Housing Market Development in Estonia: Is There a Real Estate Boom?

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Abstract

The Estonian economy including the real estate market, especially the housing market, has undergone a rapid development since its very existence in the 1990s. The number of notarised purchase-sale contracts of real estate has increased over 80 times over the past 10 years. The fastest growth rates in the real estate market have been in the housing sector. The total value of notarised purchase-sale contracts of registered immovables with residential buildings and ownership of dwellings has increased from 271 million euros in 2001 to 1982 million euros in 2005, whereas the average purchase-sale price per square metre of a 2-room apartment in Tallinn rose in 2004 22% and in 2005 59%. In recent years there have been repeated hints in the housing market of an approaching real estate crash.

The development of the housing market has been investigated from three main aspects. First, the development of and changes in Estonian economic environment are evaluated and links to the general development of the whole real estate market and especially of housing market are provided. Secondly, in greater detail the demand and factors influencing demand in the housing market are analysed. Thirdly, the supply of the housing market, the factors that facilitate and inhibit this development are investigated. The housing market development in Estonia, differences from and similarities with Latvia and Lithuania are also presented in this paper.

JEL Classification numbers: R21, R31

Keywords: Estonian, Latvian, Lithuanian housing market, demand, supply.
1. Introduction

The Baltic countries are at the top in the EU in terms of economic growth. They have the highest growth rates in Europe and are among the most rapidly growing economies in the world.

In 2005, Estonia, Latvia and Lithuania had the strongest growth rates since 2000. The real GDP growth in 2005 was 9.8% in Estonia, 10.2% in Latvia and 7.5% in Lithuania (Von Hagen 2006). At the same time, a significant inducement of this growth is the catching-up process. The Baltic countries have still the lowest per-capita incomes in the EU.

All three countries with open economies enjoy high investment rates and a large current account deficit, but large capital inflows create a risk of sudden stops.

The rapid economic growth was also reflected in the growth rate of household expenditure and income. Low interest rates and strong investment demand have sparked an exceptionally rapid credit growth. The rapid expansion of credit to the private sector is increasingly financed by borrowing from abroad.

Strong housing markets generate employment in the real estate and related sectors, boosting incomes and consumption.

High economic growth, low interest rates have also influenced the real estate market in the Baltic countries. The research question is: can large price increases in the housing market be defined as a housing boom?

The economic environment of a parcel of real estate affects its value. The economic environment can be analysed and the resulting effect can be shown by the impact of using demand and supply analysis. Changes in the economic environment affect the position of the demand and supply curves. The factors that influence the level of demand in the living space market are as follows: age composition of households, household income, credit conditions, price of substitute units, ownership costs and expectations for the future. An examination of the supply side of the real estate market must be accomplished by examining new construction separately from the existing stock. This approach is required because these two commodities are viewed to be different by consumers and the supply of each is affected by different economic variables. The economic variables that affect the supply side of the market for new construction are: the process of the factors of production used in the construction process; productivity of the factors of production and technology; number of builders in the market and builders’ expectations for sales in the near future. In the resale market, supply is not a function of production oriented variables such as input prices, number of builders etc. It is a function of nonproduction, economic and demographic variables (Carn 1998).

Market studies rely mostly on two analytical techniques: 1) bringing out development trends, analysing the factors affecting it and projecting trends for the future, and 2) using econometric models. Econometric models are widely used in such large and well-developed real estate markets as USA (Angell and Williams 2005) and UK (Muellbauer and Murphy 1997). These models are mainly used to investigate the demand side as it is complicated to build a model for the supply side because of the secondary residential market (Leishman 2003, 137). For the Estonian real estate market the use of econometric models is limited by the short history of the real estate market. The real estate market has been modelled by Mari Rell and Martti Randveer (Randveer and Rell 2000) and Merlin Matsik (Matsik 2006). Due to the short history and
exceptionally fast development it is more appropriate to use trend analysis for analysing Estonian real estate market.

When analysing the real estate market and its cycles it is important to pay attention whether the market is on the rise or there are bubbles or a boom. Historical episodes have shown that asset price bubbles can evolve quickly and that the cost of their bursting can be very high for the economy. Asset price bubbles are difficult to identify in real time and are thus often only identified ex post. Notwithstanding, it appears that there are a number of tools that can help to identify the emergence of bubbles (ECB 2005). Housing price busts occur on average approximately once every 20 years, last about 4 years, and involve price declines of about 30 percent. While only about one-fourth of equity price booms have been followed by busts, about 40 percent of housing price booms have ended in a bust (Bordo 2003). Studies have indicated that housing price busts have been associated with more severe macroeconomic and financial developments than equity price busts (ibid).

There are many ways to define a “housing boom.” Angell and Williams (2005) define a housing boom as a 30% or greater increase in inflation adjusted (real) home prices during any three-year period. Thomas Helbing concluded in his research of real estate cycles in 14 countries between 1970-2002 that the market is booming when the price rise in two years is at least 32% corrected with inflation. In his opinion the boom does not always mean overheating of the market or formation of a so-called bubble. He defined the bubble as a situation where the prices of properties are considerably higher than their justified value (Helbing 2006).

Economic indicators that show the possibility of a boom are fast economic and loan volume growth, liberalised loan conditions, taking larger credit risks, low interest rates, overpriced properties and positive expectations for the future. Analysing the changes and growth rates of these indicators we can identify a boom or a bubble in the real estate market. Another possibility to identify a boom or a bubble is to analyse the residential market price and transactions dynamics. The analysis results in the Estonian residential market suggested that the apartment market is very price sensitive; the correlation between the number of transactions and the price was 0.9. A price rise is accompanied by a high transactions intensity and drop of prices leads to a decrease in the number of transactions. According to the usual market logic this is very illogical. At higher prices demand should be lower and at lower prices vice versa (Järve 2006).

Based on the above, this paper seeks to analyse the Estonian residential market based on the trends of factors that influence supply and demand and identify the boom in the residential real estate market.

2. Economic Background in the Baltic Countries

2.1. Economic Background and Factors Influencing Demand in the Real Estate Market in Estonia

The annual economic growth in Estonia was 9.8% in 2005, compared to 7.8% in 2004. The annual growth of private consumption was 8.1 % (rose remarkably in the fourth quarter of 2005).

The largest contributors to the growth of private consumption were the rapid growth rates of employment and salaries, decrease of income tax rate and increasing debt burden of households.
The employment rate is high and unemployment is continuing to fall. The Estonian Ministry of Finance expects employment to increase in 2006 by 1% and the unemployment rate to fall to 7.2%. The growth of employment has been remarkable in construction and in the related sectors.

**Table 1. Economic Forecast 2006-2008**

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006*</th>
<th>2007*</th>
<th>2008*</th>
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<tr>
<td>Real GDP growth (%)</td>
<td>7.2</td>
<td>6.7</td>
<td>7.8</td>
<td>9.8</td>
<td>8.1</td>
<td>7.6</td>
<td>6.9</td>
</tr>
<tr>
<td>Real private consumption growth (%)</td>
<td>10.3</td>
<td>7.4</td>
<td>4.2</td>
<td>8.1</td>
<td>7.7</td>
<td>7.2</td>
<td>7.1</td>
</tr>
<tr>
<td>Unemployment rate (%)</td>
<td>10.3</td>
<td>10.0</td>
<td>9.7</td>
<td>7.9</td>
<td>7.0</td>
<td>6.4</td>
<td>6.2</td>
</tr>
<tr>
<td>Real wage growth (%)</td>
<td>7.6</td>
<td>8.8</td>
<td>5.1</td>
<td>7.7</td>
<td>8.3</td>
<td>7.1</td>
<td>6.7</td>
</tr>
<tr>
<td>Nominal credit growth (%)</td>
<td>26.1</td>
<td>27.7</td>
<td>31.8</td>
<td>49.4</td>
<td>40.1</td>
<td>30.7</td>
<td>22.7</td>
</tr>
</tbody>
</table>

*Source: Bank of Estonia*

Average monthly gross wages in Estonia were EUR 550 in the 1st quarter of 2006. Compared to the 1st quarter 2005, the average monthly gross wages and salaries were by 15.7% higher.

**Table 2. Average Monthly Gross Wages and Salaries, 1st Quarter 2002 – 1st Quarter 2006, EUR**

<table>
<thead>
<tr>
<th></th>
<th>Year</th>
<th>1st quarter</th>
<th>2nd quarter</th>
<th>3rd quarter</th>
<th>4th quarter</th>
</tr>
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<tr>
<td>2002</td>
<td>393</td>
<td>366</td>
<td>406</td>
<td>374</td>
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<tr>
<td>2003</td>
<td>430</td>
<td>405</td>
<td>442</td>
<td>411</td>
<td>455</td>
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<tr>
<td>2004</td>
<td>466</td>
<td>431</td>
<td>474</td>
<td>449</td>
<td>492</td>
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<tr>
<td>2005</td>
<td>475</td>
<td>530</td>
<td>498</td>
<td>555</td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td>550</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Source: Statistics Estonia*

The Ministry of Finance expects the growth of gross wages in 2006 to be around 10.4%. Net wages rose in 2005 faster than gross wages (due to changes in the tax system).

Disposable income is rising fast, not only because of the rapid rise in wages but also because of the drop in income tax rates, which will probably be cut further. According to the Statistics Estonia, the average monthly expenditure per household member in 2005 was EUR 202 and the average monthly disposable income EUR 220. Compared to the previous year, the average monthly expenditure increased 12% and the average monthly disposable income 13%.

In 2005, the growth rate of expenditure per household member was induced also by the increase in incomes (by more than one-eighth), as well as by bigger loans taken by people (about 60% higher) compared to 2004. On the other hand, the impeding factors were the growth of investments in real estate (by more than two-thirds) and the increase in repayment of loans compared to the previous year (Statistics Estonia.)

The total volume of housing loans has increased as a result of low interest rates and sharp competition in the banking sector. The annual growth was more than 40% last year. More than half of the Estonian banks’ loan portfolios have been given to real
estate companies or to households for housing purposes and 70% of these are secured by a mortgage (Bank of Estonia).

Figure 1. The Total Volume of Housing Loans and Interest Rates in Estonia

![Graph showing the total volume of housing loans and interest rates in Estonia from 2000 to 2005.]

Source: Bank of Estonia

Data of the first quarter 2006 suggest that falling of the interest rates has stopped and the average interest rate is rising. A small interest rate rise does not have any deep effect on Estonian households, as the disposable income is also rising at the same time. But Estonian banks have already recommended households to fix their loan interests.

In February 2006, the central bank of Estonia changed the prudential rules more severe for the Estonian banking sector. They raised the risk weighting of mortgage loans from 50% to 100% (Prudential Ratios of Credit Institutions).

The Bank of Estonia is using the currency board arrangement and it means that the central bank of Estonia has limited possibilities to intervene in the market. We also must consider that most of the loans to households are financed by borrowing from abroad. If there are some changes in the portfolios of international investors, it may lead to some problems also for the banking sector.

Some influence on the Estonian housing market is exerted by the activity of the Estonian Government. First, in 2001 it founded Kredex (The Credit and Export Guarantee Fund). Kredex guarantees business and also housing loans targeted at young families and tenants living in restituted buildings. Secondly, it is possible to obtain an income tax refund from the housing loan interest payments.

2.2. Economic Background and Factors Influencing Demand in the Real Estate Market in Latvia

GDP per capita in Latvia is lower than in other Baltic countries. However, economic growth there was the fastest in the Baltics – 10.2% in 2005. Latvia is the most rapidly growing economy throughout the European Union. In 2004 the unemployment level
went down. Labour participation increased last year and we can also observe a declining trend of unemployment numbers in Latvia. The unemployment level in the first quarter 2006 was 7.3%.

The real net wage rise in 2005 was 9.4% and gross wages rose in the first quarter of 2006 by 19.2% compared to the 1st quarter 2005 (Central Statistical Bureau Latvia). Average monthly gross wages in the first quarter of 2006 amounted to 268.94 lats, which is approximately 382.67 euros (1 lat = 1.42287 euros as of 02.06.2006).

The increase of wages was induced by an increase of minimum monthly wages from 80 to 90 lats; the increase of net wages – by increase of non-taxable monthly minimum wages from 26 to 32 lats, and the increase of basic exemption from 18 to 22 lats per month, as of 1 January 2006.

Domestic demand in Latvia is high and private consumption is growing (10.8% in 2005) due to better credit offers by banks. Problematic is that Latvian banks still have aggressive lending policies and mortgage loans are the fastest growing category. Lending to households does not show any signs of slowdown. There is a very customer-friendly long-term crediting policy of banks in the real estate sector.

The prices in the real estate sector are climbing much faster than the growth of average incomes. The rapid growth of lending is underpinned by very low real interest rates (interest rates minus expected inflation); the real interests on Latvian household loans in March were 1.2%, whereas the EU average was 4.7%.

2.3. Economic Background and Factors Influencing Demand in the Real Estate Market in Lithuania

GDP growth reached 7.5% in 2005. The Lithuanian Ministry of Finance is expecting the real growth of GDP to be 7.0% in 2006. The unemployment level is declining like in other Baltic countries – in 2005 it was 8.3% and the Ministry of Finance forecasts a 6.9% growth for 2006.

We can also perceive a growing domestic demand. Disposable income in 2005, compared with 2004, increased 16.9 per cent. Household budget survey data for 2005 (Lithuanian Department of Statistics) show that the monthly disposable income per household member was EUR 168 (LTL 580; since 2 February 2002 the LTL is pegged to euro at a fixed rate of 3.4528) while monthly real incomes increased 13.8 per cent. Monthly disposable income per household member in 2005 ranged from EUR 184 for urban population to EUR 135 for rural population. Compared with the previous year, the disposable income of urban population had increased 17.8 per cent. The growth of disposable income both in urban and rural areas was mostly induced by growth of income from employment. Another, no less important factor was the growth of social transfers.

In 2005, the average monthly consumption expenditure per household member was EUR 167, meaning a growth of 12.9 per cent since 2004. The average monthly consumption expenditure of urban population was EUR 186 (Lithuanian Department of Statistics). The Lithuanian Ministry of Finance is expecting a 8.6% growth of consumption in 2006.

Personal income tax was lowered in July 2006 from 33% to 27%. Until 1 July 2006, the income tax rates were 15 and 33; from 1 July 2006 to 31 December 2007, the income tax rates shall be 15 and 27 and from 1 January 2008 – 15% and 24% (Ministry of Finance of the Republic of Lithuania).
Economic growth has an effect on real estate market. Favourable conditions of mortgage loans and growing demand for housing (which motivates construction development) have encouraged real estate market activity.

The upcoming introduction of euro has inspired market activity as well as new construction. A portion of real estate market participants are inclined to invest in real estate, especially in land before Lithuania joins the euro zone. This not only increases the number of transactions but also has an impact on growth of real estate prices.

3. Development of the Real Estate Market

The Estonian, Latvian and Lithuanian real estate markets emerged early in the 1990s with the implementation of ownership reform, when land received private owners. The ownership reform signified a possibility to buy land, privatise dwellings and return properties expropriated by the Soviet power to their rightful owners. These actions created a large number of private owners. Early in the 1990s the real estate markets of the Baltic countries were relatively passive and the price levels were low. The low activity was primarily due to the low purchasing power and inaccessibility/expensiveness of loans and the privatisation process itself. In Estonia, for the privatisation of real estate and other state-owned properties the state created a privatisation voucher (EVP), which was issued to people on the basis of their past service length, number of children, etc. As the privatisation transactions (incl. privatisation of dwellings and land) could be made for EVPs, privatisation transactions were performed for times lower prices still than the market price at that time. The ongoing privatisation process inhibited the development of real estate market primarily because very many people could privatise their dwellings for much lower prices than market prices, owing to what there was no need to obtain real estate from free market. When such transactions were made after all, the object of these transactions was often not real estate but the right to privatise real estate from the state.

A big change in the real estate market was introduced by the Law of Property Act adopted in December 1993, which replaced the previous Soviet period laws on purchase-sale transactions with modern ones. Contemporary, environmentally appropriate legal bases contributed considerably to the enlivening of the real estate market, leading to a relatively fast growth stage in the subsequent years. This period witnessed construction of the first new apartment buildings, but most of the objects of transaction in the housing market were still used apartments. Bringing new development projects into market was limited by the underdeveloped financial market and a big difference between prices of new dwellings and those of used apartments.

The activity of the real estate market is vividly illustrated by number of transactions and total value of transactions. The number of transactions since 1995 till the spring of 2006 increased over 80 times, the total value of transactions increased 3 times faster. Most of the transactions have been and still are performed in Tallinn and Harjumaa.

The securities market crash in the autumn of 1997 had a major impact on the so far stable and quite rapidly growing real estate market – the number of transactions dropped sharply, but no big falls occurred in the price levels. The absence of a major drop in prices was above all due to that the price levels in the real estate market at that time were low, even much lower than the construction costs of apartments and therefore there was actually no possibility for a fall of prices. Some stagnation as a result of the securities market crash in the real estate market was over in a couple of years, and
therefore, the year 1999/2000 can be regarded as a period of recovery for the real estate market.

Figure 2. Notarised Purchase-Sale Contracts of Real Estate in Estonia

![Graph showing notarised purchase-sale contracts of real estate in Estonia](image)

Source: Statistics Estonia

As the capital city Tallinn and its close vicinity Harjumaa have been in the so-called market leader status in the Estonian real estate market, changes in the real estate market have revealed first in this region. Therefore, the first faster growth in the real estate market occurred just in Tallinn and Harjumaa where prices of residential real estate rose from year to year at the rate of 10-30%. The increase of sales was especially fast in 2005 when the total value of real estate transactions increased 72% and the number of transactions 31%. When the market of used apartments reached close to the construction prices, the construction of apartment buildings also boosted remarkably.

Figure 3. Percentage of Real Estate Transactions in GDP

![Graph showing percentage of real estate transactions in GDP](image)

The effects of real estate market price rises on total value of transactions are illustrated by real estate indexes created by the real estate firm Uus Maa. The index of apartments increased 2.35-fold from December 2000 to March 2005, that of residential
plots and one- and two-family dwellings 25% and the index of office space rent increased only 5%

The percentage of real estate transactions in GDP has increased 2.4 times since 2000, and the increase was especially fast in 2005.

The Latvian real estate market has also developed very fast and reached 63,947 transactions in 2005. Similarly to Estonia, most of the real estate transactions in Latvia took place in the city of Riga and its closest regions.

**Figure 4. Number of Real Estate Transactions in Latvia 2001 – 2005**

![Number of Real Estate Transactions in Latvia 2001 – 2005](image)

*Source: Arco Real Estate*

**Figure 5. Real Estate Market Increase in Estonia and Latvia 2001 – 2005**

![Real Estate Market Increase in Estonia and Latvia 2001 – 2005](image)

*Source: Statistics Estonia, Arco Real Estate*

Until 2005, the growth rates of both of these real estate markets were very similar. In 2005, the Estonian real estate market grew especially fast, which resulted in a 14% higher transactions number in the Latvian real estate market, though the Latvian real estate market is substantially bigger.
3.1. Residential Premises Market

The residential premises market is the most rapidly developing part of the real estate market in Estonia. The notarised purchase-sale contracts of immovables with residential buildings and ownership of dwellings accounted for 75% of the total number of transactions in 2005.

Development of new residential premises in Tallinn and in its close vicinity started in 1997, which somewhat weakened by 1998. A reason for the slowing down of the development activity was primarily the shortage of favourable credit facilities and the ensuing insufficient demand. The market of used apartments turned during 1998 from the previously seller-oriented market to a buyer-oriented market, which involved a price fall of about 10%. While over 1996-1997 prices rose 25-35%, then the decline that started in the second half of 1998 lowered the dwelling prices back to the level of 1997.

Figure 6. Notarised Purchase-Sale Contracts of Registered Immovables with Residential Buildings and Ownership of Dwellings

![Graph showing notarised purchase-sale contracts](image)

Source: Statistics Estonia

In 1999, no essential changes occurred in the price levels in the housing market – the purchasing power was still low. At the same time, development of new apartments started to increase gradually – the supply of new apartments increased approximately by 650-700 from the end of 1998 till the second half of 1999.

In 2000, one could boldly state that the depression of recent years was over. The increased borrowing and the related higher purchasing power caused an active trading period. Moreover, no essential price rise could be perceived in this period – prices rose only up to 5% in some sectors. In 2001, the market development continued to show an upward trend – various new development projects were started, which were mostly successfully accomplished. While previously the developers had focused their attention on the city centre of Tallinn, then in 2002 the development activity was carried from the city centre to the traditional districts of multi-family apartment buildings. The end of 2001 and the beginning of 2002 brought a rise in residential space prices up to 35%. The development activity also reached Tartu and Pärnu, although with a time shift of a couple of years compared to Tallinn. Although in terms of population number the
major towns of Estonia are also Narva and Kohtla-Järve, no considerable development activity has reached these towns till today, mainly because of lower than average standard of living there.

**Figure 7. Average Purchase-Sale Prices per Square Metre of a 2-room Apartment in Tallinn, kroons**

The year 2005 was characterised by significant price increases and growing number of transactions in the standard apartment market in Tallinn and Harju county. The price increases were driven by a general rise in the standard of living of the residents of Tallinn. The average gross salary in Tallinn rose by 8%. At the same time, supply could not keep up with the general demand, which raised the average price level. A comparison with the average price level of the Soviet time standard apartments shows that the prices went up by 25-30% during the year. The price rise occurred mainly after the first quarter of 2005. The prices were continuously adjusted upwards in the sales market of new apartments where the demand also significantly exceeded supply. At the beginning of 2006, the price rise slowed down and the sales periods of apartments increased in Tallinn. In other cities the growth continued for the first two months this year.

The price changes in the housing market are characterised by average purchase-sale prices per square metre of a 2-room apartment in Tallinn.

In comparison of the capital cities of the Baltic states the residential space prices are the highest in Riga. The prices per square metre in Tallinn and Vilnius are
about 20% lower. The most demanded in Tallinn are 2-3 room apartments; in Riga and Vilnius 1-2 room apartments.

In 2005, the average price level in Tallinn, due to demand, was 1100-1600 EUR/sqm, in Riga it was only 800–1400 and in Vilnius 1000–1500 EUR/sqm. In Tallinn the interior decoration was included in the apartment price; in Riga most of the new apartments are sold without interior decoration, as a “white” or “black” box; almost the same is the tendency in Vilnius.

**Figure 8. Average City Centre Residential Prices, EUR/sqm**

![Graph showing average city centre residential prices](image)

*Source: Ober Haus Real Estate*

The prices of residential space depend mostly on location and condition of the apartment. Based on the information of Ober House Real Estate, the prices of newly reconstructed apartments in Riga grew drastically by an average of 70-90% during 2005. In the rest of the regions prices grew by an average of 30% for new projects. Prices of new apartments located in the city centre are between 1,800 and 4,300 EUR/sqm, while in the Old Town they cost between 3,500 and 5,000 EUR/sqm. Prices of new, partially decorated apartments outside the city centre range from 900 to 1,500 EUR/sqm. Demand is increasing due to the fast economic growth, consumer confidence, and improved mortgage offers from banks.

The highest demand is for 50–100 sqm apartments. The demand can be divided into two parts – local and foreign citizens. At the end of 2005 there was a shift in this proportion in favour of locals. There is a high demand for renovated high-quality apartments in the silent centre in Riga. The latest trend is buying new apartments for letting them out later.

Prices of both newly built and older apartments in Vilnius made an astonishing upsurge of 40-65% in suburban districts in 2005. By the end of 2005, a standard two-room apartment (around 50 sqm) in older house cost EUR 50,000–65,000. A newly built apartment of the same size (fully equipped) cost EUR 65,000–95,000. This remarkable jump in older apartment prices can be explained by high demand for apartments, which is not adequately satisfied by new supply. Prices of newly built apartments in the city centre and nearby districts rose 30–40% in 2005. Newly built
Apartments (without interior decoration) were sold for 1,000 to 1,600 EUR/sqm in residential districts and from 1,800 to 2,800 EUR/sqm in prestigious city districts.

The average price of a newly built apartment in the city centre and old town varies from 1,850 to 3,500 EUR/sqm; in some cases prices even hit 5,000 EUR/sqm. These apartments are sold without interior decoration, which requires another 200-300 EUR/sqm. Demand is so high that 85% of all apartments scheduled for delivery in 2006 were already pre-sold by the end of January. Demand for apartments remains high and the present supply cannot meet the demand. The highest demand is still for cheaper one- or two-room apartments with a price starting from 1,000–1,200 EUR/sqm before the interior decoration. The growing overall demand has its effect also on the prices of smaller (150–200 sqm) detached houses in the city outskirts. Those who are willing but not able to buy a detached house attempt to purchase an apartment in a low-rise (3 or 4 floors) apartment building requiring another 200-300 EUR/sqm for interior decoration (http://www.ober-haus.com/file.php?id=403).

**Table 3. Apartment Prices in the Baltic Capitals, EUR/sqm**

<table>
<thead>
<tr>
<th>District/Country</th>
<th>Tallinn</th>
<th>Riga</th>
<th>Vilnius</th>
</tr>
</thead>
<tbody>
<tr>
<td>Old town (reconstructed)</td>
<td>770-1300</td>
<td>700-1400</td>
<td>500-950</td>
</tr>
<tr>
<td>2000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>Starting from 2000</td>
<td>2500-4000</td>
<td>1700-4000</td>
</tr>
<tr>
<td>Central city (new and reconstructed)</td>
<td>580-870</td>
<td>600-950</td>
<td>400-900</td>
</tr>
<tr>
<td>2000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>1600-2600</td>
<td>2300-3500</td>
<td>1600-3500*</td>
</tr>
<tr>
<td>Suburban areas (standard apartments)</td>
<td>260-390</td>
<td>310-430</td>
<td>200-340</td>
</tr>
<tr>
<td>2000</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2005</td>
<td>700-1100</td>
<td>680-1100</td>
<td>750-1100</td>
</tr>
<tr>
<td>Suburban areas (new apartments)</td>
<td>1100-1600</td>
<td>900-1400</td>
<td>1200-1800</td>
</tr>
</tbody>
</table>

*Including prestigious area

*Source: Arco Real Estate*

The prices of residential land started to increase very rapidly over the two last years and continue the rise. The residential land is most expensive in Vilnius.

**Table 4. Prices of Residential Land 2005, EUR/sqm**

<table>
<thead>
<tr>
<th></th>
<th>The Most Demanded Areas</th>
<th>Suburban Areas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tallinn</td>
<td>30-40</td>
<td>25-30</td>
</tr>
<tr>
<td>Riga</td>
<td>30-35</td>
<td>15-25</td>
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<tr>
<td>Vilnius</td>
<td>30-45</td>
<td>20-30</td>
</tr>
</tbody>
</table>

*Source: Arco Real Estate*

As regards the price of unimproved land suitable for the construction of apartment buildings in Tallinn, an important fact to mention is that the majority of the developers (and sellers) today attach importance to the building rights of plots and the value of the rights. That is contrary to the developments five years ago when the unit price of the plot was the main consideration. Therefore, it is quite natural that the plots of land with more extensive building rights have been sold for a relatively larger price per unit of area and the existence of a detailed plan assumes importance, which
generally guarantees the existence of promised building rights (http://www.arcovara.ee/?id=15/).

4. Supply in the Real Estate Market

Supply in the Estonian real estate market has been considerably influenced by developments in the construction sector, which contributed 7.1% of the GDP in 2005 and the growth of this sector in the past decade was 2.7 times at constant prices of 2000.

Useful floor area of residential premises completed in a year increased over the period 1996-2005 from 103.5 thous. sqm to 325.6 thous. sqm and useful floor area of non-residential buildings completed in a year from 131 thous. sqm to 743.9 thous. sqm. Supply in the real estate market diminished only in the last years of the past century, caused by the securities market crash in 1997.

Figure 9. Construction Production in Estonia at Current Prices, million kroons

Supply in the real estate market has increased at a growing rate over the last three years, especially the development of residential construction.

During the period 2000-2004, the total volume of residential construction increased 3.85 times. The share of apartment buildings in the construction production increased at the fastest rate: in 2000 it was 45.9%, by the year 2004 67.8%. The construction of apartment buildings in the same period increased 5.7 times.

Figure 10. Construction Production of Residential Buildings in Estonia at Current Prices, million kroons
Table 5. Structure and Growth of Residential Construction Production, %

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>Growth of production, times</th>
</tr>
</thead>
<tbody>
<tr>
<td>All residential premises</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>3.85</td>
</tr>
<tr>
<td>− one- and two-family dwellings</td>
<td>34.5</td>
<td>32.1</td>
<td>30.4</td>
<td>31.2</td>
<td>23.5</td>
<td>2.63</td>
</tr>
<tr>
<td>− terraced houses</td>
<td>8.1</td>
<td>9.5</td>
<td>10.5</td>
<td>5.5</td>
<td>4.9</td>
<td>2.3</td>
</tr>
<tr>
<td>− apartment buildings</td>
<td>45.9</td>
<td>47.5</td>
<td>48.5</td>
<td>57.2</td>
<td>67.8</td>
<td>5.7</td>
</tr>
<tr>
<td>− dwellings for institutional care</td>
<td>11.5</td>
<td>10.8</td>
<td>10.6</td>
<td>6.1</td>
<td>3.8</td>
<td>1.25</td>
</tr>
</tbody>
</table>

Source: Statistics Estonia

The capacity of unfinished buildings has significantly increased during the last two years. The number of granted building permits exceeded the number of completed dwellings in 2004 about 3 times and in 2005 about 2.5 times, which means that a large amount of new living space will be added in the short term.

Figure 11. Number of Granted Building Permits and Completed Dwellings (New Construction)
Most of the completed dwellings (67%) are located in urban areas. As a result of construction development, the average floor area per inhabitant increased from 27.2 sqm in 2000 to 28.2 sqm in 2005.

In 2006 Estonia expects to reach 3,500 new apartments in the housing market. Most of the apartments in new buildings are sold before designing is completed. Supply is lower and expected to remain lower than demand over the coming two to three years as the number of detailed plans approved by the city of Tallinn is still low and construction periods have lengthened – due solely to a lack of construction personnel on the labour market.

**Figure 12. Housing Development in Latvia**

The apartment construction is increasing at an almost exponential pace. The residential supply has increased since 2000 by a total of 23,600 units. In 2005, the number of actually built new dwellings that came to the market reached 4,500 units. The new blockhouse projects are typically sold out within 2-3 months after coming to the market. The number of new apartments planned for the first half of 2006 is 7,900 units.
The trend is upward sloping and it is realistic as there are at least 130 blockhouse projects waiting for approval in the Construction Board. In addition, there are plans to reconstruct and develop the “decaying” residential areas in a large scale. There is an evident wave of foreign investors’ interest in new projects in Latvia. This is reasonable due to Riga being the largest capital city in the Baltics (Real Estate Market Report 2006, http://www.oberhaus.ee/file.php?id=401).

Figure 13. Granted Permits for New Residential Construction and Dwellings Completed in Lithuania

In Lithuania almost 3,900 new apartments were built in 2005, 35% more than the 2,900 units delivered in 2004. It looks as though the supply will continue to fall short of fulfilling market demand in the short term. Most of the apartments were built in the so-called suburban districts. There will be a small increase in the number of projects in the prestigious districts of Vilnius. The number of new apartments here failed to reach 300 in 2005. By the end of 2006, the whole market should see a delivery of 5,000–5,500 new apartments, depending greatly on how development cycles of the biggest projects pan out.

5. Conclusions: Is There a Boom in Estonian Housing Market?

The Baltic States’ real estate markets have developed very fast during the past five years, which continued through 2005 when the real estate market experienced a remarkable growth in all three Baltic countries. The housing market seems to have reached the peak, but signs show that there is still room for growth.

The price increase and high demand in the housing market are mostly driven by the following factors:

- Rapid economic growth leading to an increase in disposable income.
- The relatively low level of financial leverage of local households combined with a significant decrease of interest rates and increasingly favourable terms of mortgage lending, banks’ lending policy.
- Increasing interest of foreign investors in residential properties for investment purposes.
- A low ratio of living space per capita to deteriorating housing stock. The average useful area per inhabitant in the Baltic states is one of the lowest in EU countries and currently stands at 28.2 sqm/person in Estonia, 25.7 in Lithuania (2004) and 24.3 sqm/person in Latvia. The average useful floor space per inhabitant in EU stands at 32.8 sqm/person. The same indicator for old Europe is considerably higher, reaching 36.6 sqm/person.
- Supply is lower than demand due to the lack of construction personnel on the labour market and problems with site planning.

The following table gives an overview of the housing market development and the factors affecting it in Estonia.

<table>
<thead>
<tr>
<th>Characteristics of housing market and factors influencing high demand</th>
<th>Sign (growth/decrease)</th>
<th>Growth per year, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth (%)</td>
<td>▲</td>
<td>7.8% (2004) 9.8% (2005)</td>
</tr>
<tr>
<td>Real private consumption growth (%)</td>
<td>▲</td>
<td>4.2% (2004) 8.1% (2005)</td>
</tr>
<tr>
<td>Unemployment rate (%)</td>
<td>▼</td>
<td>9.7% (2004) 7.9% (2005)</td>
</tr>
<tr>
<td>Real wage growth (%)</td>
<td>▲</td>
<td>5.1% (2004) 7.7% (2005)</td>
</tr>
<tr>
<td>Nominal credit growth (%)</td>
<td>▲</td>
<td>31.8% (2004) 49.4% (2005)</td>
</tr>
</tbody>
</table>

Over-valued housing markets pose substantial risks of a major change in perceptions of future house price expectations. Real estate price bubbles refer to situations where prices exceed their fundamental value. Rapid growth of housing prices in Estonia, especially in 2005, can be called a housing boom, but the boom doesn’t always have to be a bubble.

Rapid growth of housing prices does not last forever. The increase in prices at the real estate market in Estonia stopped in the first quarter of 2006. The decline in the growth of housing prices was caused by the rise in interest rates, fast growth of loans, which has brought the debt burden of households to the Nordic countries’ level and the turnover of debt finance accounts for nearly ¾ of housing transactions. The price rise is
also controlled by the correlation between the housing price per square metre and the income of individuals, which is unnaturally high. It has been constantly rising since 2003 and in the apartments’ market in Tallinn was 1.8 in the second quarter of 2006. The correlation between income and the process would be normal when the price of living space per square metre were equal to the monthly salary.

"The measurement of house prices poses significant conceptual and practical problems, mainly because dwellings are heterogeneous assets whose prices can only be observed when they are sold" (Wood 2005).

References


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