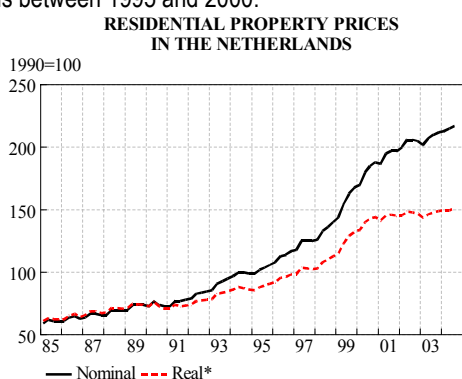


HOUSING MARKET: FROM VIRTUOUS TO VICIOUS CIRCLE

- The Netherlands is ahead of the rest of the eurozone in the residential property cycle. In the Netherlands, household indebtedness has reached record levels, mortgage lending and property prices are slowing.
- The performance of the residential property market has a strong influence on Dutch consumers, exposing the economy to a complete reversal in the property impact. Since 2002, the property market has no longer generated a positive "wealth effect", and this at a time when the economy most needs it. Stagnating income and, ultimately, a tougher monetary policy threaten the financial situation of heavily indebted consumers exposed to interest rate hikes.

The boom in the property sector between 1996 and 2001 was attributable to a number of factors boosting demand...

The end of the 1990s was marked by soaring property prices: an increase of more than 80% in nominal terms and more than 60% in real terms between 1995 and 2000.



Source: NVM, average selling price for all residential property
* deflated by the national consumer price index

... in addition to sustained growth, favourable mortgage lending terms...

The Dutch mortgage market is one of the most comprehensive in terms of the range of products¹ (second mortgages, products enabling extraction of the capital gains on property, choice of several repayment and interest rate adjustment schedules). The market also benefits from reasonable transaction costs (agency fees), modest regulatory constraints (administrative costs are low and there is a limited period for the lender to recover the guarantee in the event of default) and a public guarantee programme in the event of payment default (*Nationale Hypotheek Garantie*: the borrower benefits from a lower interest rate (up to 50bp) and, in return, the lender secures a repayment guarantee for loans of less than EUR 230,000). All these factors encourage households to take out loans with a value in excess of the property price when the market is rising. The LTV ratio (Loan-To-Value: loan amount in relation to property value) is the highest among OECD countries² (average of 90 % and 115 % at most). In other words, taking out a property loan makes it possible not only to purchase a property but also to carry out any building/ home improvement projects and/or purchase any capital goods.

Moreover, homebuyers are helped by particularly generous tax incentives (interest charge deducted from taxable income) equivalent to a 2- percentage point reduction in the mortgage rate. These incentives encourage homebuyers to take out financial packages on large loans, repaid at term through a savings plan (sometimes involving high-risk products) established during the life

¹ According to Mercer Oliver Wyman's 2003 "study on the financial integration of European mortgage markets", the Dutch mortgage market is the most comprehensive after the UK.

² The OECD's June 2004 economic outlook, "property and housing markets and the economic cycle".

of the loan to repay the capital (according to the March 2002 *Dutch Household Survey*³, 90 % of mortgage loans do not involve the direct repayment of the principal during the life of the loan: 40 % consist only of interest repayments, 30% of mortgages are based on savings plans and 19% are based on life assurance and investment of securities).

The healthy economic environment in the Netherlands at the end of the 1990s led to increased demand for residential property and consequently growth in lending of around 20% per year between 1996 and end-2001. Given the inflexible offering⁴, property prices rocketed and underpinned lending. These two related phenomena, sustained by an increase in consumer purchasing power, fuelled housing demand, especially among young couples, who incurred debts up to the limit of their financial capacity (4.9% of homeowners in 2003-2004 have loans with a LTV ratio of more than 100% and most are in the 25-34 age bracket).

... and now households are heavily indebted

The slowdown in property prices that began in 2000, with a virtual stagnation in real terms, was followed by a slowdown in mortgage lending. In 2002, yoy loans outstanding lost 15 percentage points vs. the previous year. This downturn can be attributed to the weak economic growth since 2001 and the persistent rise in unemployment adversely affecting the confidence and solvency of consumers. However, households continued to take on more debt, albeit at a much slower pace.

Interest rates have fallen in real terms since 2001. In mid-2003, the average interest rate on new mortgage loans was 4.5%, down 100bp yoy and at its lowest level since 1956. The decline in interest rates removed the constraint on liquidity. Interest charges rose from 9% of gross disposable income in 1996 to only 12% in 2000 before falling back to 11.4 % in 2003.

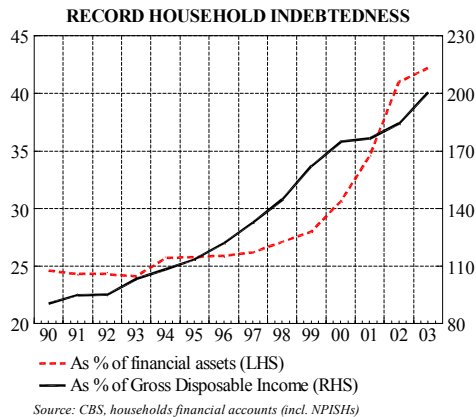
Record household debt (200% of gross disposable income in 2003), i.e. the highest level in the eurozone, and mortgage debt that has virtually doubled in the space of 10 years, are the counterpart of past excesses. The debt/financial assets ratio has also risen persistently since 1998, reflecting the deterioration in Dutch households' solvency.

Since the early 1990s, the Dutch have considerably increased the proportion of their wealth held in securities (one of the highest levels in the eurozone), since their pension system relies to a large extent on privately funded schemes. This makes pensions and consumers very sensitive to a stock market downturn (the AEX lost an average 36% in 2002 vs. 25% for the Eurostoxx 50). Households debt represented 42% of financial assets

³ De Nederlandsche Bank: "Spotlight on household wealth management in the Netherlands", June 2002; "Financial behaviour of Dutch households" Sept 2004

⁴ The OECD estimates that the price elasticity of the property offering in the Netherlands is one of the lowest, together with the UK.

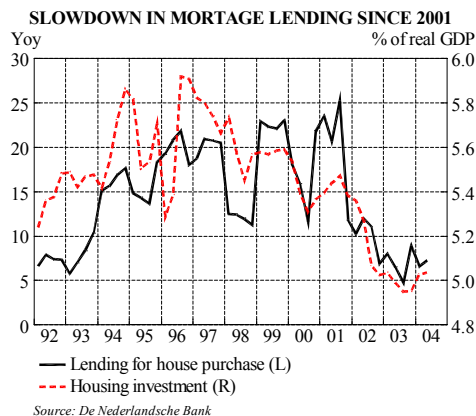
and 98% of liquid financial assets (excluding claim on pension funds) in 2003.



Overall, however, consumers' wealth situation has stabilised as a result of higher property prices³. The proportion of households whose debt represents more than 50% of their assets (financial and physical) fell from 30% in 1993-1996 to 25% in 1997-2004. This improvement is attributable mainly to high-income earners, since the least affluent households saw their situation deteriorate: in 2004, 19% have debts representing more than 50% of their assets (and in many cases negative net wealth). It is this latter group that is most at risk in the event of a fall in prices and/or a rise in interest rates.

The residential property market has entered an adjustment phase

The recent rebound in housing investment is probably temporary...

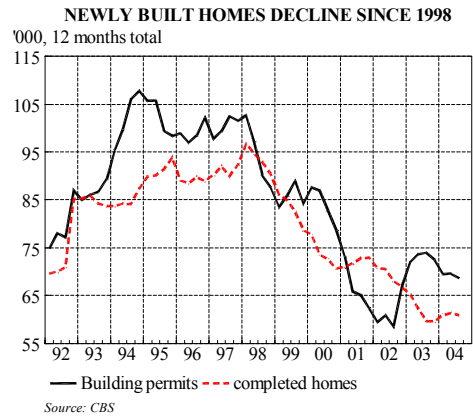


The slowdown in lending since end-2001, combined with the slowdown in property prices, has coincided with the decline in housing investment. It fell sharply in 2002 and 2003, negatively impacting growth to the tune of 0.2 of a point of GDP. The increase in housing investment at end-2003/beginning 2004 (+1% compared with the previous quarter in Q4 2003, then +3.5% at the start of 2004) will no doubt be short-lived (it had already declined 2.4% in Q2).

This rebound reflected the anticipated introduction of a new tax deduction system (less advantageous than the previous system) on 1st January 2004. The government introduced a new property tax regime ("bijleenregeling") designed to encourage households to use the entire proceeds from a property sale to purchase a new property (mortgage interest is now deductible only up to the amount represented by the difference between the price of the new property and the net proceeds from the sale of the old property), thereby reducing demand. The yoy increase in lending for house purchase is currently around 7% or two points below the eurozone figure.

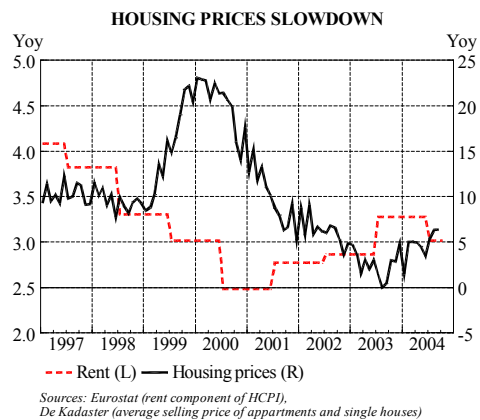
Despite jumping in 2003, the number of building permits has

plummeted. Between 1998 and the low point in 2002, the number of building permits dropped by 40,000 units, representing a decline of nearly 50%.



... and property prices have barely risen since mid-2002

2003 was marked by a virtual stagnation in nominal property prices: +2.5% after an already significant slowdown in 2002 (+6.2%). This virtual stagnation is even more marked in the case of real prices. In Q2 2004, real property prices increased by only 2.8% yoy and 4.3% in nominal terms.



Anticipating the introduction of the "bijleenregeling" regime, homebuyers attempted to capitalise on the old system during the last few months of 2003, causing a pick-up in transactions on older properties (the market for older properties outweighs the new market). As a result, there was an exceptional increase in the number of older houses sold at end-2003, a trend that persisted early in 2004 due to the usual delay (around 6 months in the Netherlands) in registering contracts. The number of transactions remained high at the beginning of 2004, albeit below previous peaks. This nevertheless demonstrates the availability of property in the market and the probable existence of speculative activity.

The performance of the property market has a strong influence on consumer spending...

Property assets have a major impact on consumer spending. The OECD (Pietro Catte, Nathalie Girouard, Robert Price and Christophe André, "Housing markets, wealth and the business cycle", OECD Working Paper 2004) estimates that the marginal propensity of the Dutch to spend their property wealth is one of the highest among the developed countries (0.02% short-term and 0.08% long-term). This is not due to the widespread acquisition of property assets among consumers, despite favourable homebuying terms in the 1990s following the government's withdrawal (although the rate of occupant owners rose from around 40% in the 1990s to 53% in 2002, it is still the lowest in the eurozone after Germany) but to the very sophisticated options available to property owners to secure a loan with their property

assets. As a result, residential property has a significant wealth effect in the Netherlands. Given the sharp increase in property prices in the second half of the 1990s, the amount of capital gains "extracted" through mortgage refinancing was substantial. 70% of secured loans have been reinjected into home improvement projects, 10% into financial assets, 8% into consumer goods and 6% have been used to repay other loans. These transactions have helped boost the liquidity available to consumers, contributing to the healthy state of consumer spending (+4.7% in 1999 and +3.5% in 2000) but also to some overheating of the economy (growth of +4% in 1999 and +3.5% in 2000). However, since end-2002, Dutch consumers' strong exposure to variations in real property prices (one of the highest levels of exposure after the UK) has had the opposite effect and weighed heavily on private consumption. After driving it upwards during the rising phase of the property cycle, the slowdown in the property market has negatively impacted consumption at a time when it most needed support. Consumption fell 0.9% in 2003, contributing to the deep recession that the country experienced that year (-0.9%). The DNB expects mortgage equity withdrawals to remain stable at EUR 5bn this year, once again making a negative contribution to growth.

HOUSING EQUITY WITHDRAWAL**

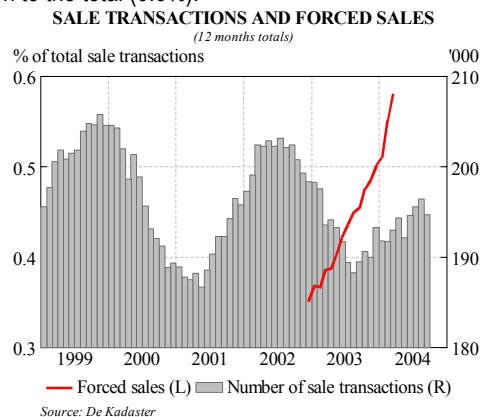
	1998	1999	2000	2001	2002	2003*
Contribution to domestic expenditure (EURbn)	3.1	6.8	9.9	4.5	4.7	5.0
Contribution to GDP growth (in % points)	0.5	1.0	1.1	-0.5	-0.5	-0.3

*first 6 months **secured loans on a dwelling not financing a property
 Source: Dutch Household Survey June 2003, De Nederlandsche Bank "Financial behaviour of Dutch households", Quarterly Bulletin Sept. 2003

... exposing the economy to a complete reversal in the property cycle

The question of a reversal in the property cycle can no longer be ruled out. The record rise in unemployment since 2002, the government's 2004-2005 austerity plan (2-year wage freeze, higher national insurance contributions, tougher eligibility conditions for unemployment and invalidity benefits) and declining consumer confidence are all likely to accelerate the deterioration in the property sector. The number of forced sales is up substantially

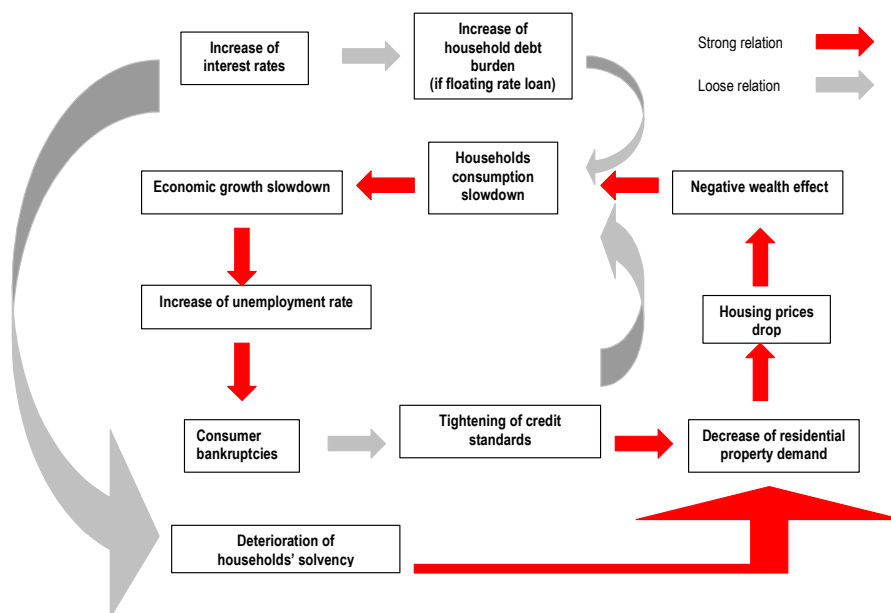
since 2002 (+60% yoy in Q1 2004), even if the figure is negligible in relation to the total (0.6%).



Moreover, according to the ECB's *Bank Lending Survey*, the banks have been continually tightening access to credit since mid-2003. According to the April 2004 survey, 50% of Dutch banks say they have tightened the credit standards applied to property loans over the last three months (vs. 11% for the entire eurozone). 33% of Dutch banks have done this for consumer credit (vs. 0% for the eurozone). A credit squeeze could have a sharply depressive effect on property prices and consumer spending, directly through consumer credit (which we have not seen yet, since it increased by nearly 9% yoy in Q2) and indirectly through the wealth effect. The ECB's interest rate hike, expected around mid-2005, could be the catalyst which plunges the Netherlands into a vicious circle, since consumers are now more exposed than in the past to the direct effects of an interest rate rise³. Floating rate loans represented 15% of the total in 2003 (7 points more than in 2000) and long-term loans characterised by a 2-5 year fixed rates period 25% of the total (9 points more than in 2000). Households have sought to benefit as much as possible on the decline in interest rates that began in 2001 instead of taking advantage of this period of low long rates to consolidate their debt.

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HOUSING MARKET'S VICIOUS CIRCLE



Credit channel: a tightening of credit standards leads to a slowdown in consumer spending and a decline in housing demand.

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