
Determinants of Housing Market Fluctuations: Case Study of Lithuania

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Abstract

The article aims to distinguish the most important determinants of housing market fluctuations in Lithuania for period of 2005–2015. Analysis of housing market cycle performed, major prices’ movements and affecting factors discussed. Moreover, in order to distinguish the most significant determinants of housing market fluctuations, expert survey performed and significances of determinants by using the Analytic Hierarchy Process (AHP) method identified. Research reveals that prices movements in Lithuania’s housing sector can be largely explained by economic fundamentals as well as housing market indicators.

Keywords: housing market; prices; fluctuations; determinants; AHP; Lithuania.

1. Introduction

The past decade has seen many of the most persistent and severe housing booms since the 1970s. According to Agnello and Schuknecht [1], only Japan, Germany and Belgium do not report housing booms in the past decade. Sweden’s boom from 1997 to 2007 lasted 11 years and resulted in an above-trend increase of house prices by 67%, prices in France increased by over 50% over nine years, similar trends were observed in Spain and the UK. In other countries the magnitude of house price increases beyond trend ranged from 22% to 67% and the duration from 3 to 11 years [1].

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The enlargement of the EU has influenced development of economy and the housing market in the Baltic States. Notably, in the period of 2004–2008 Lithuania experienced very strong economic growth. Countries were significantly influenced by favorable lending and expansion of private sector credit. Due to global financial crisis Lithuania experienced the period of the most dramatic boom in housing prices over the last decade, which was followed by economic downturn, and consequently, the burst of prices bubble. However, in 2014 country already demonstrated housing market recovery and prices growth. Lithuania was one of the few countries in the EU to experience positive prices growth since the period of crisis. Such movements of the housing prices attracted attention of the Bank of Lithuania, State Enterprise Center of Registers, other authorities and private business enterprises; however, the scientific research on the most important determinants to explain prices’ movements in Lithuania is still fragmented and limited. Raslanas [2] analyzed determinants of early prices movements in capital Vilnius, Galinienė et al. [3] researched market cycle in the Baltic countries for period of 1995–2003, in more recent study Azbainis et al. [4] constructed conceptual model of Lithuanian real estate development in 2000–2009 and revealed the tangible and intangible factors, Baležentis et al. [5] assessed the performance of real estate sector during period of crisis by multiple criteria methods, Banaitienė et al. [6] assessed the impact of foreign direct investment to construction market movements in the Baltic States for the period from 2000 to 2011. This research aims to distinguish the most important determinants of housing prices fluctuations in Lithuania for period of ten years (2005–2015). Authors believe that findings of the research will provide insights on further developments of the housing market.

2. Literature Review

The international literature on booms and busts in housing market is extensive. The traditional literature analyses the determinants of housing prices and more recently focuses on the macroeconomic and policy implications, related to the housing prices misalignments (e.g. McQuinn, O’Reilly [7]; Kaklauskas et al. [8], [9], [10]; Nuuter et al. [11], among many others).

Single and cross-country studies usually find that housing markets and the macroeconomics are strongly interrelated at country-level and internationally correlated [12]. Studies suggest that at national and regional levels, housing prices are strongly influenced by the economic cycles and therefore driven by fundamentals like GDP and income growth, inflation, employment rate, etc. (e.g. de Wit et al. [13], Agnello, Schuknecht [1], Adams, Füss [14]). Fadiga and Wang [15] evaluated the dynamics in four USA regional housing markets. They found that unemployment, federal funds rate, corporate default risk, economic expansion, unanticipated inflation in the construction market are the key factors that affect both the short-run and the long-run housing dynamics. Additionally Adams and Füss [14] studied 15 countries over a period of 30 years and found that a 1% increase in economic activity raises the demand for houses and thus house prices over the long run by 0.6%. Stevenson [16] studied the price behavior among regional housing markets in Ireland. He found the movements in regional house prices can be attributed primarily to key economic fundamentals.

Review of studies by McQuinn and O’Reilly [7] suggested that two of the key drivers frequently cited in the recent run up in house prices have been rising income levels and the benign interest rate environment faced by many countries. Financial variables such as interest rate, money and mortgage supply have been found related to housing prices developments by many authors (see e.g. Tse et al. [17], Su et al. [18], Ngo [19]).

One can agree that favorable mortgage conditions are one of the most important catalysts of housing booms, while contrary financial crisis reflects in housing market busts. For instance, Bjørnland and Jacobsen [21] found that Norwegian, Swedish and British house prices reacted immediately and strongly to monetary policy shock. According to Engsted and Pedersen [21], “the decreasing house prices after 2006 in many countries can be explained by higher risk-aversion and tightening of credit constraints following the general economic downturn, especially the global recession beginning in 2008”.

Some of the authors also emphasize the influence of irrational factors, such as buyer expectations and speculative behavior on housing prices (e.g. Engsted and Pedersen [21], Lind [22], Kaklauskas et al. [8], [9], [10], etc.). When housing prices are increasing rather quickly and if there are strong expectations of future price increases, then some people might see an opportunity for quick profits by buying an apartment or house and selling it again rather soon. This speculative behavior might then further increase demand and prices. In many historical asset market bubbles this type of behavior has been observed, even if it cannot be expected to be central on the housing market where transaction
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