
**ANALYZING THE ROMANIAN RESIDENTIAL MARKET
UNDER THE GLOBAL ECONOMIC CRISIS EFFECT**

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Abstract

As the financial crisis effects continue to spread around the world, Romania is no exception to the global economic climate, as the country continues its attempts to better integrate into the European Union.

To what extent is the Romanian residential market affected by the United State financial crisis? What are the causes and effects of the Romanian crisis? How has the crisis evolved so far and our prognostics regarding it? These are some of the questions to which we answer in the present article.

We will take into consideration factors such as the residential market of both new and old products, comparing their evolution up until March 2009 and studying their prices, units sold, and latest projects focused on our nation's capital. Our prognostics estimates that the residential market will start the process of revitalization by Q4 2009 – Q2 2010, when the great demand will be sustained by good bank credit loans.

Keywords

mortgage subprime loans, the contagion effect, the cumulative causality effect, the herd effect, reference interest rate, credits, fiscal facilitation, developer financing, real estate transactions, constructions, sales prices, demand, offer, BREI-N, BREI-V, speculative investments.

JEL Classification: E30, E44, L74

Introduction

Over the last few years, prosperity reigned over the Romanian residential market, attracting local, as well as foreign investors. The year 2007 was particularly successful in that the sales of both old and new apartments was on a continuously rising slope. Such was not the case with 2008, and a change for the worse arrived that year.

The highest market prices of the Romanian residential products peaked in March-April 2008. The prices stagnated in July, after which they went into a downward slope starting August. The effect of the global financial crisis was finally hitting the residential market even in Romania. Romania had been enjoying record

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sales growth well into 2007, even as the global financial markets and mortgages were collapsing.

Crisis causes

To get a better idea of what caused this crisis nationally, we must gain an understanding of how it all started in the US and just how it made its way all the way to Romania. As a result, we have identified the following categories of causes: macro- and micro-economic, organizational, legislative, financial, and monetary.

SUA, The Economic Crisis Starter. Over the last twenty years, the US was considered the driving engine of the global economic growth. Authorities encouraged consumer spending and brought in rapid growth through fast and easy crediting. The Federal Reserve, however, warned in 2007 that consumer debt stemming from unpaid mortgage rates had \$ 100,000 billion dollars.

Thus, the first warning signs of the crisis came as early as 2007, as numerous small credit institutions went bankrupt from mortgage subprime loans. Then came the collapse of the bigger companies, banks and investment funds who were citing the same reasons for their losses. Still, financial analysts insisted there were no reasons to panic.

In Europe, the first effect of the crisis was felt on August 9, 2007, when BNP Paribas, the bank with most assets on the Euro territory, cancelled its paying of three debt funds. The reason? The funds could no longer be evaluated due to their exposure to the US mortgage subprime loans. Up until fall 2007, the crisis spread across Europe, affecting the banks from England (Northern Rock went bankrupt), Germany and even the Switzerland through the losses suffered by UBS AG and Credit Suisse Group.

At the end of October, 2007, BNR increases for the first time its reference interest rate, and governor Mugur Isarescu announces that some assets' prices can be "inflated." One month later, Standard & Poor's lowers Romania's rating due to the increase in the foreign deficit, and the Euro goes over 3,5 Lei.

Despite efforts from both the EU and the US Federal Reserve to prevent the crisis from worsening, the end of the year 2007 brings yet more bad financial news from banks such as UBS, Citigroup, Merrill Lunch, and Morgan Stanley. In January 2009, the financial markets continued to suffer and the stock markets worldwide were declining significantly. In Romania, the reference interest increased from 7,5% to 8%, and the national currency continued to lose its value (e.g. 3,61 Lei per Euro in December versus 3,13 Lei per Euro, its lowest value that year).

In 2008, the US implemented fiscal and monetary strategies to stimulate consumer spending and economic growth. [Congress approved a federal bailout of the US financial system and the Federal Reserve System (FDS) lowered its reference interest rate. However, the banks used the bailout money to cover for their losses. In April 2008, 55% of the banks operating on the US territory made it more difficult for

consumers and businesses to obtain credit, which went against the initial goal of the Federal Reserve.

In April, the Standard & Poor's agency also publicized its analysis results, according to which Romania was one of the most vulnerable countries in the face of the US economic crisis, next to Libya and Turkey.

Crisis Propagation Causes into Romania. The internal causes of Romania's exposure to the foreign crisis are related, on the one hand, to the current funds deficit, the inconsistencies in Bucharest's stock exchange, the interest on the bank deposits held by the Federal Reserve, the low sustainability of the public finances, as well as the increase in foreign debt.

On the other hand, the extent to which the American crisis affected Romania is based on three types of effects:

The Contagion Effect—the spread of the instability from one region to another—seen as a result of globalization, leads to the similarities between the economic cycles of the world's biggest economic powers (US, Europe, China and Japan).

The Cumulative Casualty Effect: the imbalance occurring in one region compensates the imbalances in other regions, leading to shock waves.

The Herd Effect: The managers of high-risk investments compete against each other simultaneously over the same territories. Thus, they also simultaneously leave these territories when the potential for profit decreases.

European Causes. Along with the globalization and European factors, which are related to Romania's dependency on Europe and Europe's dependency on the US, there are also the institutional factors that we take into consideration in this context.

These factors arise from the lack of certain regulatory institutions at the European level when it comes to financial risks. To fix these aspects, the European Union (EU) restructured its internal composition and implemented CERS and SESV.

Another shortfall compensated by the Larosiere Report is the lack of the mechanisms which deal with crisis.

When it comes to global institutional causes, we may include the absence of a timely warning about the macroeconomic and financial risks, and the appropriate solution provided by the FMI. According to G20, this one will work closely with Financial Stability Board in order to archive it.

Even so, if we were to learn a lesson from the harsh reality of the current economic crisis it is that regulations and supervisions can co-exist even with all the modernization of the financial markets. Speaking of which, another cause for the current crisis is at the level of companies and private individuals and it is called responsibility. On one hand, risk management could be bigger of a priority for the big companies; on the other, the population at large (each one of us) could limit its consumption as to not exceed the limits of the household budget.

Causes of the Mortgage Crisis in Romania.

The construction industry rates in third in the bankruptcy statistics for all industries, and this is for a good reason. It is the first sector to be affected by the crisis due to the stalling of the housing market, the banks decision to cut credits for construction-related expenses, late payments from the state budget owed from the last months of 2008, as well as some of the investors announcing to delay or stop their housing market investments. In other words, starting halfway through the year 2008, it became very obvious that construction companies were having a difficult time paying their debt and accessing their finances. Supply chain problems made problems with the cash flow even worse, since companies were not receiving payments from their clients and, in turn, could also not pay what they owed.

The rising cost of construction materials also had a negative impact on the activity of the construction companies. Along with assumptions made by investors, it also became obvious that land price and construction-material cost contributed to the rise in the housing prices and to the halt mentioned above. The second half of 2008 brought in a significant decrease in prices. In particular, the forged-steel products' prices decreased by 40 to 50%.

The fact that the year 2009 brought a rise in bankruptcy for the housing market comes as no surprise to anyone. After all, at the end of 2008 it was almost impossible for the construction companies to pay their debt, and this did not change well into 2009. Moreover, state budget payments have yet to be completed, credits are almost impossible to obtain from the banks, and investments in the financial market are not to be expected anytime soon.

Crisis effects

The effects over the Romanian Residential Market rise in the development of the following indicators: transactions, prices, production, bankruptcies, crediting, credit debts.

Bankruptcies. Between January 1st and November 17th, 2008, the number of bankruptcies in building-materials and construction industries nearly doubled compared to a similar period in the previous year. Of the total number of bankruptcies recorded by ONRC in the 2008 period mentioned, 84.7% were recorded by the Romanian capital companies.

The construction industry recorded 1.200 bankruptcies in 2008 (compared to 525 in 2007), followed by the housing transaction-related bankruptcies with 900 (compared to 448 in 2007).

Ten percent of the real estate members who are part of ARAI declared bankruptcy between October 2008 and March 2009. The rest of the real estate members, having no properties to sell, make a living out of renting or consulting. Some of them have also developed auxiliary businesses, such as housing

administration, interior design, moving services, or cleaning service (this according to the ARAI).

The rise in bankruptcies was caused, up until October 2008, by the creditors' desire to recover their investments as soon as possible, which means that the insolvency process represents the fastest way of legally recovering investments from debtors.

Credit debts. Credit debt increased by 48.4% in the first two months of 2009, up to 4.252 billions Lei (991 millions Euros). On December 31st, 2008, the Romanian population at large as well as the Romanian firms had leftover debt owed to the banks summing up to 2.865 billions Lei (719 millions Euros).

On the foreign currency side, the leftover debt has now reached 1.831 billions Lei (426.8 million Euros), increasing by 84.4% from the end of 2008 when it was at 993.3 millions Lei (249 millions Euros). These numbers were influenced by the depreciation of the Leu (by 7.7% between the end of December and February 28th), considering that the Central Bank releases its statistics in Lei equivalents.

The leftover debt increased at a slower pace (29%) during the first two months, from 1.872 billions Lei (469 millions Euros) up to 2.421 billions Lei (564,25 millions Euros), according to BNR. As a result of the increase in unpaid debt, the overall leftover debt stemming from bank loans reached 2.05% at the end of February, from 1.44% at the end of 2008 to 0.82% on February 29, 2008.

Both companies and the population at large carried leftover debt that increased by 72% during the first two months of 2009 and reached a value of 1.42 billions Lei (330.4 millions Euros); of this amount, 70% was borrowed in foreign currency. Coming in second place after Bucharest, the largest amount of leftover debt was recorded in Brasov with 195.11 million Lei (45.47 million Euros), followed by Timis with 174.16 million Lei (40.6 million Euros).

Crediting. Starting September 2008, banks increased their costs significantly for mortgage loans in Euro, the annual interest rates increasing from 8.23% annually up to 11.3% in January 2009, according to the Central Bank's statistics.

In November 2008, the International Ratings Agency Fitch lowered Romania's ratings for long-term, foreign currency loans, from BBB to BB+, and for long-term loans in Lei from BBB+ to BBB-. This evaluation is based on the agency's concerns regarding Romania's macroeconomic politics and the country's capacity to avoid a severe economic and financial crisis. Fitch's decision pulls out Romania from the category of states that received "investment grade"-type of scores, says Reuters. This also comes after Standard & Poor's lowered Romania's ratings as well at the end of October.

February 2009 was the first in the last seven when the interest rates decreased. The rate of the banks' annual interest rate for the Euro decreased as well, from 11,30% annually in January to 9.26% annually. Local banks relaxed their terms for foreign loans in February, under the anticipation that the IMF would sign for the

borrowing from foreign financial institutions. This also led to decreases in interest rates for the banks from their lenders, which, in turn, led to decreases in interest rates for the banks' clients. This better cash flow at the monetary market level, which led to a decrease in interest rates for crediting among banks, also allowed for the decrease of interest rates for loans in Lei.

In February, the leftover debt from the credit awarded by non-government institutions rose by 0.2% (-.7% in real terms) compared to January 2009, up to 206.890,1 million Lei, according to data released by the BNR. The credit in Lei maintained a steady slope in February (in real terms, it decreased by 0.9%), while the credit in foreign currency expressed in Lei increased by 0.4% (in Euros, the foreign currency credit increased by 0.1%).

At the end of February the credit awarded by non-government institutions recorded an increase of over 30.7% (22.2% in real terms) compared to February 29th, 2008, due to the increase by 17.3% of the Lei component (9.7% in real terms), and by 41.7% of the foreign component expressed in Lei (in Euros, the rise of the foreign currency value was 23.1%).

Between April and May 2009, banks are forced to go back to crediting after the banking system recorded losses in the first two months of 2009, and two of the nation's biggest banks reported a drastic decrease in profits for the year's first trimester. UniCredit Tiriac Bank announced the adjustment of its interest rate by 3% for private individuals' credits, a trend started by other big banks, such as Transilvania Bank, Raiffeisen Bank, and GarantiBank.

In May 2009 BNR reduced the nationally-imposed interest rate from 10% to 9.5% annually, after in February 2009 another 0.5% decrease had been made. BCR anticipated this decrease to go down to about 9% in the following months. BNR, however, decided to maintain the minimum reserve requirement for the passive investments in foreign currency to 40% and, for the passive investments in Lei to 18%.

In March 2009, the Romanian government borrowed 12.95 million Euros from the IMF (International Monetary Fund), as part of a foreign financing plan worth 20 billion Euros, to which the European Commission and other international financial institutions participate. While Fitch appreciated this intervention, they cautiously proceeded with the changing of their rating and kept an eye out for how the local authorities follow through with their promises.

Tranzactions. Real estate transaction number for December 2008 was only 33,007, 50% less than December 2007.

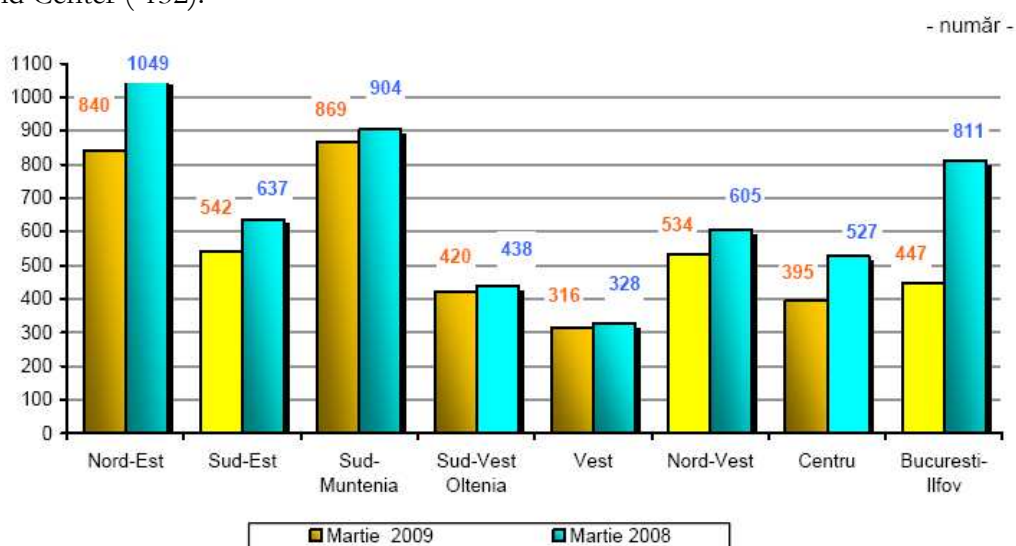
In January 2009 transaction number also decreased by 50% compared with January 2008, from 33,400 to 17,300 sales, but November reached the minimum level, with a 54% decrease, after only 15% in September and November. (National Union of the Public Notaries of Romania, UNNPR).

Per total, in 2008, 484.765 transactions have been made (UNNPR), 7% less than 2007 when 521.636 transactions were closed. For the first two months of 2009, a

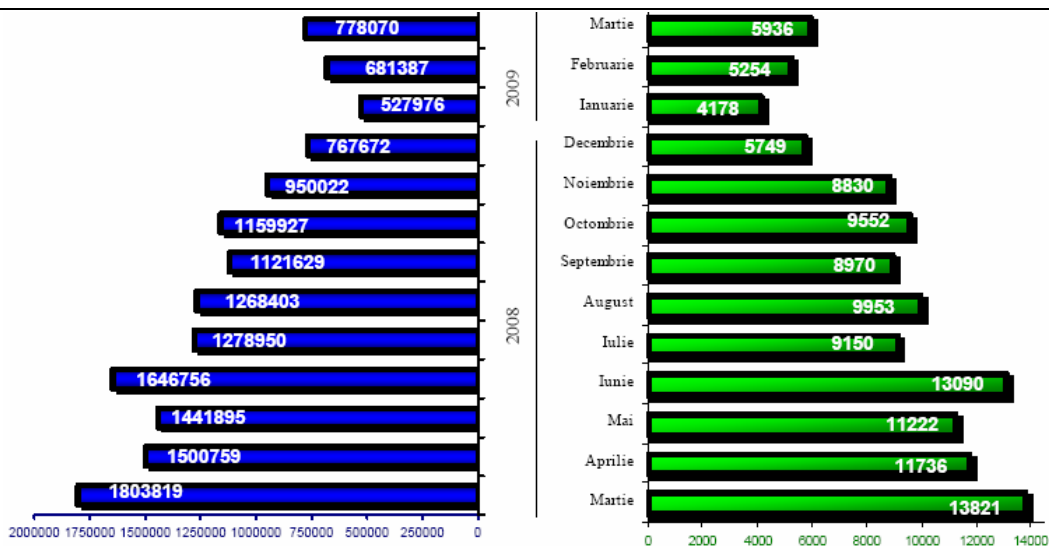
26% transactions decrease was reported compared to the similar period of 2008. Decreases of real estate operations have been registered throughout the country: Ilfov (minus 36%), Constanta (minus 33%), Timis and Arad (minus 23%).

Production. In Q1 2009, 10571 construction authorizations for residential buildings have been issued, 10.5 % less than Q1 2008. In Q3 2008, 11806 construction authorizations for residential buildings have been issued, 13.1 % more than Q3 2007. The most relevant decreases were in the areas : Bucharest-Ilfov (-692), Center (-263), Nord-Vest (-153) and North - East (-104).

In March 2009, 4363 construction authorizations for residential buildings have been issued, 16,7% more than February 2009 and 17,7% less than March 2008. The most relevant decreases were in the areas: Bucharest-Ilfov (-364), Nord-Est (-209) and Center (-132).

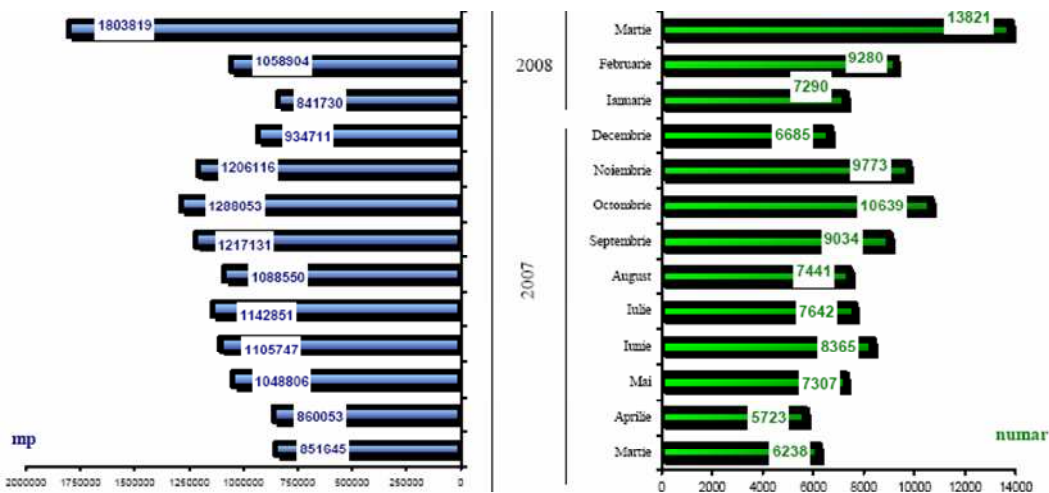


Graphic 1: Construction authorizations for residential buildings, by areas, March 2008 versus March 2009



Surface Area (sqm)

Residential Authorizations (no)



Graphic 2: Construction authorizations for residential buildings number and area evolution, March 2007- March 2009.

Prices. In order to analyze residential products price dynamics under crisis influence, we chose the Bucharest market quantification

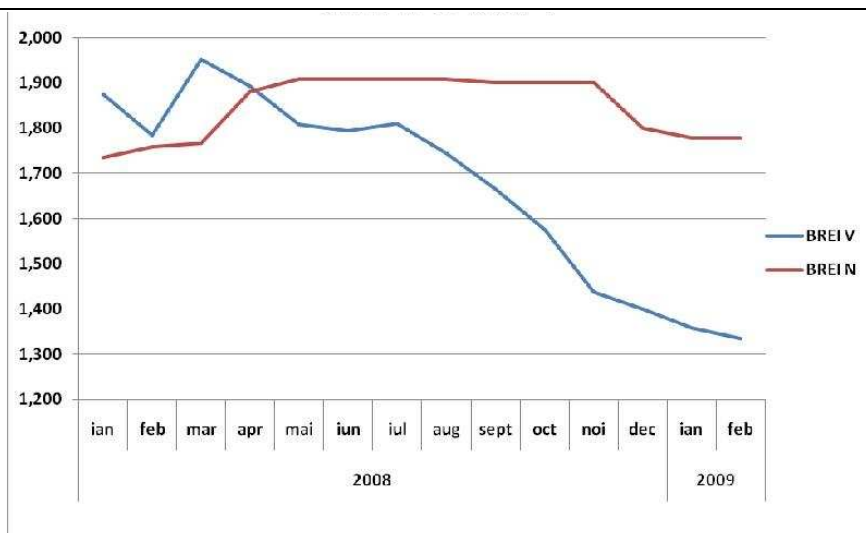
After the last years and a 2007 characterized by a continuous upward trend of the residential market, for both new and old apartments, 2008 was strikingly different. The pick of price evolution on the residential market was reached in months 3-4 of 2008, all values after that being on a descending trend. Q2 2008 brings stagnation followed in Q3 and Q4 by a monthly fall, down to 15 % in 6 months.

The difference between the extreme values in 2008 (Maximum in April and minimum in December) is 350 Euro/mp*, a decrease by 20% in nine months according to BREI index.

Old residential versus new residential price evolution. The striking difference between these 2 markets comes on the first place from the difference between the people who make offers on the market. On the new apartments residential market, the offer comes from developers – companies that have previous experience on other international markets, access to financial resources and a split exposure on the real estate market, not only on the residential market. On the other hand, the offer on the old apartments residential market comes from owners, in most cases natural persons on their first selling transaction of an apartment and with an immediate need to sell. Moreover, developers ask for an “objective” price, based on hard cost, soft cost and a desired profit margin, whereas the price of old apartments is “subjected”, influenced by rumors on the market. Its decreases and increases do not reflect a growth or fall in the real property value.

Even though BREI-V was way under BREI-N at the beginning of 2007, it registered a spectacular growth throughout the year. It surpassed BREI-N with 140 units reaching 1.875 Euro/mp* in January 2008, a 29% increase. Despite some sudden falls in February, BREI-V remained on top of BREI-N for the whole first trimester of the previous year. This situation changed starting with April, when BREI-V was under BREI-N. For the rest of 2008, BREI-V had a descending path, which was only interrupted by a period of constant values in summer.

For BREI-N the year was split in 2 periods: a growth period, for the first 5 months and one of constant values in the next six months. The end of the year brings the first decrease of BREI-N, even though this decrease was sensed from September. We decided to introduce the effect of promotions on prices in BREI, after a 6 month period of constant promotions from the developers. We have considered that the “asking price” was thus being affected. In previous years, these price reductions were specific for periods when the number of transactions diminished, as in summer.



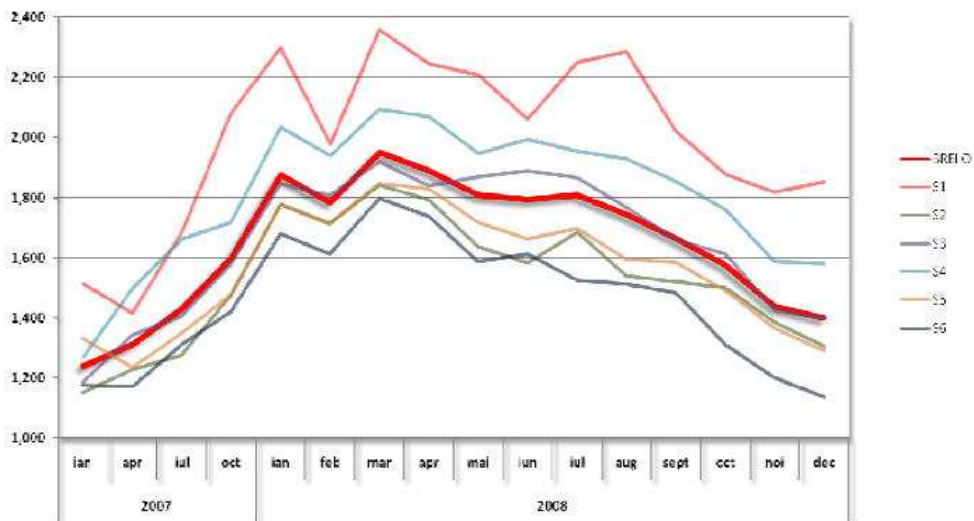
Graphic 3: Comparative price evolution on old and new residential in Bucharest according to BREI-n, BREI-v (2008-Feb2009)

Price dynamics by sector. For BREI-V every district's evolution was correlated with the general index evolution. The most affected was district 6, with a decrease by 32%, over 500 Euro/sqm*. It is the most exposed because it targets middle class clients, who were most affected by the crisis. Moreover, district 6 has no luxury area, it is mostly influenced by the evolution in 2 areas: Militari and Drumul Taberei, both with a constant big offer that had to deal with a constant smaller demand.

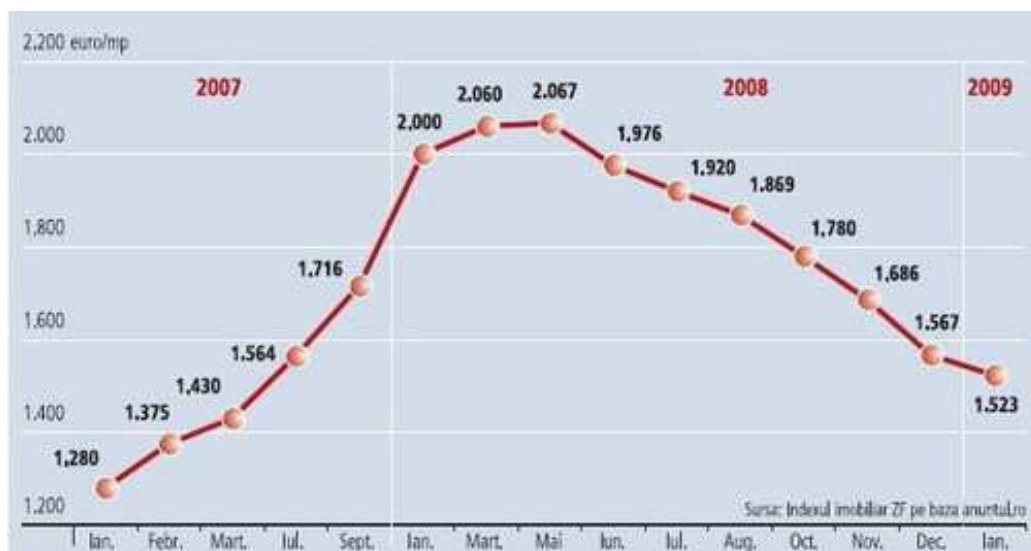
Mostly formed of luxury areas, prices in the 1st district decreased least in the previous year, by only 19%. It remains the most expensive district, with a medium price of 1.855 Euro/sqm*. The other districts decreased with appreciatively the same percent, 25% in December as compared with January.

Table 1: Old residential prices by sector conf to BREI-v (Bucharest in 2007-2008)

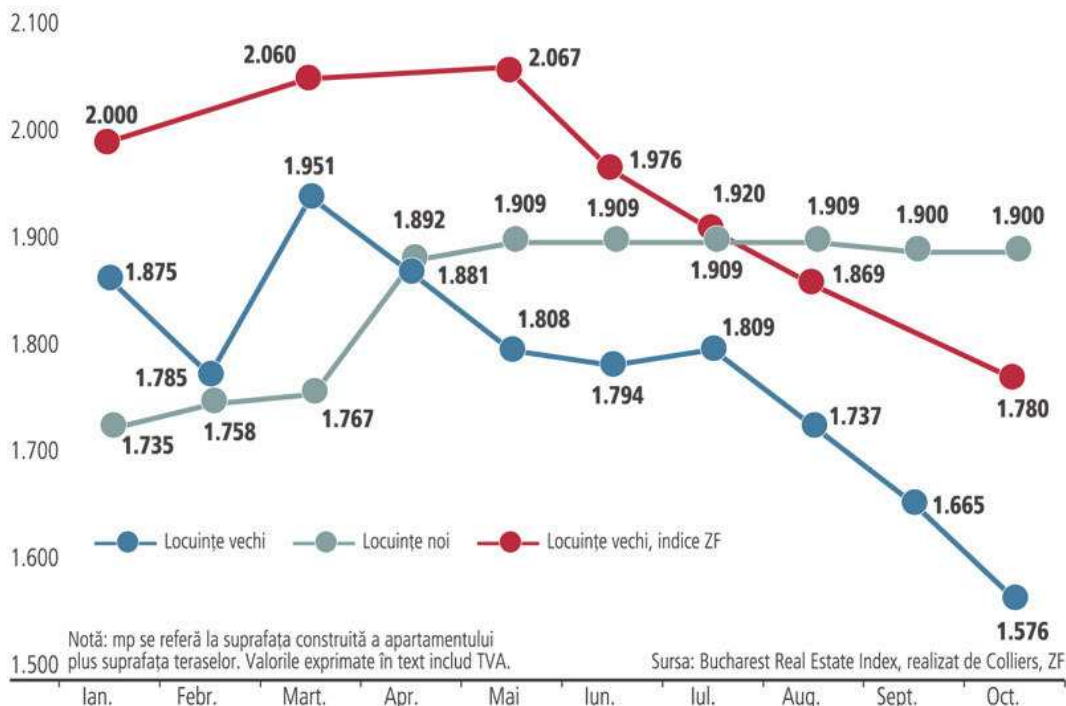
	2007				2008											
	ian	apr	iul	oct	ian	feb	mar	apr	mai	iun	iul	aug	sept	oct	noi	dec
BREI V	1,241	1,312	1,429	1,599	1,875	1,785	1,951	1,892	1,808	1,794	1,809	1,744	1,665	1,576	1,438	1,400
Sector 1	1,514	1,418	1,686	2,080	2,297	1,978	2,359	2,245	2,208	2,061	2,250	2,285	2,022	1,878	1,818	1,855
Sector 2	1,151	1,229	1,276	1,477	1,777	1,712	1,843	1,794	1,637	1,584	1,685	1,540	1,521	1,501	1,386	1,306
Sector 3	1,185	1,343	1,406	1,580	1,848	1,807	1,920	1,840	1,870	1,891	1,867	1,767	1,660	1,612	1,424	1,397
Sector 4	1,273	1,498	1,663	1,718	2,034	1,941	2,096	2,069	1,948	1,995	1,955	1,929	1,856	1,760	1,588	1,582
Sector 5	1,331	1,235	1,348	1,477	1,776	1,715	1,847	1,829	1,716	1,661	1,698	1,595	1,585	1,489	1,365	1,290
Sector 6	1,175	1,171	1,310	1,419	1,680	1,614	1,798	1,737	1,589	1,612	1,525	1,514	1,484	1,310	1,199	1,135



Graphic 4: Comparative price evolution sectors conf BREI (2007-2008)



Graphic 5: Price evolution 3 rooms apartments in Bucharest according to sell prices registered on anuntul.ro website (Jan 2007 – Jan 2009)



Graphic 6: Comparative price evolution on old and new residential in Bucharest according to BREI-n, BREI-v and anuntul.ro (2008)

Conclusions and prognostics

Construction sector had a spectacular evolution in 2008 with an increase of 56% insolvencies. But also, the same sector in Romania had the biggest increase from UE, 16.1% in 2008. The increase was due to a large number of residential and commercial projects launch in 2007 and Q1 2008 witch generated an important business volume in the first part of 2008, as the crisis reached Romania later then the rest of EU.

Real estate transaction sector brought a 31% insolvencies increase in 2008, showing crisis begging witch will advance with the first part of 2009. UNNPR indicates 123.392 real estate transactions in 2008 and a DTZ Echinox study estimated that they fall by 45% in 2008 comparing to 2007. The first part of 2008 registered already a decline of residential transactions, mainly due to price level witch seemed to reach a braking maximum point.

External financial crisis shock waves combined with price levels in Q2 2008 and low bank credit toward developers got to a blocking residential market with Q3 2008. In this context, NBR's change in credit policies – increase - towards population (with effect on mortgage loans) in Q4 2008 had a powerful influence on this market, without baring the one fault for it.

Residential market crisis was to be an upcoming moment in Romania, due to price level and speculative market character. This anticipation of it, due to external crisis contamination brings not only an important price reconfiguration (20-50% up to April 2009) but also the overall market reconfiguration and maturity, with a decreased in developers number but an increase in their quality offer.

Prognostics. Even if prestigious real estate consultants have pessimistic prognostics over the residential Romanian market, (four years), associating it's manifestation to the one in Asia, we consider decisive for Romania's case the offer/demand rapport, witch hasn't been saturated on either dimensions.

Demand. The most affected by the demand were the investors , witch frozeed their aquisitions due to financing problems and descending price expectation. This fact determins a gap between the existing offer and the potential demand on new appartments segment. The gap is enlarged by the last estimations of an up to 70% aquisitions by investors during 2005-2007. Consequently, the demand market will be on the future dominated by final and it shall register a diminueshed volume (2000 units per year in Bucharest).

Mainly for the final consumer, the demand depends by good bank credit offers. Theoretically, as an effect of lowering the reference interest rate by NBR, successively in February and May 2009, from 10,25 to 9.5 % (and we estimate 9% by summer 2009) the credit rates (including mortgage credit loans) should go down. But, as lately banks have already diminished credit rates in order to re launch credit market, a new one is not to be predicted unless the minimum mandatory reserve is to be kept at the same level by the NBR. So, the effects of this February-May lowered rate by NBR is to take effect in bank's policies by Q3 2009, with full effect on T2-T3 2010.

Offer. New appartmens to be on sale will come from two sources. The main will remain direct sales from developing projects. This part of the offer is to be restricted to 6,000 – 7,000 de units (forseen to be delivered in the next 12-18 mounts) compaired with the 12,000 units anounced (Octombrie 2008), as developers should prospone projects or fases of them. Those urged to move in a new apartment will have acces to a second selling source: the appartments put on re-sale by investors witch seek a fast escape from the market and by the final users witch give up their appartments due to financing problems. This new source is to bring on the market up to 5,500 de apartaments in finished or almost finished appartments.

Medium pesimistic scenario (of the offer absortion). The scenario who sees the investors re selling their residential products, determining continuous moderate descending prices. and market rehabilitation in four-five years, when the actual offer would be absorbed, considering that the announced projects in 2008 were mainly suspended.

Optiomistic scenario (of the market psychology). An optimist scenario estimates the residential market will start the process of revitalization by Q4 2009 – Q2 2010, when the great demand will be sustained by good bank credit loans. This

scenario bets on the buyer physiology of “catching” the price curve’s minimum; when that should be felt of being close, the hold actions until now should manifest. As the actual prices are perceived to be determined mostly by psychological reasons not by the real offer/demand balance. It is unlikely that during this period another important residential project would be launched. There will come a period of stabilizing the market and finalization of the projects in an advanced stage of construction.

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