

THE RESIDENTIAL PROPERTY MARKET

- *Italy's demographic weakness has limited the growth of its housing stock. In fact, the rise in the number of new houses seen since 1998 has not been drastic. And thanks to tax incentives, the renovation of existing buildings made a large contribution to the expansion of housing supply.*
- *Demand has been boosted by the lowering of short-term and long-term interest rates that began when Italy became part of the eurozone. The rapid decline in unemployment starting in 1999 has also played a driving role.*
- *Relatively short supply set against buoyant demand has caused prices to rise substantially and in real terms they are currently close to the peak of 1992. After two years of weak economic expansion, house price inflation should slow in 2004, while continuing to outpace the consumer price index. Higher short-term and long-term interest rates mean that a sharper slowdown cannot be ruled out in 2005. Even so, given Italy's low level of household debt and the likely increase in income growth as the economy recovers, a sharp correction on the scale of the last property crisis is relatively unlikely.*

A – Housing supply

1/ Italy's demographic weakness is limiting its housing stock

Italy's population has been stagnant for the past 20 years. Because Italy has one of the lowest birth rates in Europe, the natural growth rate is negative and it is only a net gain from migration that prevents the population from declining.

Despite this demographic weakness, the housing stock has continued to grow, albeit at an increasingly slow pace. This is most notably due to changes in the family structure, with family members less likely to live together and a higher divorce rate. These factors have led to a drop in the average number of persons in each household. This has raised the number of households and underpinned the growth of housing stock despite the lack of growth in the overall population. The expansion of tourism and the number of second homes have certainly also played a role.

It is fair to assume that social trends will have less of an impact in coming years. In "mature" countries, the number of persons per household is between 2.1 and 2.5 and therefore the housing stock, like the population, should stand still.

Housing stock and demographics

	1951	1961	1971	1981	1991	2001
Housing stock (x1,000)	11,411	14,214	17,4334	21,937	25,029	26,526
Annual average growth (%)		2.22	2.06	2.32	1.33	0.58
Population (x1,000)	47,516	50,624	54,137	56,557	56,778	56,996
Annual average growth (%)		0.64	0.67	0.44	0.04	0.04
Number of households (x1,000)	11,814	13,747	15,981	18,632	19,909	21,811
Annual average growth (%)		1.53	1.52	1.55	0.66	0.92
Number of persons per household	3.9	3.6	3.4	3.0	2.8	2.6
Houses per 1,000 inhabitants	240	281	322	388	441	465
Houses per household	0.97	1.03	1.09	1.18	1.26	1.23

Sources: Census data, ISTAT

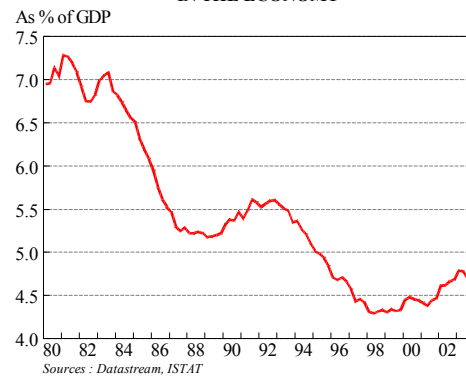
Incidentally, Italy's housing stock has the following characteristics:

- it is relatively old: 30% of houses pre-date 1945, 40% were built between 1945 and 1970 and 30% after 1970;
- it is in relatively poor condition: it is estimated that a quarter of the housing stock requires substantial repair;
- collective dwellings far outnumber individual houses.

2/ Housing investment remains moderate despite an upturn in the late 1990s

Because of demographic changes, the share of the building sector in the overall economy has fallen steadily over the past 20 years. For instance, housing investment (buying and renovating) fell from 7% of GDP in 1980 to 4.5% in 1998. Nonetheless, housing investment has bounced back from its trough of the late 1990s.

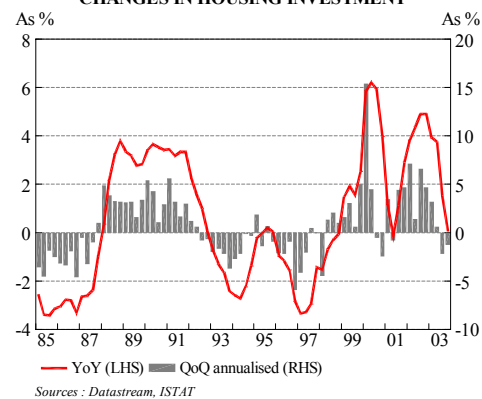
SHARE OF HOUSING INVESTMENT IN THE ECONOMY



There are two explanations for this recovery:

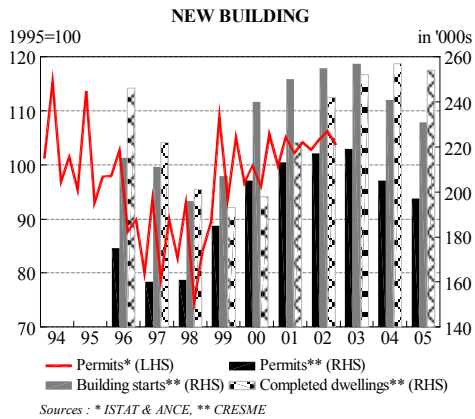
- the drop in interest rates following Italy's membership of the eurozone has made housing affordable for some buyers;
- tax incentives have boosted the renovation market.

CHANGES IN HOUSING INVESTMENT



i/ Towards a slowdown in homebuilding

Thanks to interest rate convergence under EMU membership, new builds rebounded significantly in the late 1990s. It is worth noting however that there has not been a drastic increase in the number of new houses being built. At most, the yearly rate is around 260,000 houses for a population of 57 million (i.e. 4.6 new houses for every 1,000 inhabitants). This is comparable to France, for example, which is building at the steady pace of 300,000 houses per year for 60 million inhabitants (or 5 new houses per 1,000 inhabitants). However, it is well short of Spain's tally, which is currently 600,000 housing starts per year for around 41 million inhabitants – a little under 15 new houses for every 1,000 inhabitants. Therefore, the current situation looks more like the peak of a "normal" cycle for the construction sector than a Spanish-style boom.



CRESME adjusts figures for housing starts and completed dwellings by including illegal building (i.e. without a permit). Therefore the number of housing starts and completed homes is higher than the number of permits issued.

The rebound in new building is certainly in its final days. Two years of poor economic growth and higher interest rates this year and especially the next should reduce the number of permits issued and the volume of housing starts.

ii/ Tax incentives have boosted renovation

We mentioned earlier that a substantial portion of housing stock requires substantial repair. The government has introduced several tax incentives over the past few years in answer to this problem:

- from 1998, households have been able to deduct 41% of renovation costs from individual income tax (IRPEF);
- in 2000, the government launched a programme reducing VAT on renovation supplies and materials from 20% to 10% and allowing up to 19% of the interest costs of loans used to finance repairs of unsafe parts of buildings to be set against income tax. However, the portion of costs that could be deducted was later reduced from 41% to 36%;
- the 2002 Finance Act extended the 36% tax deduction to purchases of buildings renovated by building and renovation companies;
- the 2004 Finance Act has restored VAT to 20%. However, the income tax deduction was raised back to 41%.

These measures have had a considerable impact on the activity of the sector. The boom in housing investment in 2000, for example, was driven by VAT cuts on renovation costs.

On the whole, housing investment now represents a small portion of the Italian economy (between 4% and 5% of GDP depending on the stage of the cycle). Given demographic developments, there is no reason for this to change. Furthermore, the boost to new building that Italy enjoyed when it joined EMU and moved to lower interest rates is now in the past. Also, the renovation market should suffer now that the reduced VAT has been scrapped. In the short term, therefore, we can expect housing investment to stagnate.

B – Housing demand

1/ Solid macroeconomic performance has boosted housing demand...

Housing demand was bolstered by the acceleration in economic growth in the late 1990s and more particularly the sharp drop in unemployment that began in 1999 and that led to an increase in purchasing power. The search for better housing conditions also fuelled demand.

This extra demand was mostly geared towards homeownership at a time when Italy already had a high level of owner occupation and at the same time a relatively low supply of rental stock compared with other European countries, with an extremely low level of social housing.

The surge in rental prices from 1998 onwards combined with lower interest rates spurred on the increase in homeownership, which is now more than 70%.

2/ ... and above all lower interest rates

Housing demand has been boosted not only by macroeconomic factors, but also by interest rate convergence arising from EMU membership.



Mortgage interest rates, which were still at 10% on the eve of Italy's qualification for the euro in late 1997, have fallen to around 5% in less than two years, triggering an upsurge in mortgage lending. Interest rates fell again following the global economic crisis in 2001-2002, fuelling another surge in home lending. Mortgage lending continues to grow at a steady pace today, with outstandings showing an increase of more than 20% yoy in Q3 2003.

C – Changes in the property market

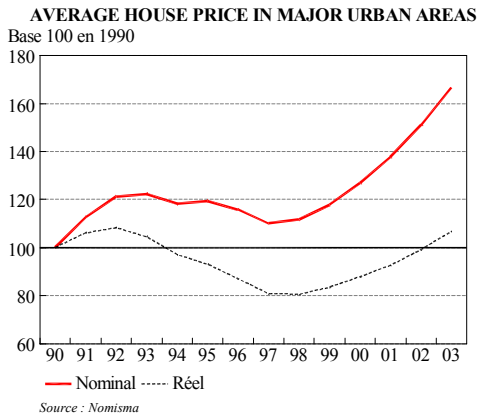
1/ An increase in transactions and prices

The renewed vitality of demand quickly showed in the sales figures, which accelerated sharply from 1998 onwards. In 2002, sales reached the record level of 753,578 units according to the Ministry of the Interior (761,522.20 according to the Territorial Agency). However, the agency also reported that sales in H1 2003 were slightly down on 2002 at 367,807 units – a decline of 2.9%.

Prices have risen sharply as a result of this buoyant demand and the limited supply mentioned above (particularly of quality houses). Prices are now at an all-time high in nominal terms. In real terms (i.e. deflated by consumer prices), they were as high in late 2003 as they had been during the last peak in 1992. During the previous cycle, nominal prices fell 11% between the high of early 1993 and the low of 1997. As for real prices, they fell around 25% between the peak of early 1992 and the trough of late 1997.

By the end of 2003, the average house price had risen 10.7% on the previous year according to figures from the research organisation *Nomisma* covering Italy's 13 largest urban areas¹. The strongest increases were recorded in Rome, Genoa and Milan.

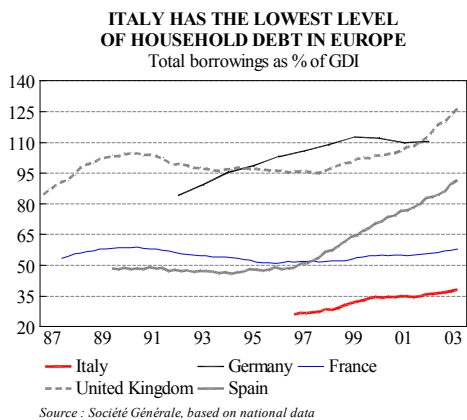
¹ Average price all types included: new, modernised, old or requiring complete rehabilitation



Because of the increase in transactions and house prices, Italy's residential property market is now worth EUR 85 billion in turnover a year, representing a little over 80% of the total property market according to *Scenari Immobiliari*.

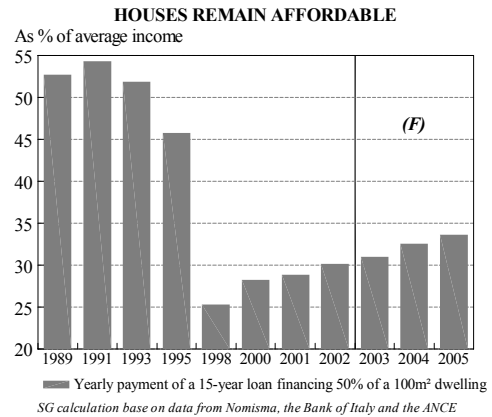
2/ Outlook: the market is certain to slow, but will not collapse

The property market is without doubt nearing the peak of the cycle. Demand should weaken after two years of mediocre economic growth, marked by a deceleration of purchasing power and – since late 2003 – a slowdown in job starts. The majority of consumers wanting to buy have already taken advantage of low interest rates to do so. And as the cost of money may rise this year, and especially the next, affordability will decrease.



Even so, the market seems unlikely to collapse. Italian has one of the lowest levels of household debt in Europe. Debt (i.e. total loans included in household liabilities) is only 38% of gross disposable income (GDI). This is less than in France (around 60% of GDI) and much less than Spain (more than 90% of GDI) and the United Kingdom (more than 125%). And in terms of the ratio of total liabilities to total household financial assets, the situation is even more favourable. Italy has a household debt-to-assets ratio of barely 14% compared with 35% for the United Kingdom, more than 40% for France and 41% for Spain.

Furthermore, houses are only slightly less affordable now despite the sharp increase in prices. We estimate that the yearly repayment on a 15-year loan used to finance 50% of the purchase of an averagely priced 100m² dwelling represented only 31% of the average income in 2003. Certainly, this is more than in 1998, when the cost was a little over a quarter of income, but much less than in the early 1990s, when yearly mortgage repayments used up more than half of income.



How will the affordability of houses change over the coming years? This question leads on to an outline of some of the characteristics of the Italian mortgage market:

- low LTV (loan to value ratio): 50-60% of the purchase price of Italian houses is covered by lending, although the rules allow a maximum of 80% (rising to 100% in some cases);
- a relatively low proportion of fixed-rate loans (around 30%). The rest are divided almost evenly between variable rate loans and a mixture of fixed and variable interest mortgages²;
- a relatively short lending period: 10-15 years;
- an increasingly competitive market with the arrival of new, Abbey National-type players.

The high percentage of variable-rate finance places Italy's property market at additional risk of a sharp downward correction. If short-term interest rates rise sharply (to counter inflation for example), new buyers would find it much more difficult to gain a foothold on the market, while the decreased solvency of existing borrowers would have destabilising effects on the rest of the economy.

Despite the rise in short-term interest rates anticipated in 2005, affordability is unlikely to decrease to the levels of the early 1990s. For this to happen, interest rates would have to rise by more than 1,000bp, all other things being equal, which is obviously impossible.

Finally, we can expect a further increase in prices this year given that financing conditions will remain extremely favourable and household debt will remain low. However, the very small rise in annual income over the past two years and a stagnant employment market in the early part of this year suggest a slowdown will occur. It is therefore reasonable to assume, as in our forecast, that prices will rise by no more than 4 to 5% in 2004. Transactions will probably tail off from their record highs in confirmation of the trend observed in the first half of 2003. In 2005, we assume prices will stabilise. Although the anticipated economic recovery will lead to a pick-up in annual income, the rise in interest rates from rock bottom to a more neutral level should have a significant impact on housing demand.

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² A mixed product usually entails a fixed rate for a period of 1 to 5 years, then the choice of a fixed (IRS plus a margin) or a variable rate (Euribor 1,2,3,6,12 months – often 3 months – plus a margin).