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The Impact of Rapid Credit Growth on Slovakia's Housing Market

By Peter Harvan, Anton Jevčák, Peter Pontuch and Vladimír Solanič

Summary

Since joining the EU in 2004, bank lending to the non-financial private sector in Slovakia has grown continuously. While corporate credit volumes stopped growing in the aftermath of the 2008/09 global financial crisis, household borrowing has continued to grow at double digit rates, mainly to finance property purchases.

We evaluate the impact of these developments on household debt levels in Slovakia, investment activity and house prices. We find that credit expansion has not resulted in any apparent macro-economic imbalance, as household debt levels remain relatively moderate, despite the rapid growth in housing-related borrowing. The ratio of residential construction investment to GDP has not been subject to boom-type dynamics. The performance of the banking sector's household loan portfolio has also remained relatively stable in recent years. Although the proportion of non-performing loans rose briefly in 2009-2010, they swiftly returned to low pre-crisis levels. House prices, which began a sharp correction in 2009, have been rising again since late 2014 but it is too early to judge the extent to which this trend will continue.

To avoid the development of any possible excesses in the housing market, some reassessment of fiscal and regulatory policies related to the housing sector could be useful. Policies to develop the formal rental market and a shift to value-based taxation of residential property could reduce the strong preference for owner-occupied housing in Slovakia. Addressing regulation bottlenecks in housing construction could also help to increase the responsiveness of housing supply.

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Introduction

Rapid credit growth is generally considered as one of the most relevant indicators of financial system vulnerability. Among recent studies, empirical research by Schularick and Taylor (2012) shows that past domestic bank credit growth is a highly significant predictor of a financial crisis event in a given country and that risks to its financial stability increase with higher credit-to-GDP levels. Anundsen et al. (2014) also present country-level empirical evidence indicating that growth of credit to the non-financial private sector has a positive and highly significant effect on the likelihood of a financial crisis. Moreover, credit growth and the credit-to-GDP gap are confirmed to perform well as individual early warning indicators among others by Behn et al. (2013) or Drehmann et al. (2011).

Since its entry into the EU in 2004, Slovakia has experienced a continuous expansion in bank lending to the non-financial private sector. While growth of credit to non-financial corporations ceased in the aftermath of the 2008/09 global financial crisis, credit to households continued to increase at double digit growth rates. In particular, lending of Monetary Financial Institutions (MFI) for house purchases increased at an average rate of almost 13% between 2010 and 2014 and amounted to some 77% of total MFI loans to individual households at the end of 2014.

The continued rapid expansion of bank lending for house purchases in the post-crisis period has so far not been reflected in the overall level of construction activity or in the aggregate house price developments. Following a peak in 2009, real residential construction declined for two years and then remained broadly stable. Similarly, the house price index followed a declining trend from late 2009 until end-2012. Although the trend reversed in early 2013, the house price index only exceeded its 2010 level in 2015-Q1.

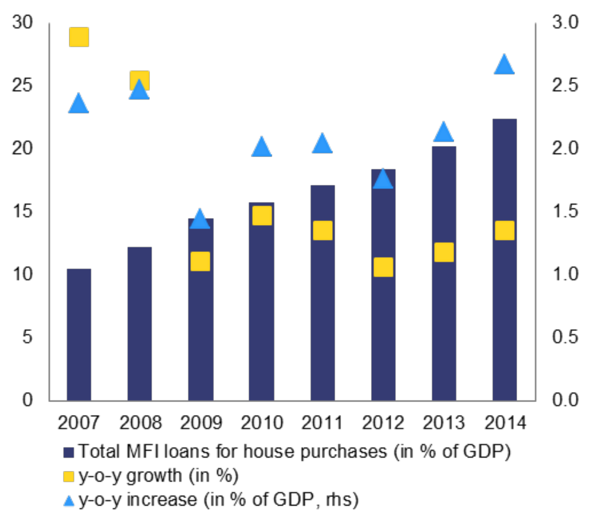
Nevertheless, although credit expansion has not resulted in any apparent macro-economic imbalance, it has surely supported households' purchasing power and thus domestic demand. A substantial slow-down in the pace of new credit provision could thus have a significant negative impact on Slovakia's growth performance. The available macro-economic policy instruments should therefore be set in a way that would minimise potential risks associated with the evolution of the financial cycle.

Given Slovakia's membership in the euro area, the monetary policy stance might not necessarily be fully attuned to its national circumstances. The National Bank of Slovakia (NBS) introduced a set of macro-prudential measures to address developments in retail lending. However, these might not be sufficient to avoid future excessive increase in house prices if the current credit growth trend persists. As a result, it might be appropriate to re-assess some of the fiscal and regulatory policies related to the housing sector in order to ensure its resilience (i.e. to avoid large price or output swings) in view of continued rapid expansion of bank lending for house purchases.

Growing indebtedness of the household sector

Outstanding loans to households for house purchases increased from below 10% of GDP in 2006 to above 22% in 2014. This was the consequence of rapid credit growth, which exceeded 20% annually in 2007-08 and, despite having slowed down considerably, continued to exceed 10% in the following years (see Graph 1). The average annual increase in the stock of this type of MFI loans amounted to more than 2% of GDP over 2010-14, providing a boost to domestic demand growth. At the same time, the stock of loans to households for house purchase has remained far below the 2014 euro-area average of about 38% of GDP.

Graph 1 MFI loans to households for house purchases

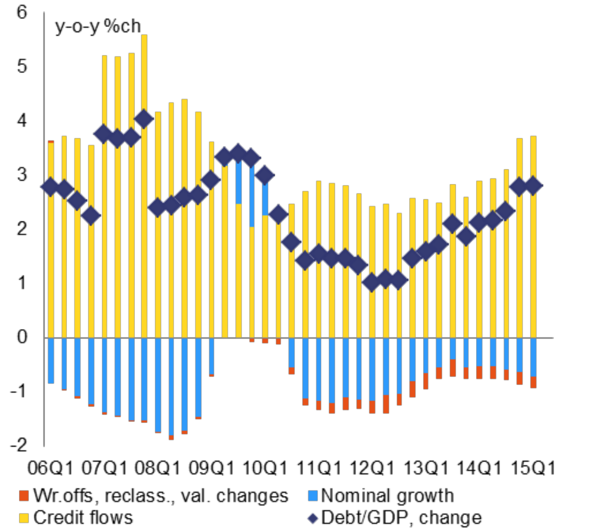


Source: NBS

Total household indebtedness remains relatively moderate despite rapid growth in mostly housing-related borrowing. Total household debt to GDP was around 33% of GDP in 2014, close to the levels in the Czech Republic, Poland or Slovenia, and well below levels in most euro area countries. The annual change in the Slovak households' indebtedness ratio has been rather stable since 2005, mostly in the 2 to 3 percentage point range (see Graph 2). The contribution of credit flows to this change has also been rather stable, with no apparent boom-bust patterns, and in particular no household deleveraging in the crisis period.

The vulnerability of Slovak households to shocks to interest rates, house prices, and incomes also seems to be overall contained, despite some potential concentration risks. Simulations by Ampudia et al. (2014), using household survey data at the peak of the latest upturn, reveal that Slovak households were quite resilient to rises in interest rates and to falls in house prices or incomes. Nevertheless, this study also indicates some debt concentration problems among Slovak households. A relatively high share of indebted households (above 30%, second only to Portugal) have a negative financing margin (measured as the residual income after taxes, debt repayments and estimated normal living costs), forcing them to either use savings or compress living costs. Although subject to estimation uncertainty, this situation is reflected in a higher probability of default.

Graph 2 Drivers of the year-on-year change in household debt to GDP

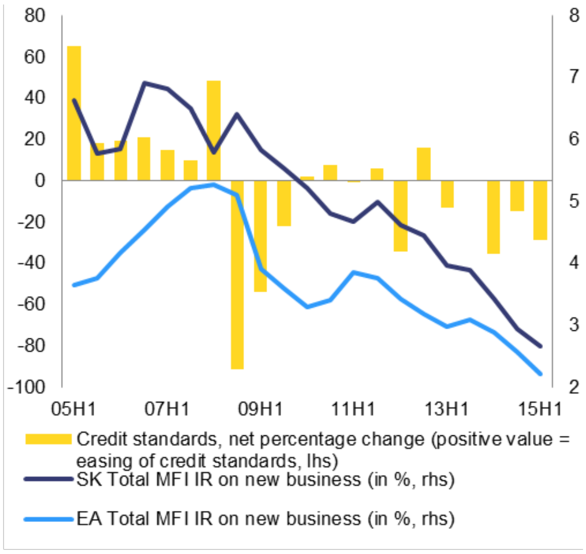


Source: Eurostat, own calculations

Interest rates followed a declining trend from early 2009 up to mid-2015. Interest rates on MFI loans to households for house purchases fell by almost 3.8 percentage points over the last six and half years. This was in line with developments in the euro area as a whole, reflecting an increasingly accommodative monetary policy stance. Declining costs of bank credit thus supported the continued rapid pace of credit expansion. They might have, however, also made new borrowers, with in most cases only temporarily fixed borrowing costs, more vulnerable to interest rate shocks.

Credit standards on housing loans were tightened considerably during the global financial crisis and in its aftermath. However, even though the banking sector did not materially ease the supply of housing loans, the tighter post-crisis credit standards still allowed for continued rapid housing credit expansion.

Graph 3 Credit standards and interest rates on housing loans to households



Source: NBS (Survey on Supply and Demand on Lending Market), ECB SDW

Performance of the banks' portfolio of loans to households has been stable in recent years. The share of non-performing household loans (NPLs) increased from 4% in mid-2008 to almost 6% in 2010, as the 2009 recession negatively affected households' debt repayment capacity. Thanks to swift economic recovery, the share of NPLs declined again and has remained at close to 4% since 2012. At the same time, the loan-to-value ratio on new housing loans has oscillated around 70% since end-2008, substantially below the peak level of around 90% observed in 2007 and 2008-H1.

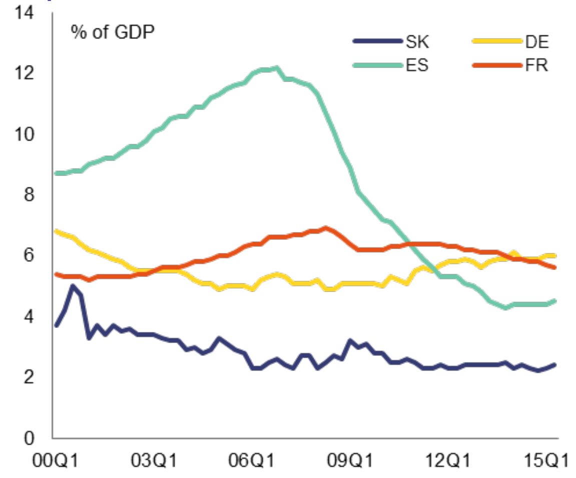
The macroeconomic relevance of the housing sector

Developments in housing markets have widespread macroeconomic effects. House price movements and related wealth effects together with fluctuations in residential construction influence the overall level of domestic economic activity while also interacting with the quality of bank balance sheets and credit supply[1]. As a result, housing sector developments usually play an important role for the overall macro-financial stability of a country.

Residential construction investment as a share of GDP has been on a declining trend since the early

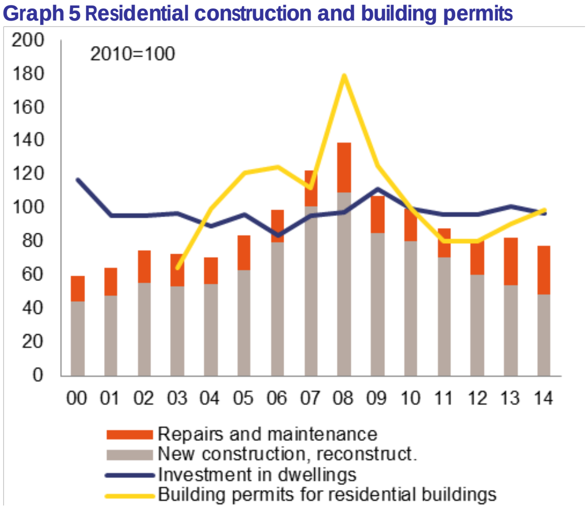
2000s. After having followed an upward trend between 2006 and 2009, real residential construction investment declined in 2010 and then remained broadly stable up to 2014. Nevertheless, residential construction has been on a clear downward path as a share of GDP for almost fifteen years, at a level well below those of larger EU countries (see Graph 4).

Graph 4 Residential construction investment in EU



Source: Eurostat

Graph 5 Residential construction and building permits



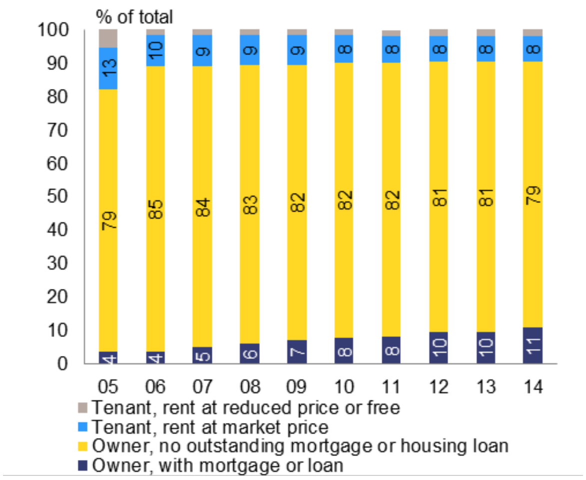
Source: Eurostat

At the same time, following a massive spike in 2008, the granting of new building permits dropped significantly below pre-crisis levels in recent years (see Graph 5). This was also reflected in the falling share of the new construction and reconstruction works in the overall residential construction since 2012.

House ownership has increased considerably over the past decade. In 2014, over 90% of the Slovak population lived in owner-occupied dwellings – the third highest level in the EU. This was some 7 percentage points higher than in 2005 due to an increase of ownership backed by mortgages (see Graph 6).

The rental market remains relatively small in Slovakia. While the share of population in market rental housing is one of the highest among the CEE EU member states (7.6% in 2013), it remains significantly below other EU countries and has been on a decreasing path (see Graph 6). Moreover, the share of population renting at reduced prices is very low (2%). Consequently, the share of population in total rental housing was the third lowest in the EU in 2013.

Graph 6 Tenure structure in Slovakia between 2005-2014

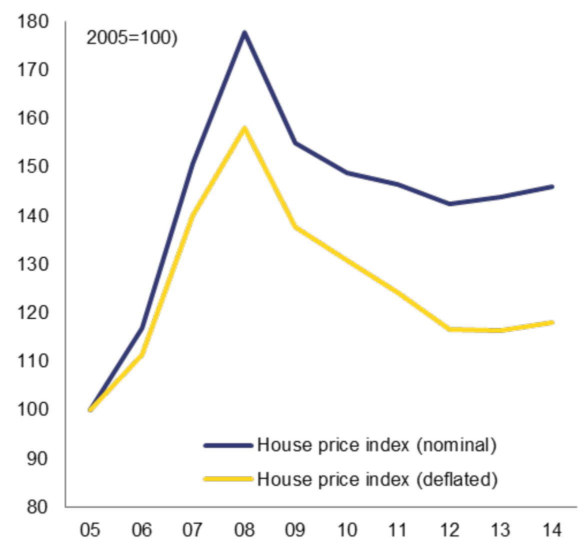


Source: Eurostat

The evolution of house prices

In the pre-crisis period across house prices increased substantially in all regions. Between 2005 and 2008, prices increased by 77% in nominal terms and by 58% after adjustment for inflation (see Graph 7).

Graph 7 Nominal and real house prices

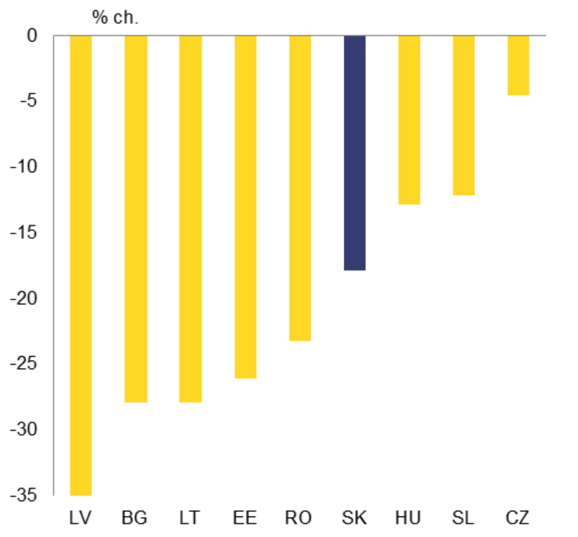


Source: Eurostat.

The corresponding annual growth rates were well above the 6% indicative threshold of the Macroeconomic Imbalance Procedure scoreboard.[2] While most real estate transactions were taking place in the economically most dynamic Bratislava region, increases in prices were broad based, as they rose considerably in all eight Slovak regions in the pre-crisis period.

In the run-up to the crisis, the rise in prices outpaced growth in incomes and rents, as well as broader economic fundamentals. To assess valuation of the housing market, three methods are used: (i) the price-to-income ratio, (ii) the price-to-rent ratio, and (iii) the deviation of house prices from values justified by housing demand and supply fundamentals.[3] The short available time series of house prices makes an analysis of housing market overvaluation difficult and leads to possible understatement of the price misalignment. Nevertheless, changes in the three valuation indicators consistently signal unsustainable price developments in the pre-crisis period (see Graph 10).

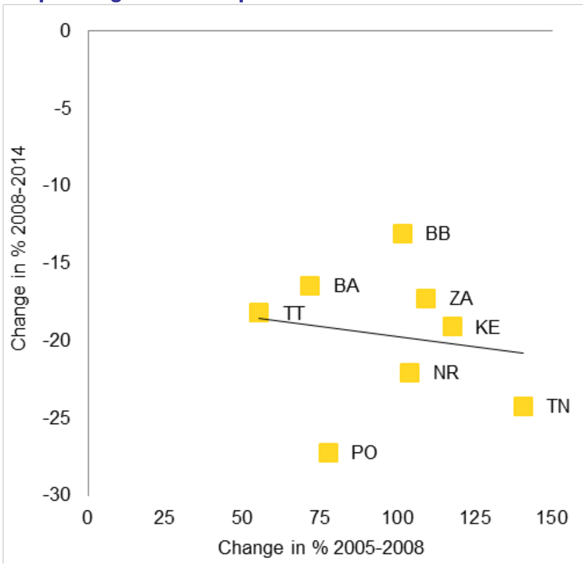
Graph 8 Decline in nominal house prices (% change from peak to 2014)



Source: Eurostat, Commission Services

The post-crisis correction of house prices has lasted several years, varying among regions, and a timid recovery only started in 2014. While prices of residential property dropped markedly in 2009 (by some 13% in nominal terms), the decline continued also in the subsequent years. By 2014, nominal prices declined by 17% from the peak in 2008. The nominal reduction was relatively small compared to other CEE EU Member states (see Graph 8). At the regional level, the correction of house prices varied between 13% and 27%.[4] The magnitude of the decline does not appear to have been strongly related to the original increase (see Graph 9). House prices picked up in late 2014 and in early 2015, but it is too early to judge whether the recent upward trend turns out to be persistent.

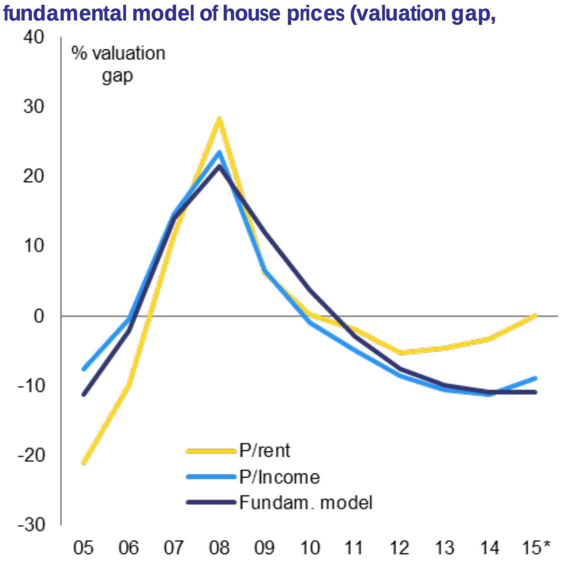
Graph 9 Regional house prices in Slovakia



Source: NBS

Valuation indicators suggest that a significant correction occurred in the post-crisis period.[5] All three valuation gaps underwent a strong adjustment between 2009 and 2012. Graph 10 does not signal any return to unsustainable house price valuations in recent years. In 2014, prices were roughly at valuations levels observed around 2005-06.

Graph 10 Price-to-income ratio, price-to-rent ratio and a fundamental model of house prices (valuation gap,



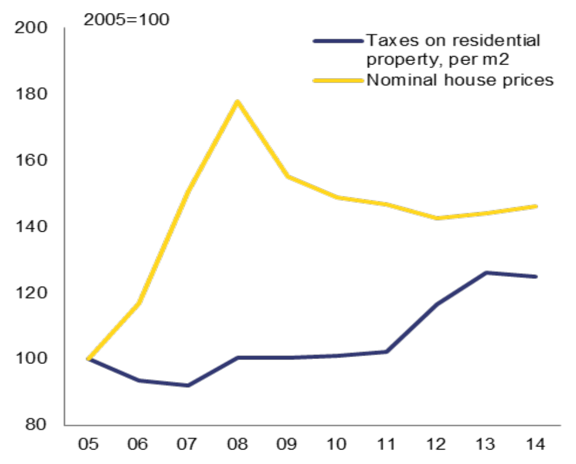
Source: Eurostat, Commission services

In the medium term, price pressures in the housing sector might pick up due to several structural factors. Slovakia is among the countries with the lowest average number of rooms per person (1.1 in 2013). Consequently, a large part of population lives in overcrowded households (39.8%), the sixth highest proportion in the EU in 2013. The overcrowding rate is lowest for owners with a mortgage (32.3% in 2013) while the rate for tenants renting at market prices is twice as high (65.5% in 2013). More than half of young people (aged 25-34) live with their parents, the second highest in the EU in 2013. Cár (2012) argues that a large share of prime age population (25-40) and a rising number of single person households will further boost demand for housing. Unless housing supply adapts rapidly to this materialisation of latent demand, upward price pressures could again become an issue.

The role of housing policies

The tax system in Slovakia is favourable to home ownership. Real estate transfers are effectively tax free, as gifts and inheritance of property is not taxed. In contrast to investment in other financial assets, since 2011 capital gains on sale of real estate are tax-free after five years of ownership.[6] The recurrent tax on immovable property is effectively the only property tax levied in Slovakia. However, rates applied to residential property are relatively low and taxation does not respond to changes in market value. The tax is levied at the level of municipalities, which set the tax rate in euros per m^2 each year within a binding limit.[7] Municipalities have been hesitant to raise it in times of strong prices increases in 2005-2008 (see Graph 11) and instead relied more heavily on taxing business properties.[8]

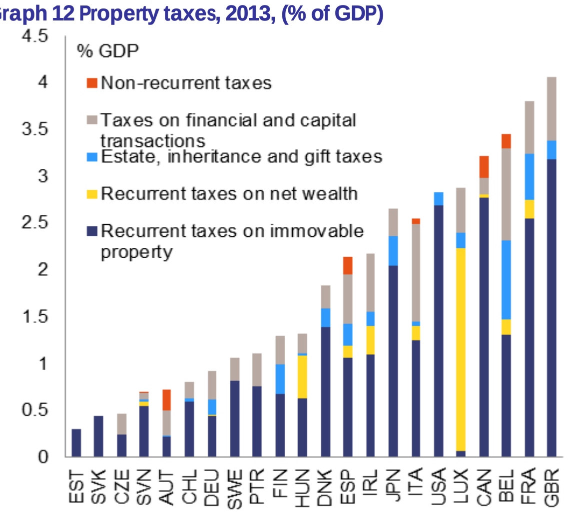
Graph 11 House prices and taxation of residential property



Source: Commission services, NBS, Slovak Alliance of Businesses (PAS)

Increasing taxes to the level observed in other EU countries would result in significant revenue gains. The total revenue from real estate taxation was the second lowest in the OECD in 2013 (see Graph 12). The estimated effective tax rate[9] for one m^2 of a residential property was 0.02% in 2014, relatively low compared to other EU countries (see e.g. Van den Noord (2005)). The effective tax rate on residential property varies from 0.4% in Finland to as high as 1.5% in Germany. Following the 2012 reform, Portugal applies an effective tax rate of 0.8% on regularly revised market prices with safeguard clauses that take into account low-income homeowners' ability to pay. Applying the Finnish or Portuguese effective tax rate on residential property market prices in Slovakia would raise total property tax revenue by an estimated 0.7% to 1.4% of GDP.[10]

Graph 12 Property taxes, 2013, (% of GDP)



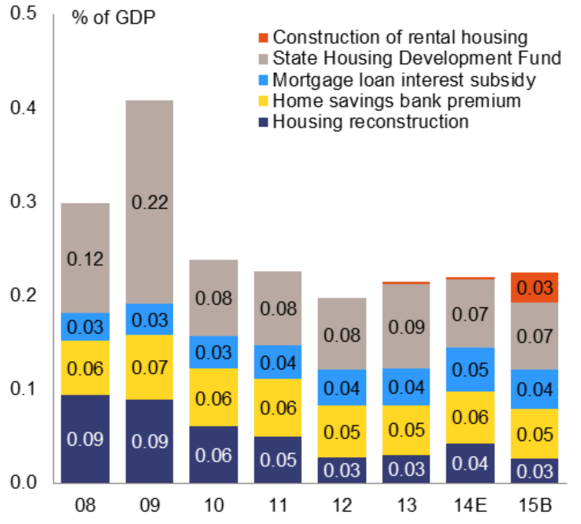
Source: OECD

The tax system provides only limited direct public support to housing. No tax credits are available for households or companies and mortgage interest payments are not deductible. Municipalities can choose to exempt low-income and elderly households from the recurrent residential property tax.

While support for housing through public expenditures is low and falling, a large part of the public support is still geared towards home ownership. Public support in the housing market fell from 0.4% of GDP in 2009 to some 0.2% of GDP in recent years (see Graph 13), relatively low compared to other OECD countries (Andrews et al. (2011)). Home ownership is supported through a mortgage loan interest subsidy for young people[11], a premium on new deposits in home savings bank accounts[12] and favourable loans to low-income households and municipalities provided through the

State Fund for Housing Development.[13] However, a portable housing allowance could be a more suitable form of public support (OECD 2011) given that housing loan subsidies for low-income households are likely to be inefficient as they face higher default risks and get capitalized in higher prices (Kappler et al. (2011)).

Graph 13 Housing subsidies from the state budget, in cash terms



Source: Commission Services, MoF

Rental market regulation is relatively flexible, but it seems to favour short-term rentals. The rental segment, as an alternative to home purchase, can act as a countering force diminishing pressure on house prices and reducing their volatility. In 2012, the flexibility of the Slovak rental regulation was close to the EU average, as measured by two composite indicators of frictions, namely rent control and tenant-landlord relationship (Cuerpo et al. (2014)). However, the recently introduced regulatory framework seems to favour short rental terms, which provide only a temporary housing solution and do not represent a genuine alternative to ownership. To make long-term rental a more viable option, future regulatory reforms could thus better balance the landlord and tenant interests, ensuring stability and predictability for tenants seeking contracts with longer lease duration while safeguarding property rights for landlords.

The regulatory framework might be a factor constraining the responsiveness of new housing construction in Slovakia, with effects on house prices. According to OECD (2009) calculations, even a small change in the dwelling stock is estimated to have a significant impact on house price growth in Slovakia. Despite rapid increases in house prices and improving financing conditions, construction activity remained relatively subdued before 2007 and the number of issued building permits was rather stable in 2005-07, only increasing significantly in 2008 (see Graph 5). This time lag might be explained by the protracted regulatory procedures. For example, Slovakia consistently ranks below the EU average in dealing with construction permits in the World Bank Doing Business survey. While a responsive housing supply may reduce house price volatility, it also leads to greater fluctuations in residential investment (Andrews et al. (2011)).

The majority of loans for house purchases are not subject to mortgage regulation in Slovakia. While mortgage loans have been regulated through the Act on banks from 2001, regulated mortgage loans currently amount to less than 30% of all housing loans, leaving most of the lending for house purchases outside the scope of mortgage regulation. Effectively, banks are required to follow the regulation only for mortgages subsidised by the state. As a result, banks mostly provide loans for house purchases under a more relaxed legal framework when competing for customers, which might present a financial stability risk.

The National bank of Slovakia decided to address risks related to market developments in retail lending by adopting its first recommendation in the area of macro-prudential policy in October 2014.[14] Inter alia it recommends that banks' LTV ratios for secured housing loans never exceed 100% and that the share of housing loans with LTV ratio exceeding 90% does not exceed a certain limit which is set to decline from 25% in early 2015 to 10% from January 2017. LTV ratio limits set in the recommendation thus do not cover the total stock of loans to a given household but only a secured housing loan which might represent just a subset of the bank's overall exposure to this household. It nevertheless also recommends that banks' internal credit risk management systems include a mandatory limit for the indicator of customer repayment ability so that costumers' expenditures, including standard living costs as well as their total debt servicing requirements, do not exceed their income. Moreover, banks are recommended to ensure that no more that 10% of the new housing loans have a maturity of more than 30 years.

Making the housing market more resilient

The current situation on the housing market might warrant actions to increase its resilience in view of continued rapid expansion of bank lending for house purchases. In a medium term perspective, demand for housing is expected to further pick up as Slovakia's economic performance continues to improve. Demographic factors and supply constraints are also likely to add to renewed upward pressures on house prices that could contribute to a potential build-up of imbalances in the future.

In this context, taxation incentives favouring home ownership could be reconsidered, in particular the preferential treatment of capital gains from housing investment. Moreover, as recommended by the 2013 country specific recommendations for Slovakia, real-estate taxation should be linked to the market value of property and revised frequently. Estimated revenue potential from real estate taxation in Slovakia is significant.

Further development of the formal rental market would create a genuine alternative to owner-occupied housing while also facilitating interregional labour mobility. There is room to better balance landlord and tenant rights, by protecting property rights of the former while ensuring stability and predictability to the latter. Moreover, fiscal subsidies could be shifted from home ownership to rental and social housing while targeting of public support could also be improved by more frequent use of means-testing.

Finally, bottlenecks in the housing construction could be addressed in order to make housing supply more responsive. In particular, there appears to be scope for simplification of procedures associated with obtaining a building permit. Moreover, planning and zoning targets could be set at the level of agglomerations together with appropriate incentives for local authorities, in order to reflect regional housing needs. Expansion of the social housing sector could also be part of the supply-side policy response.

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[1] See EC 2011 and EC 2012.

[2] The procedure aims to identify and prevent the emergence of harmful macroeconomic imbalances. See: http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm

[3] For further details, see European Commission: 'Housing market adjustment in the European Union,' box 1.3, in European Economic Forecast-Spring 2014, European Economy 2014(3).

[4] See: http://www.nbs.sk/en/statistics/selected-macroeconomics-indicators/residential-property-prices/residential-property-prices-by-regions

[5] Similar observations can be made looking at the Housing Affordability Index produced regularly by the National Bank of Slovakia (See for example: http://www.nbs.sk/_img/Documents/_komentare/2015/348_CNNB_rk152Q.pdf).

[6] Previously income was tax-free after two years of residence.

[7] The highest rate is not allowed to exceed the lowest rate by more than a factor of 20 in case of the land tax and a factor of 40 in case of the building or apartment tax.

[8] Revenue from businesses properties accounted for some 67 % of the total real-estate related tax revenue in 2014.

[9] Calculated as the average unweighted euro tax rate levied by municipalities on flats and residential building divided by the average price of m^2 of a residential property estimated by the NBS.

[10] Housing wealth estimate is based on data from the statistical office on the average size of a dwelling in Slovakia and the total number of dwelling. The average price of a m^2 of residential property by region is estimated by the NBS. According to Van den Noord (2005), effective tax rate range from 0.4 % in Spain to 1.5 % applied in Germany. A recent reform in Portugal applied a rate of 0.4 % to 0.7 % on urban properties.

[11] The state provides a reduction of 2 percentage points in the interest rate on the mortgage with an additional 1 percentage point reduction coming from the bank for loans up to EUR 50 000 (so the initial interest rate is reduced by 3 percentage points) for people between 18 and 34 and income less than 1.3 times the national gross wage. The reduction is provided during first year of the mortgage repayment.

[12] In 2015, the state tops up an annual deposit by 5.5 % with a fixed nominal ceiling of EUR 66.39.

[13] A third of loans in 2014 were used for construction of rental housing. The rest was used mainly for housing reconstruction (64%) and construction or purchase of owner-occupied housing (2 %).

[14] http://www.nbs.sk/_img/Documents/_Dohlad/Makropolitika/Recommendation_NBS_1_2014_EN.pdf

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  - from the delegations in non-EU countries (http://eeas.europa.eu/delegations/index_en.htm);
  - by contacting the Europe Direct service (http://europa.eu/europedirect/index_en.htm) or calling 00 800 6 7 8 9 10 11 (freephone number from anywhere in the EU) (*).

(*) The information given is free, as are most calls (though some operators, phone boxes or hotels may charge you).

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