

FEATURES OF PRICE BUBBLE IN REAL ESTATE MARKET IN LITHUANIA

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Abstract

This paper is about real estate market in Lithuania. The objective of this article is to evaluate the situation of residential sector in real estate market, to analyze features that indicate the bubble and to point out what conditions the situation when price bubble appears.

Key words

Real estate market, price bubble, economic indicators, construction companies, profit.

Introduction

Real estate is a safe investment, commodity, asset, workplace and resort, the means of business and livelihood source. Real estate market is very important to whole state economy: the increase in real estate market and construction sector influences economic growth a lot. However, during the last few years, since 2003 prices of real estate in Lithuania have increased rapidly and the experts of real estate market started talking about price bubble.

The **objective of this article** is to evaluate the situation of residential sector in real estate market, to analyze features that indicate the bubble and to point out what conditions the situation when price bubble appears.

The **object of this article** is the price bubble in real estate market.

Tasks of the article:

- To analyze the features which indicate the formation of price bubble in real estate market.
- To point out the reasons that conditioned the situation when price bubble appeared.

The **methods of research** are the following: gathering material and processing of data.

1 PRICE BUBBLE FEATURES

Having analyzed the data given by real estate companies “Ober-haus”, “In real” and “Resolution” the following conclusion may be made: the increase of prices which began in 2003 does not subside. Though in 2006 the increase of prices was not very rapid but we cannot say that the prices stabilized completely. Exactly due to the increase of prices which continues for few years the experts of real estate state that there is the price bubble formed in the market. The concept of price bubble is defined differently by various experts. According to the report of “Nord LB” (2005), price bubble is a situation when prices in market are formed by psychological factors and they lose the touch with fundamental factors that explain them (DnB Nord bank, 2005). The analyst of real estate I. Zakalskytė (Zakalskytė, 2006) states that price bubble is a very sudden price boost when the growth of price creates further increase expectations and thus more customers are attracted. These two definitions of price bubble emphasize that psychological reasons have a big influence to the formation of price bubble.

The subjects that has the most influential impact to real estate market are described in fig. 1.

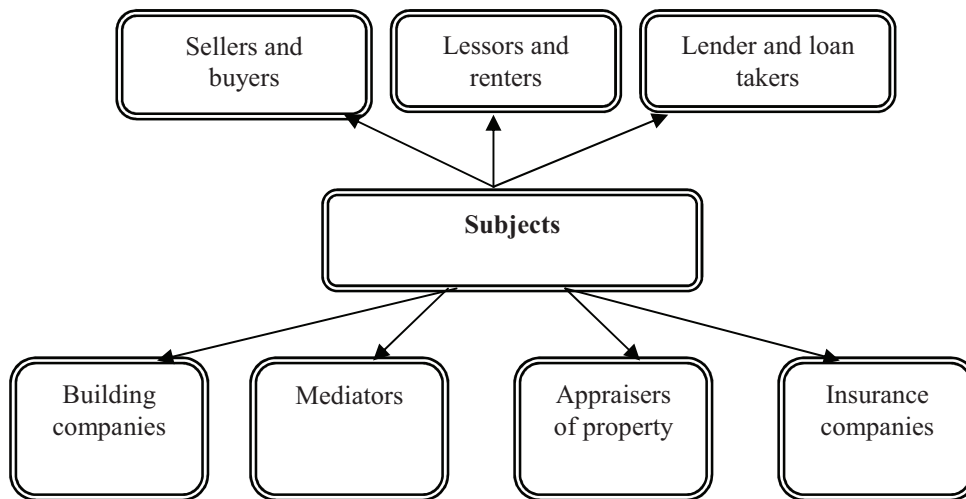


Fig. 1. The subjects that has the most influential impact to real estate market

The other analysts (Brzeski, 2006, Jacobus, 2006) of real estate explain price bubble in the following way: price bubble in real estate is one of economic bubble types which show themselves in local and global markets periodically. The price bubble in real estate shows itself by sudden, speculative increase of real estate value till the level which can be explained neither by economic growth nor by other indicators related to people's income is reached (Real estate market analytics "Burbulas.lt", 2006). According to Bank of Lithuania Economic Department director Raimondas Kuodis (Kuodis, 2006), price bubble is the increase of home price in continuing process when primary price growth creates further increase expectations and attracts new customers, mostly speculators who concern about the profit from home trade but not about the possibility to generate rent income. Thus summarizing all definitions, it may be stated that price bubble is a sudden increase of real estate prices which is not proportion to economic growth and which is influenced by psychological factors a lot.

It is very difficult to rate whether there is a price bubble formed in the market. It can be detected from the features which are in Lithuanian real estate market currently. According to "Nord LB" real estate market review 2005, few features may be pointed out (Fig. 2). They show that there is a price bubble in real estate market (DnB Nord bank, 2005).

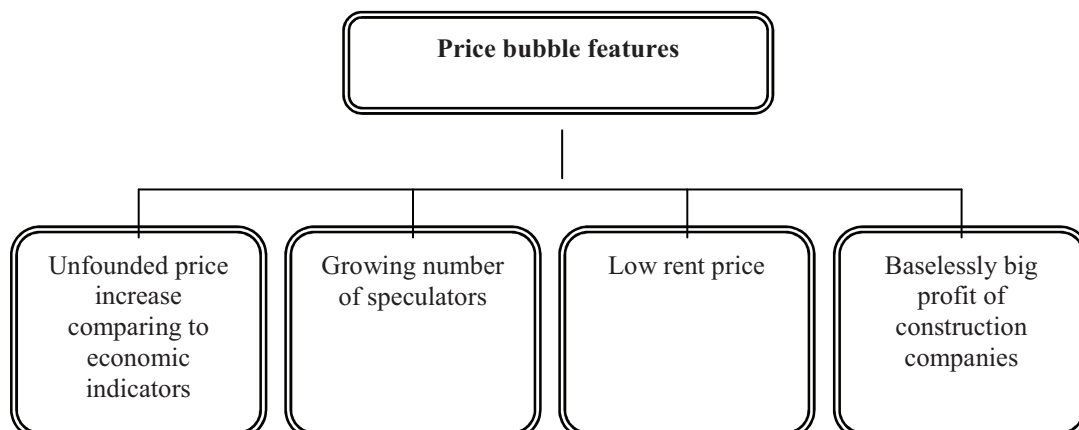


Fig. 2. Price bubble features

First of all, it is rapid and unfounded price increase. This increase continues for few years in Lithuanian real estate market. Price increase of old flats is significant especially. Various

experts of real estate market stated that prices will stabilize and go down in this segment. Though currently prices do not increase in such rapid pace as in 2004 and 2005, however, there is not their significant reduction too.

1.1 Comparison between basic economic indicators and home price change

Having compared the change of basic economic indicators with home price change, it is evident that increase of real estate prices is unfounded. Increase of real estate prices rather exceeds the increase of economic indicators (Table 1).

Table 1. Comparison between basic economic indicators and home price change in Lithuania

Indicators	2003 /2002	2004 /2003	2005 /2004
Change of gross domestic product	10,3 %	7,3 %	7,6 %
Average wage change	5,5 %	7,2 %	11 %
Inflation	-1,3 %	2,9 %	3 %
Home price change	30 %	40 %	50 %

Source: created by authors according to Statistics Department data.

According to the experts of National Development Institute, home prices in Vilnius are just 30% lower than prices in Berlin and Brussels. However, wage in Vilnius is almost 8 times lower, the density of population is 5 – 6 times lower and population is decreasing if comparing with these countries (National Development Institute, 2006).

All these analyzed indicators show that the increase of home prices is unfounded; therefore it is possible to state that it is one of the features which indicate the price bubble in real estate market.

1.2 Growing number of speculators

The second feature of price bubble is a growing number of speculators. They purchase and reserve flats expecting to sell them later and to earn from their rise in price. Speculators have negative influence to real estate market because they freeze the part of real estate which could be supplied to supply. It starts when supply is little and does not satisfy market demands. As Lithuania has joined European Union, a lot of foreigners arrive in Lithuania and they purchase real estate there. It is possible to state that thus they freeze the part of real estate which is empty and is not rent the best part of the year. According to “Nord LB” report of 2005, there were about 20% speculators in the market (DnB Nord bank, 2005).

1.3 Low rent price

The third feature indicating price bubble in real estate market is rather low rent prices. Though real estate prices increase rapidly, rent prices do not change almost. According to the experts of National Development Institute, such inadequacy on one hand shows weakness of sale-price increase because possession income does not grow while its price does. In normal conditions home rent and purchase price should be two dimensions closely dependent on each other and their movement direction and rates do not synchronize only then when home is purchased with the intension of investing (National Development Institute, 2006). Next data supplied show disproportion of home prices and rent prices (Table 2).

Table 2. Comparison between the changes of rent prices and home prices

Indicators	2003/2002	2004/2003	2005/2004
Rent prices change	10 %	10 %	5 %
Home prices change	30 %	40 %	50 %

Source: created by authors according to “Ober Haus” reports.

1.4 Baselessly big profit of construction companies

According to Bank of Lithuania Economic Department director Raimondas Kuodis (Kuodis, 2006), home price consists of four main parts, they are the following: land price, price of building materials, workers’ wage and construction companies’ profit. Workers’ wage has increased not a little during these latter years, maybe twice. Home rise in price from 20 to 25 percent could be explained by wage expenses which come to a quarter of home price. Building materials have risen in price not much, while home has risen in price more than 100 percent during few years. Construction companies’ profit currently is such big that other sectors can only envy it. Analyzed and supplied one year old data prove that home cost does not vary so rapidly as home prices (Table 3).

Table 3. Construction works cost change comparing with home prices

Indicators	2004/ 2003
Increase of construction prices	+6,1 %
Growth of wage in construction sector	+15,2 %
Building materials and products	+1,7 %
Machine and mechanical works	+3,8 %
The change land prices	+40-60 %
The change of home prices	+40-60 %

Source: National Development Institute, 2006.

According to the experts of National Development Institute, the only one objective factor of price increase could be the lack of lands suitable for construction due to delayed procedures of land return and purpose change. In such case only construction companies’ profitability increase at the expense of home purchasers. It is one more feature of price bubble in the market.

All analyzed features prove and allow conclude that there is a price bubble formed in real estate market.

Conclusion

1. Having analyzed the data given by real estate companies “Ober-haus”, “In real” and “Resolution” the following conclusion may be made: the increase of prices which began in 2003 does not subside.
2. The concept of price bubble is defined differently by various experts. Thus summarizing all definitions, it may be stated that price bubble is a sudden increase of real estate prices which is not proportion to economic growth and which is influenced by psychological factors a lot.
3. It is very difficult to rate whether there is a price bubble formed in the market. It can be detected from the features which are in Lithuanian real estate market currently. According to real estate market review 2005, few features may be pointed out. They show that there is a price bubble in real estate market. First of all, it is rapid and

unfounded price increase. This increase continues for few years in Lithuanian real estate market. Having compared the change of basic economic indicators with home price change, it is evident that increase of real estate prices is unfounded. All analyzed indicators show that the increase of home prices is unfounded; therefore it is possible to state that it is one of the features which indicate the price bubble in real estate market.

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