

Euroland's Real Estate and its Importance for the Euroland Economy and ECB Policy

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"The bubbles that exist now in housing are in more than two dozen countries." Alan Greenspan, 2 October 2007

The crisis in the US housing market will – in the view of PIMCO – dominate Fed policy over the next years, and signs for this are already evident. The real estate slowdown has impacted US GDP reports via the negative contribution from the construction sector and we expect that consumption will not escape some significant correction going forward. Will Euroland's housing market and economy face a similar fate?

Euroland Chasing US Property Prices

More recently, worries about housing markets in other parts of the world have surfaced and with it the fear that the housing slowdown might become a more global phenomenon. The Financial Times of 29 September reported on its front page that "Holiday homes face price fall threat," stressing the ongoing weakness in the Spanish housing market. As I am French, I am also well placed to report that the doubling of the property prices in France over the last eight years or so has undoubtedly supported consumers' confidence and their ultimate consumption. I myself enjoyed the wealth effect to some extent (though I don't own much!) and certainly feel a bit less comfortable now that prices seem to have plateaued and that some house price deflation might seem as unavoidable in my nice city of Les Sables d'Olonne on the French Atlantic coast as in some parts of the United States.

In fact, the real house price appreciation trend in Euroland over the last years has kept up with the US (Chart 1).

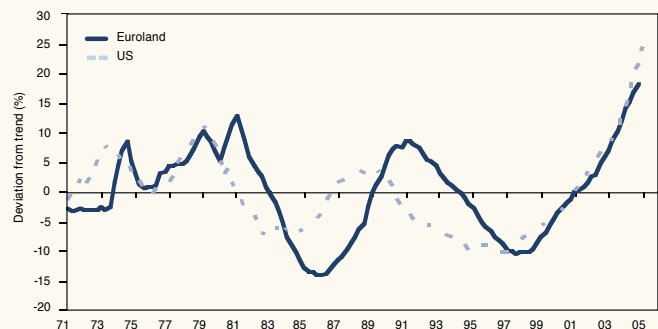
How important is and has the real estate market been for the Euroland economy in the last years? Are there signs of weakness yet in the housing market? And, finally, what impact can we expect on consumption and the overall economy, credit growth and European Central Bank (ECB) policy? These are the questions we will address in this piece.

Residential Investment's Limited Impact

There are different ways through which the real estate market can impact the economy. The obvious one is by looking at the contribution of the construction sector to GDP growth measured by the share of residential investment in GDP as shown in Chart 2. Spain has clearly been benefiting from the boom in the construction sector. The contribution to GDP growth from that part of the economy has been about 1% per year since 1999.

In fact, the housing boom in Spain presents some similarities with the post-unification era in Germany, as well as with the most recent developments in the US. The share of the construction sector in the Spanish GDP

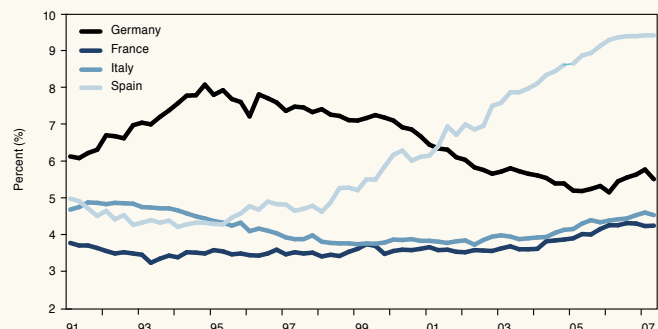
Real House Prices in Euroland and the US



SOURCE: OECD, DB Global Markets Research

Chart 1

Residential Construction (% GDP)



SOURCE: Reuters EcoWin Pro

Chart 2

is now higher than it was in Germany at the end of the post-unification real estate boom and much higher than it was at the peak of the US housing cycle in 2005.

The impact is less pronounced in other countries. Looking at France, the contribution of the construction sector to GDP growth has been about 0.2% in the last years while, in Germany, it has even been negative until 2004. Since then, residential investment has stopped being a drag to German GDP growth, which in itself can be seen as a positive.

Transactions and Wealth Effect Drive Consumption

Another way of looking at the importance of the real estate market, particularly housing, is through the consumption effect, which consists of two factors: the number of transactions and the wealth effect. When people buy apartments or houses, they tend to buy more furniture, TVs, etc: This is the transactions effect. When people see the prices of their homes go up, they feel wealthier, have better credit scores and tend to consume more: This is the wealth effect.

From the late 1990s until 2004, both the number of transactions and prices – as shown in Chart 3 – accelerated, especially in France and Spain.

The wealth effect is particularly evident in Chart 4. When we look at 2003 consumption growth in a large group of countries worldwide and regress the growth rate with the level of house price appreciation, we see a strong correlation. Germany and Japan, for example, had no price appreciation and no real consumption growth. On the other hand, Spain and France had strong price appreciation and stronger consumption.

So far, we have seen in this instalment of the *European Perspectives* that since the beginning of this century the share of residential investment has increased in Euroland,

particularly in Spain, and that price appreciation in Euroland supported consumption, especially in Spain and France. What we haven't considered yet is that the boom in housing resulted also in an acceleration of credit growth for home purchases (Chart 5).

We know the ingredients from the finance side that fueled credit growth and thus the housing markets in Europe: low interest rates in the European Monetary Union (EMU) (thanks to the convergence of the national bond curves down to the German yields), innovation in the mortgage markets (with the creation, for example, of new 50-year mortgages) and the exporting of the UK housing bubble into other European regions (through the surge in demand for holiday homes).

We would add that the real estate market tends to act on momentum with increasing prices boosting the demand for real estate as those who are planning a purchase tend to accelerate their decision and as increasing prices make a real estate investment look more attractive for the cohort of pro-cyclical minded investors. On the flip-side, housing slowdowns tend to take a long time to reverse, and this is why the current signs of weakness are particularly alarming.

First Signs of Weakness in Euroland Housing

Currently, there are at least three signs of a weakening in the Euroland housing market: Price appreciation is slowing while mortgage growth and housing permits are indicating a sharp correction in construction activity in the coming months.

Price growth has been slowing for about a year. In France and Spain, the slowdown in price appreciation is remarkable (Chart 3). In fact, the last numbers released by FNAIM (the French federation of real estate agents) indicate some deflation in the French housing market

House Prices in Euroland

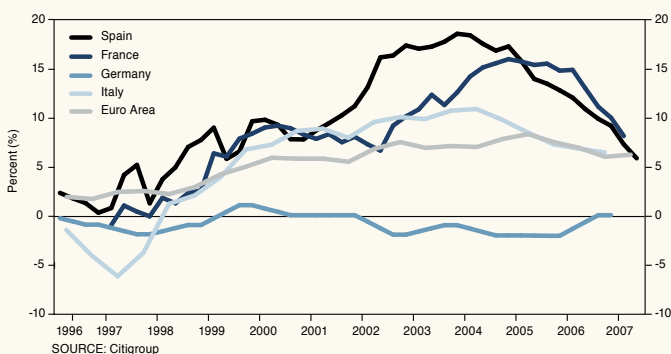


Chart 3

Consumption and House Price Appreciation 2003

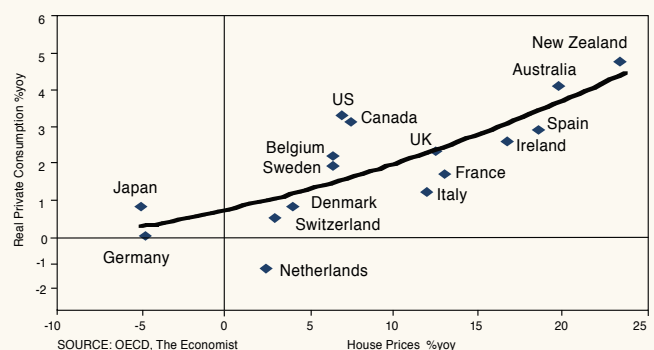


Chart 4

in the last months, with a decline in the prices of apartments of 1.7% over the quarter to September 2007. After multiple rate hikes by the ECB, higher mortgage rates are starting to impact borrowers. In addition, prices have reached levels that made it increasingly difficult for people earning non-investment bank salaries to purchase anything in cities like Paris or Barcelona (the average price per square meter in the centre of Paris is now exceeding 7,000 euros).

Moreover, mortgage growth, as measured by the loans made to households for property purchases, has slowed remarkably since the middle of 2006 (as shown in Chart 5) under the influence of higher mortgage rates, lower affordability and probably a less favourable outlook for housing. What is similarly remarkable – and supports our previous intuition that housing and consumption are well linked – is that consumer credit growth declined simultaneously (Chart 5). The growth rate of credit to households has been slowing overall, which might indicate some weakness to come in Euroland consumption.

This is, of course, an important consideration for the ECB. This development should make the central bank less worried about the pace of credit growth than before, even though broad-based monetary growth remains quite strong due to other factors like the attractiveness of monetary assets in the context of a flat yield curve.

Housing permits in Euroland are now slumping in line with the bearish developments described above. This is particularly the case in Spain, where the number of housing permits is falling by an annualised rate of about 40% (Chart 6). But permits are also falling at the entire euro area level, as the composite shows.

In addition, anecdotal evidence suggests a decline in the number of transactions in countries like Spain and France, but unfortunately, there appears to be no hard data depicting these series (if anybody knows of such a data series, please let me know!).

When summing it up, the story sounds very much like in the US at first sight: Prices are not rising anymore or are even falling, mortgage growth is declining and housing permits indicate a stronger slowdown to come in the contribution of residential investments to GDP growth. However, a Euroland-wide price depreciation does not appear to be a reasonable scenario given the differences between the countries in the euro zone.

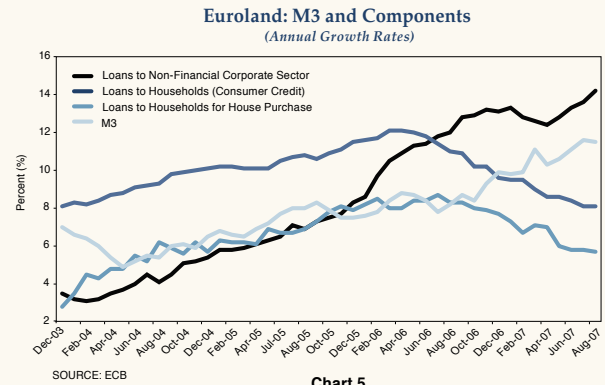


Chart 5

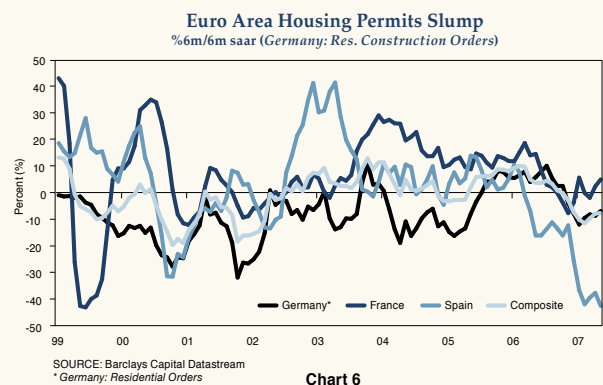


Chart 6

Slowing GDP and Credit Growth

The development outlined above suggest that euro area GDP will most likely suffer from negative impacts through construction sector growth as well as deteriorating consumption outlooks in the countries that had enjoyed housing booms. Spain appears particularly at risk, with a GDP growth rate that could fall from a 3.5% pace to 2.5% if the construction sector would stabilise and everything else remained equal (which would not be the case given the negative externalities in terms of consumption as previously noted). France is also at risk but the consumption effect will dominate, based on a decline in the number of transactions, as well as stabilising, if not falling, prices. From an average of 2.4% household consumption growth per annum, consumption in France has already dropped to a level of 1.7%. However, the countries most affected by the housing and construction slowdown only contribute about 35% to euro area GDP, thus mitigating the impact on the euro zone average. Still, even countries like Germany are experiencing a slowdown in construction, as illustrated by the decline in housing permits.

The good news for the ECB should be the decelerating growth rate in credit to households. Interestingly, in the September ECB press conference, Jean-Claude Trichet

spent a long time explaining that several factors are causing broad money growth to rise. He particularly mentioned the flattening of the yield curve, which has increased the attractiveness of monetary assets relative to less liquid, longer-maturity instruments (which should not be too worrisome for the ECB) and the growth of loans to non-financial companies. The recent re-pricing of risks in the credit markets and the ongoing liquidity crisis in Euroland might make these contributions to monetary growth particularly vulnerable in the next months. This should please the ECB.

To sum it up, Euroland enjoyed strong real estate markets over the last years with some similarities to the US when it comes to price appreciation or the contribution of residential investment to GDP growth in some countries. Euroland is now suffering from a significant slowdown in housing, which is most likely

going to impact consumption negatively and slow down credit growth to households. In fact, some of these effects are already visible and contributed to the recent downward revisions of GDP growth forecasts for 2008 by most market participants. Ultimately, the housing market developments in Euroland support the case for an ECB on hold for now.

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Gross Domestic Product (GDP) is the value of all final goods and services produced in a specific country. It is the broadest measure of economic activity and the principal indicator of economic performance.

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