property markets.

Housing finance market changes, in the short-term, may be more favourable. With exchange costs and risks removed and a single EU interest rate (plus risk premia) then 'national' systems will be exposed to competition with interest benefits to consumers, especially in southern Europe. Non-price barriers will continue to play their part and direct cross-border lending by financial institutions will remain limited. More likely financial intermediaries in nation one will buy nation two vehicles, through take-overs, to grow cross-nationally.

Over the longer term benefits will become more apparent than costs. The once-for-all entry adjustments will, hopefully, have been forgotten. The housing capital market will also facilitate the erosion of non-price barriers to flows and cross-border 'direct' sales may be a possibility. But this will require a long-term process of institutional convergence across countries. For instance mortgage law and underwriting procedures may have to be harmonised.

Institutional convergence in 'national housing policies' will, I believe, be inevitable. Within a currency union no competitive country can afford the cost of having a housing system which reacts particularly adversely to Union monetary policy changes. For example, in the UK true fixed rate mortgages are likely to begin to replace variable rate instruments (the ECB will be in no position to make special exception for British borrowers should the UK ever join) and loan to income ratios fall. The financing of social renting is already 'converging' (away from public budgets to market loans) and the pricing of and access rules for such housing will come under scrutiny as currencies merge. And private rental housing will make a comeback as labour market flexibility becomes the key issue in European economic policies.

Many of these changes, I believe, would have been induced over the next decade, even without monetary union. But they acquire a particular significance in intra-European adjustment once national exchange rates are abolished. I have, here and over the last five years, been consistently critical of the European Commission's perspective on these issues.

But it does face problems of both knowledge and decision. It has to understand more about how fixed factors impact inter-regional adjustment. It cannot hope for efficient, flexible market changes in the fragmented, non-market, high-mobility cost systems described in Section II. However it cannot, for political and budgetary reasons, centralise housing policies in Europe.

At present, within nation states, housing policies often pursue a mix of local and national objectives and use a cocktail of central and local resources. Rather than merely labelling housing as an issue of local subsidiarity the Union has to address its legitimate economic interests in such systems and add them to local policy choice sets.

I have not addressed here, in any detail, the almost inevitable two-speed Europe. It is clear that EU members who join a single currency in 1999 will wish to both encourage 'laggards' to join the next round (2002) and to abstain from competitive devaluations. To ensure such conformity new convergence rules are being proposed, including a suggestion that all countries outside the single currency rejoin a reborn ERM. With such an ERM led by the 'euro' rather than the Deutschmark countries may find this an appealing proposition. However Eichengreen has argued persuasively that, in the absence of any capital controls of a temporary nature, such a system is unlikely to be free from the speculative pressures manifested in 1992-93 and would not endure.

The two-speed approach would complicate rather than confound the housing changes likely to appear within a single currency area. Both tracks will be subjective to competitive pressures arising globally and involve downward pressures on housing and land prices and the avoidance of house price booms. Efficient lenders, in the Union but outside of the single currency, will use wholesale money markets, hedging instruments and take-overs to secure a share of mortgage growth in the single currency area. This will be no great disadvantage as long as mortgage intermediation rate differentials are significant and swap instruments are competitively priced . Arguably, as the new millennium unfolds, the main growth opportunities for efficient lenders within the Union may not lie in the single currency core but in the former socialist economies from Poland to Hungary entering the Union. But it is unlikely that they will be in the common currency within the next decade.

The European Union, in the areas where countries share common goals and in the completion of the single market, offers and achieves gains for European citizens. But countries must make a considered choice of when and if to join a single currency. If the core insists on all joining or devises severe non-entry criteria and if the Union members retaining single countries use their exchange rate policies to persistently erode the competitive position of the core then the Union will not last. That is why it is so important that the Union gets down to the hard details of integration enhancing reforms rather than persistent calls to shared visions. Clearly Europe has much to do on the home front.

## References

- Bayoumi, T. and Eichengreen, B. (1993) 'Shocking Aspects of European Monetary Union', in Torres, F. and Giavazzi, F. (eds), *Adjustment and Growth in the European Monetary Union*, Cambridge: Cambridge University Press.
- Boleat, M. (1985) *National Housing Finance Systems*. Beckenham: Croom Helm.
- De Grauwe, P. (1994) *The Economics of Monetary Union*, Oxford: Oxford University Press.
- Diamond, D. B. and Lea, M. J. (1992) 'Housing Finance in Developed Countries', *Journal of Housing Research*, Vol. 3, No. 1 (special issue).
- E. C. Commission, (1977) *Report of the Study Group of the Role of Public Finance in European Integration*, (MacDougall Report), Brussels.
- Eichengreen, B. (1994) *International Monetary Arrangements for the 21st Century*, Washinton D.C.: The Brookings Institute.
- European Mortgage Federation, (1995) *Annual Report 1994-95*, Brussels: EMF.
- Haffner, M. E. A. (1991) '*Fiscal Treatment of Owner-Occupiers in the EC: a Description*', (unpublished).
- Hedman, E. (ed.) *Housing in Sweden in an International Perspective*, Karlskrona: BOVERKET.
- Kenen, P. B. (1995) *Economic and Monetary Union in Europe*, Cambridge: Cambridge University Press.
- Krugman, P. (1991) *Geography and Trade*, Leuven: Leuven University Press and MIT Press.
- Maclennan, D. (1994) '*A Competitive UK Economy: Issues for Housing Policies. A Competitive UK Economy: Issues for Housing Policies*'. York: Joseph Rowntree Foundation.
- Maclennan, D. (1996) '*Contrasting Fortunes: Housing Associations in Europe and the UK*'. Paper presented at ENHR/CECODAS Conference, Nunspeet, Netherlands.
- Maclennan, D. and Pryce, G. (1996) 'Global Economic Change and Housing System Impacts', *Urban Studies* (forthcoming).

- MacLennan, D., Meen, G. and Tu, Y. (1996) *'The Area Economic Impacts of Housing Investment'*, Edinburgh: Scottish Homes.
- Marston, R. C. (1995) *International Financial Integration*, Cambridge: Cambridge University Press.
- McCrone, G. and Stephens, M. (1995) *Housing Policy in Britain and Europe*, London: UCL Press.
- McKinnon, R. L. (1963) 'Optimum Currency Areas', *American Economic Review* 53, (September): 717-724.
- Mundell, R. (1961) 'A Theory of Optimal Currency Areas', *American Economic Review*, S1 (September): 657-64.