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The Housing Construction Sector in Ukraine:

Reasons for the Current Recession and Policy Implications

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The Housing Construction Sector in Ukraine: Reasons for the Current Recession and Policy Implications

Executive Summary

Since the year 2000 the housing construction sector in Ukraine enjoyed very favourable macroeconomic conditions. High liquidity led to relatively low interest rates, while real incomes increased rapidly, thus supporting strong demand for housing. On top, ever increasing housing prices ensured an additional speculative demand for housing. As a result of this particular macroeconomic constellation, the housing construction sector performed very well.

In 2008, the macroeconomic conditions have changed dramatically. First of all, interest rates went up, due to a necessary tightening of liquidity by the National Bank in order to fight inflation and as a consequence of the international financial crisis. Since as a rule construction companies and households rely heavily on bank loans, the rise in interest rates has increased the financing cost for both sides of the market and thus reduced the supply and the demand for housing. Furthermore, housing prices stopped rising and might be even decreasing, a fact which may have reduced speculative demand and can also lead to a postponement of future housing purchases by owner users. Also, a huge increase in the prices for construction materials has significantly increased costs, thus reducing profits and supply. Thus, the current decline in housing construction can be explained by both supply and demand factors.

Several policy makers have called for a macroeconomic response to the current slowdown. Although such a demand-side reaction could help the construction sector in the very short-run, it would certainly not help the country as a whole. An expansionary monetary and/or fiscal policy would further fuel inflation, which stands today at a massive 26% yoy. Besides, the adoption of demand-side policies would send the wrong signals to international financial investors and thus lead to a further increase in the country risk and the cost of external borrowing. Consequently, we strongly advise the authorities not to tackle the current problems at the construction sector from the demand side.

But this does not mean the authorities should remain inactive. There is plenty of room for policy action at the supply side. The supply side is dominated by just a few large-size holding companies, an oligopolistic structure which can be hardly considered as being cost-efficient. Also, the intransparent allocation of land plots creates huge problems for the sector and poses a high barrier to entry for new medium-size companies to the market. But also the long list of bureaucratic requirements has to be considered as a main structural deficit. Furthermore, the system of housing finance needs to be significantly improved. All in all, the best way to react to current problems is by pushing ahead structural reforms, thus lowering the cost of construction. Only a reformed construction sector will be able to react flexibly to a changing economic environment and to provide the population with proper housing at decent prices.

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1. Introduction

During 2006 – 2007, construction activity grew steadily. However, starting in 2008, Ukraine is facing a recession in the sector. The main component of this recession seems to be a sharp decrease in housing construction, as suggested by anecdotal evidence of the widespread existence of inactive housing construction sites in Kyiv and in other major cities.

This development has severe economic and social consequences. It has a measurable negative influence on economic growth (GDP) and employment, but also on the attraction of foreign capital, including foreign direct investment (FDI). Besides, the important social goal of providing the population with enough quantity and quality of housing is thus further pushed into the long-term future. Last, the financial collapse of construction firms might imply a loss of savings for many households, which conducted direct pre-financing to these firms.

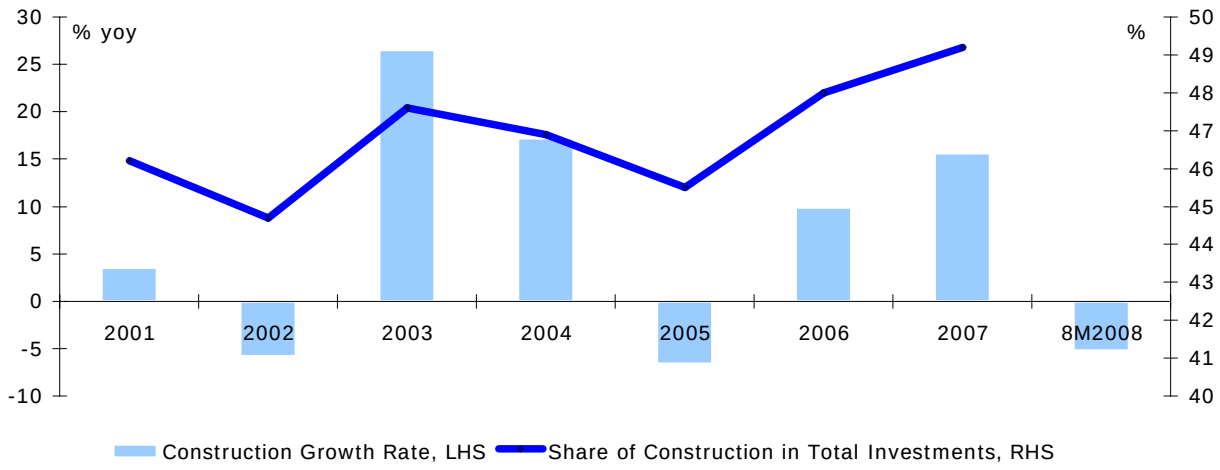
In Part 2, we provide an overview of the construction sector in Ukraine and in particular on the latest trends. In Part 3, we analyse the reasons for the current recession in the sector, looking at both supply and demand factors. In Part 4, we assess the appropriate policy response to the current problems. First, we discuss the possibility of an expansionary macroeconomic policy, as requested by several policy makers. Second, we examine the implementation of structural reforms in the construction sector as a response to the current problems. Part 5 concludes.

2. The construction sector in Ukraine in numbers

As in most countries, construction activity in Ukraine shows strong cyclical patterns. While the sector grew strongly in 2003 and 2004, it went into recession in 2005, but recovered quickly and grew fast again in 2006 and 2007. But in 2008 the sector went again into recession, as shown in Figure 1. While in 2007 the sector contributed 0.5% to real GDP growth, in the first eight months of 2008 its contribution became negative and amounted to -0.2%. As construction accounts for 45-48% of total capital investments during 2001–2007, the reduction in construction activity means lower investments in the country, adversely affecting Ukraine's economic prospects and welfare.

Figure 1

The construction cycle and its share in investments

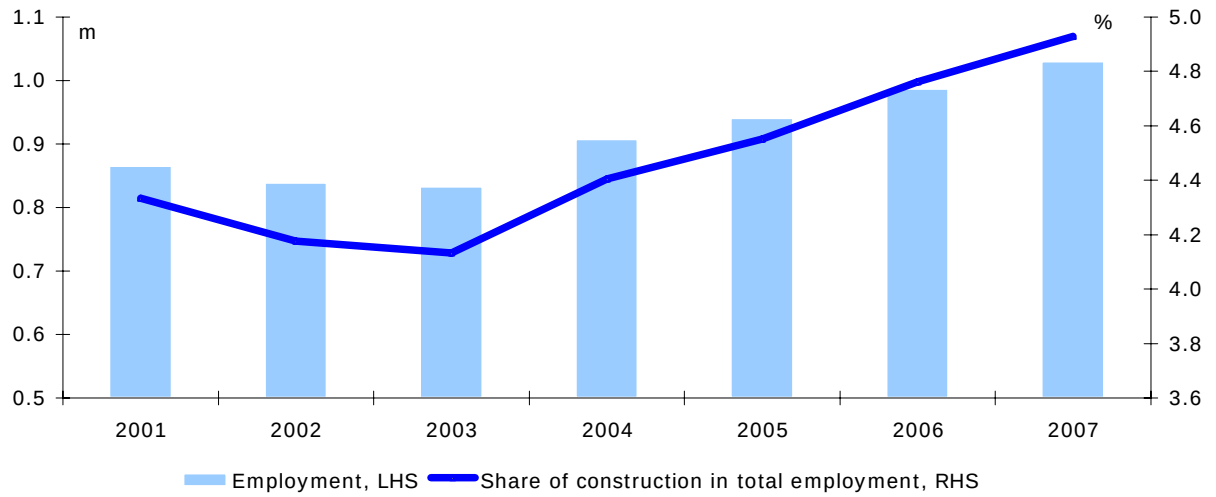


Source: Derzhkomstat

The economic importance of the construction sector relates also to its significant role for employment. Employment in the sector has steadily increased in both absolute and relative (i.e. as a share of total employment) terms since 2003. At the end of 2007, more than 1 m people were active in the sector, amounting to almost 5% of total employment.

Figure 2

Construction and employment



Source: Derzhkomstat

While official data clearly shows the reduction in construction activity in 2008, it does not provide a breakdown for the dynamics in different sub-sectors, such as housing construction, commercial construction (i.e. office, retail and warehouses) and infrastructure projects. But there is a widespread agreement among experts in the sector that the main problem lies with housing construction. According to estimates by different experts, housing construction has dropped since the start of 2008 by 10% to 15% in Ukraine. Such a drop would explain most, if not all, of the reduction in construction activity. Consequently, the key to solving the current problems in the construction sector seems to lie in housing construction, which also deserves most importance from a social policy point of view. For that reason, we will exclusively focus on housing construction in the remainder of this paper.

3. Reasons for the recent reduction in housing construction activity

The housing construction sector in Ukraine is beset with severe structural deficiencies. The market in most cities is dominated by a few holdings, with large bureaucratic costs, little competitive pressure and thus little impetus for innovations. Thanks to strong links to the city administrations, these holdings seem to have a preferential access to land plots. This fact explains to a large extent the survival of cost-inefficient holding structures in a sector characterized in most countries by the existence of a large number of medium-size companies, which fiercely compete with each other by keeping costs as low as possible.[1]

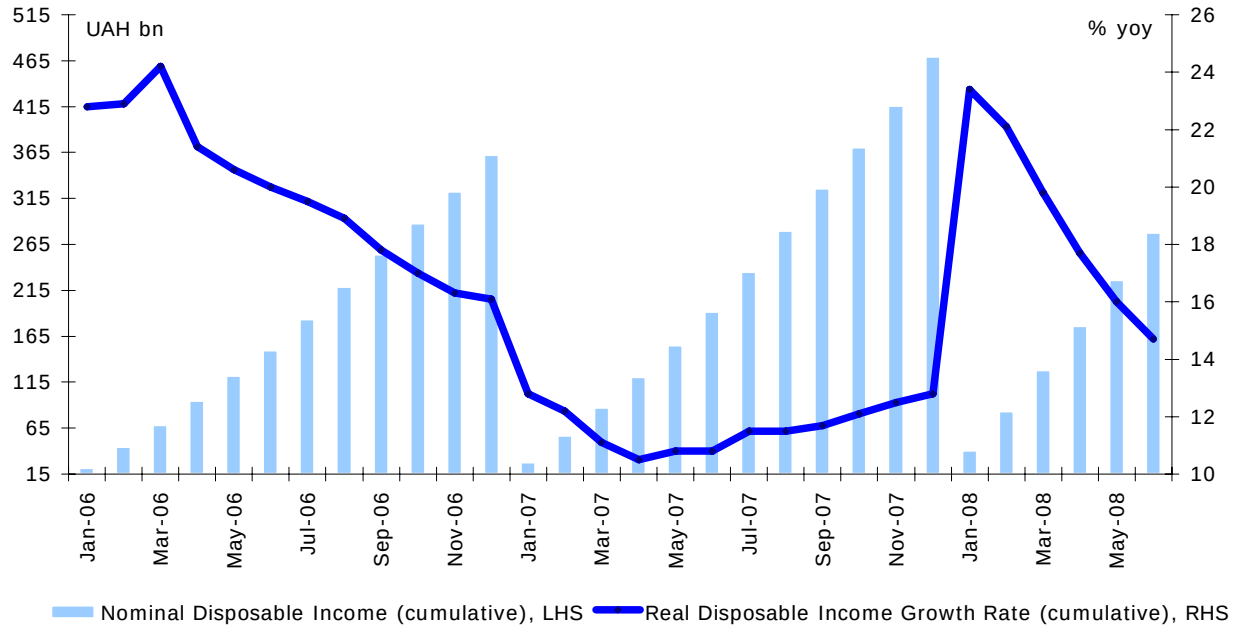
Despite these structural deficiencies, the sector managed to perform well in recent years, securing huge profits for the limited number of companies acting on the market. The main reason for the

[1] For a more detailed description of this market see Giucci/Kirchner/Kravchuk: Housing Prices in Ukraine: Trends, Analysis and Policy Implications, Policy Paper W4 of the German Advisory Group and the IER Kyiv, August 2007, www.ier.kiev.ua

strong performance was an almost "ideal" macroeconomic constellation for the housing construction sector. For example, disposable income of the population increased rapidly in real terms: by 16.1% in 2006 and by 12.8% in 2007 (see Figure 3). As a result, the demand from the population for housing increased strongly, given the still limited quantity and low quality of the stock of housing in Ukraine.

Figure 3

Disposable income

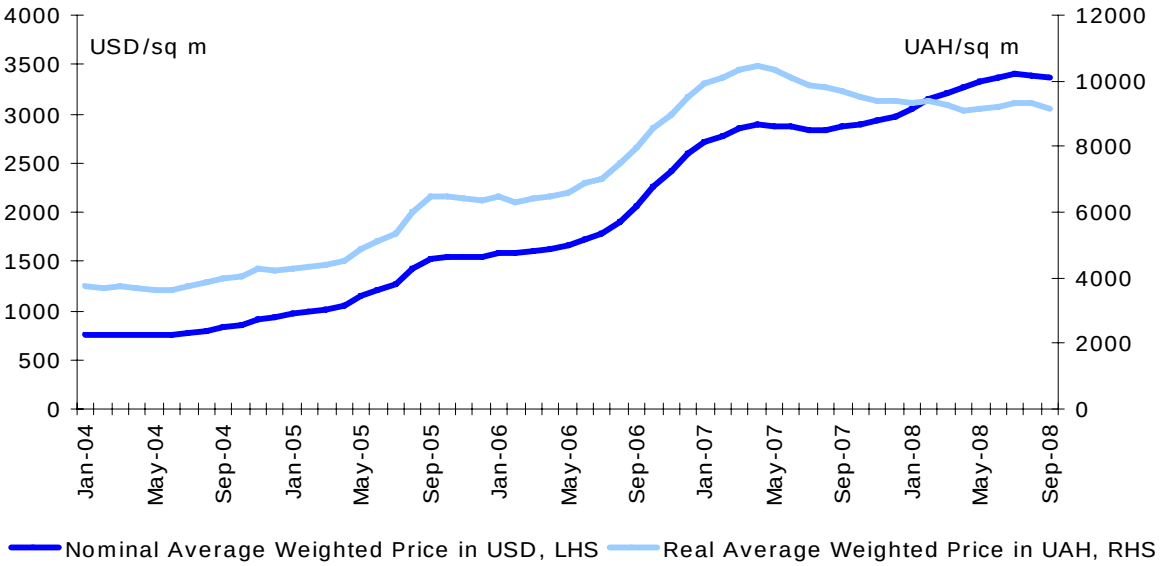


Source: Derzhkomstat

On top of this demand by mainly middle-class citizens, affluent households and business people strongly invested in housing for speculative purposes. This speculative motive was nourished by the seemingly only one-way direction of the market, i.e. by ever increasing prices for flats. While the average price for 1 sq m in Kyiv amounted to USD 749 at the start of 2004, it climbed to more than USD 2976 at the end of 2007 and amounts as of September 2008 to USD 3367 (see Figure 4).

Figure 4

Prices for apartments in Kyiv



Source: Real Estate Agency "Planeta Obolon" www.domik.net

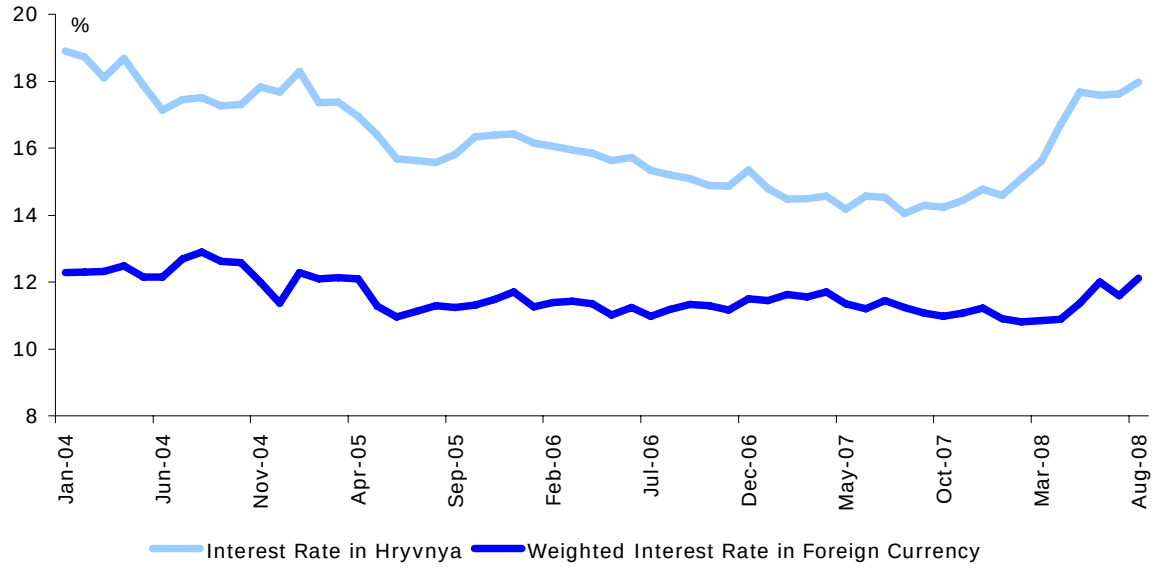
Note: Average Weighted Price of square meter is calculated for all types of appartments and buildings, and rayons of Kyiv city.

Real Average Weighted price in UAH is adjusted with monthly CPI (in prices of January 2004)

A further positive macroeconomic factor has been the low level of interest rates over 2006 - 2007, which reached historical lows, as shown in Figure 5. The cost of finance is crucial for companies (supply side) and households (demand side) alike.

Figure 5

Interest rates

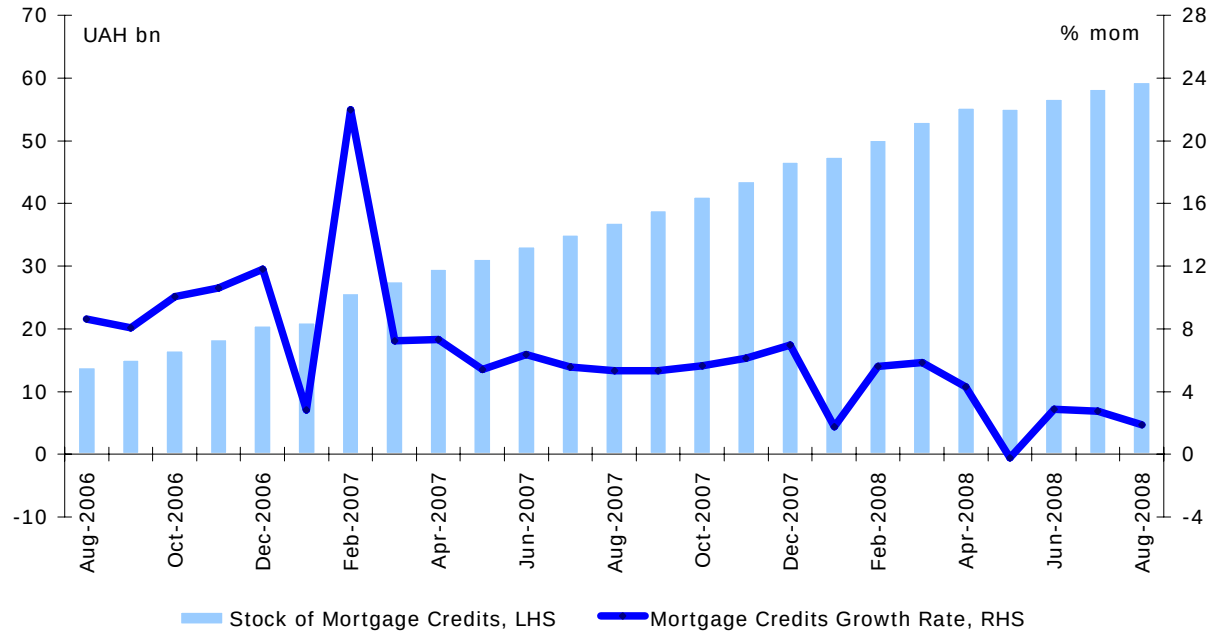


Source: NBU

The combination of low interest rates and an aggressive lending policy by several commercial banks resulted in an explosion of mortgage lending in Ukraine, which supported heavily the construction activity.

Figure 6

Mortgage lending



Source: NBU

To sum up, the housing construction sector performed well during the last years, due to very favourable macroeconomic conditions that veiled the existing strong structural deficiencies. Before turning our focus to 2008 it is important to understand that such "ideal" macroeconomic conditions for the construction sector were not sustainable and thus cannot be considered as a model for the long-term. First, the low (even negative) level of (real) interest was partly due to an excessive monetary expansion, which partly caused a rampant and unsustainable CPI inflation. Second, the one-way direction of housing prices that supported speculative demand was equally not sustainable and had to come to an end sooner or later. Third, also the strong increase in real wages and income, which surpassed increases in labour productivity, was not feasible in the long-term. Thus, the extremely favourable conditions for housing construction did not come to an abrupt end accidentally. A worsening of conditions was the direct result of a period of previous overheating. This implies that a future return to the conditions prevailing over 2006 - 2007 is technically not possible and cannot thus be considered as a suitable solution to current problems.

Let's turn now to the situation in 2008. A crucial reason for the current recession in housing construction is the worsening of credit conditions due to many reasons, including a tightening of domestic monetary policy and the fallout of the international financial crisis. Interest rates in Hryvnia have increased and also the expectations and likelihood for a devaluation have risen, making loans in foreign currency much riskier than before. Furthermore, the conditions for the provision of mortgage loans (loan-to-value ratio, stricter checks on income declarations, etc.) have been tightened driving the issue of new mortgage loans down, as can be seen in Figures 5 and 6. As a result, many households fail to secure a mortgage loan since they cannot afford it. But higher interest rates also affect the construction companies, which rely on bank finance. Thus, tougher financing conditions have negatively affected both supply and demand for housing.

A further important factor on the demand side relates to housing prices. It is not clear whether housing prices already began to decrease or not. The data used for Figure 4 do not show a decrease in prices. But it should be noted that Figure 4 is not based on official data, because of a lack of such data. Instead, data provided by real estate brokers have been used. While such data are considered to be reliable in general, we should point out to a possible conflict of interest of market participants providing the data. In particular, private agents who deal in real estate might not be interested in reporting decreasing prices. Thus, contradictions between available data and anecdotal evidence might simply reflect the lack of high-quality, consistent data. But on the other hand it is clear that prices have already dropped in real terms (i.e. inflation adjusted) and that most analysts expect a sizeable drop in housing prices in the near future. Under such circumstances, demand from both middle-class and affluent households goes down. People prefer to wait and see, before deciding to buy an apartment. The fact that the market has currently “frozen”, i.e. there are hardly any transactions taking place, is a further indication for a future price drop. Such behaviour is typically for real estate markets at inflection points, where demand has already declined but suppliers are still sticking to their (unrealistic) offer price expectations. Over time, they will be forced to sell their flats by lowering their offer prices, and subsequently demand meets supply at these lower prices.

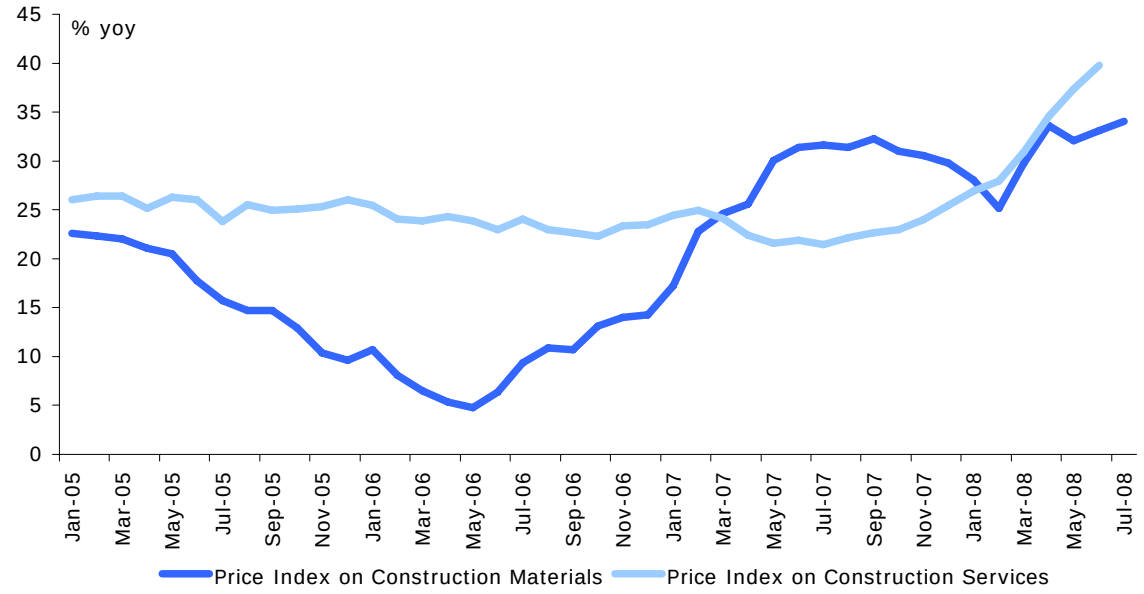
However, construction companies also face additional pressure from the supply side. Following significant increases in the prices for gas, electricity, transport and in wages, the prices for construction materials have exploded, as shown in Figure 7. Also the price for steel has increased strongly.[2] While steel price growth was at 20% yoy in January 2007, this number increased to 26.3% in January 2008. During 2008, this growth exploded, and reached a hefty 72.6% yoy in July 2008.[3] Besides, as shown in Figure 7, the prices for construction services have risen dramatically.

[2] The price of steel does not make part of the price index shown in Figure 7.

[3] However, it should be noted that steel prices have fallen dramatically over recent months after peaking in summer 2008.

Figure 7

Prices for Construction Materials and Services



Source: Derzhkomstat

NOTE: price index on Construction Materials is approximated from the price index on non-metal mineral production (bricks, cement, and glass) but does not included metal prices.

In short, the housing construction sector has been negatively hit from both the supply and the demand side. As a result, activity has declined strongly.

4. Policy implications

Broadly speaking, there are two main approaches for reactivating the housing construction sector. One is a macroeconomic approach (demand-side policy response), while the other focuses on microeconomic structural reforms (supply-side policy response).

4.1 A macroeconomic response to the current weakness in housing construction?

In principle, problems in particular sectors of the economy can be softened in the short-term by macroeconomic policies, such as expansionary monetary and/or fiscal policies. But such demand-side policies are highly debatable, since they do not solve the underlying problems in the troubled sectors. In fact, in most cases they postpone the necessary implementation of reforms, making the shock of adaptation for the shock much stronger and thus creating more hardship. Besides, demand-side policies would artificially support high housing prices and thus hurt potential home buyers.

But in the case of Ukraine today there is a much stronger and trivial argument against demand-side policies to help the construction sector: The country has no room for an expansionary macroeconomic response. When inflation is running at 26%, there is no way that the National Bank can ease monetary policy, and the Ministry of Finance has equally no space for increasing expenditure. On the contrary, any attempt to further increase domestic demand would only destabilise the increasingly fragile economic situation and lead most probably to a hard landing of the economy. Consequently, a macroeconomic response under current circumstances is out of the

question. Rather, macroeconomic policies should be directed at lowering the gap between aggregate supply and demand and enable the economy to grow in line with its long-term path.

Recommendation 1: The authorities should not tackle the current recession in the construction sector from the demand side, i.e. by implementing expansionary macroeconomic policies. Such an approach would further destabilise the country and could lead to a hard landing of the economy.

4.2 The need for structural reforms in housing construction

While as stated above the authorities have no room for increasing demand for housing using macroeconomic policy, there is plenty of policy space for increasing supply by implementing structural reforms in the sector. Below, we will focus on some of the most important structural deficiencies, which are in bad need of improvement.

(i) Market structure

The current market structure consisting of a few large holdings with overstaffed and cost-intensive administration is highly inefficient, as can be shown by international experience. Policy measures are needed to create a more competitive and efficient supply structure. A reformed competitive supply side would have strong incentives to invest in new technology, to increase productivity and to lower costs. In such a way, not only housing quality would improve and prices would come down, thus increasing the demand for housing, but also the badly needed technological modernisation of the sector would be supported.

(ii) Acquisition of land plots

One of the main problems in the sector is the highly intransparent and costly acquisition of land plots for building purposes. Land for building apartments cannot be sold, but only rented/leased by city councils. In many cases, the rent contracts for land plots only last for 3 years. This creates significant problems, also for the provision of collateral by developers for obtaining mortgage loans. As a result, the access of companies to bank loans becomes more difficult and the cost of financing more expensive. Furthermore, city authorities request developers to fulfil social obligations for renting/leasing a land plot, such as the provision of free flats or the development of roads related to the new buildings. This hardly transparent procedure can also be considered as a detriment to the development of the sector. A straightforward and transparent privatisation of land plots would certainly be a better procedure.

(iii) Housing finance and the protection of households' savings

Mortgage lending in Ukraine has developed strongly in recent years, as shown in Figure 6. While the better access to finance is a very positive fact, the current system of housing finance still features significant economic and social weaknesses. This applies in particular to the financing schemes of multi-apartment residential complexes, where households make direct prepayments to building companies or property developers before construction has even started. In some cases, households make even prepayments to developers that have not yet got an approval by the city authorities for the construction project. The weakness of this system becomes obvious when, for some reasons, the developer is not able to secure a constant inflow of cash from new households and thus he has no way to finance the further construction process. As a result, construction sites stop working and households that used their savings for such a project face an uncertain future regarding their savings and the possible finalisation of their apartment. They are obliged to service their mortgages, while the object of this loan, the apartment, is far from completion. In fact, this is exactly what is happening during the last months. New households were not able anymore to obtain affordable loans and as a consequence developers did not get fresh money to finance the construction process. At the same time, lending conditions for direct bank loans to developers also tightened. The result is a high number of inactive construction sites.

Clearly, the situation described above cannot be seen as suitable from the point of view of social policy. Thus, measures need to be taken, both in the short- and in the long-run. The long-term goal should be to better protect households by promoting direct savings schemes between banks and households. In particular, contractual saving schemes could play a major role, as is the case in many different countries, including the new members of the European Union. Under such a scheme, households save money at an account for a number of years and receive later their savings plus a loan, which allows them to buy an already finished flat. The system works in such a way that fresh households (savers) finance the loans of the households that have already saved for a number of years and now get into the credit phase of the scheme.[4] As long as households put their savings directly with hardly regulated and supervised construction companies or developers, the major risk of households losing a large part of their savings will remain.

But also action in the short-term might be required. Here it should be checked whether the government has any means for ensuring a quick finalisation of the construction projects, for which households have already paid. Further research and advisory work are required to develop concrete recommendations in this direction.

(iv) Housing finance and banking sector

Housing finance has also a crucial importance for the banking sector. In this regard, a high number of legal problems increase the costs of banks for providing mortgage loans, a fact which in part explains the high level of interest rates in Ukraine in comparison to other countries. Thus, solving these legal problems in the fields of cadastre, collateral regulation and foreclosure would contribute to lower interest rates in the long-term, thus supporting the housing construction sector.

In the context of housing finance it should be noted that the current problems in the sector, including a possible drop in housing prices, might have a negative effect on the quality of bank's assets, a risk that the current international developments clearly highlight. To date, it is difficult to quantify the extent of the risks, also because of the lack of experience when it comes to dealing with bad mortgage debt in Ukraine. In particular, it remains to be seen how fast banks can implement foreclosures and how much such procedures will cost banks. However, this particular topic and its policy implications are very vast and cannot be dealt with in detail within the framework of the present paper.

The analysis and policy recommendations described above can be summarised with the help of simple analytical tools in the Annex.

Recommendation 2: The current recession in the construction sector should be dealt with from the supply side of the market, i.e. by implementing badly needed structural reforms.

5. Conclusions

The recession in the housing construction sector is a major economic and social problem. Without doubt, the government has to deal with the issue and find solutions to the existing crisis. The current debate on what to do to improve the situation is a classical "macroeconomic vs. structural reforms debate". We argue that a macroeconomic (i.e. demand-side) response makes in general little sense to support particular sectors of the economy. But equally important, given the concrete macroeconomic situation in Ukraine, there is no room for an expansionary monetary and/or fiscal policy. The very high level of inflation and the increasingly challenging internal and external economic conditions preclude the implementation of measures to increase aggregate demand.

[4] See also Roy/Giucci: Contractual Savings Schemes in Ukraine, Round Table Paper of the German Advisory Group and the IER Kyiv, November 2004, www.ier.kiev.ua

Consequently, there is no alternative to the implementation of structural reforms. In fact, the current situation should be seen not only as a crisis, but also as a big chance for Ukraine for finally reforming its highly inefficient housing construction sector. Today is the ideal time for conducting structural reforms, because this is the only way to re-activate the sector and to put its growth path back on a healthy and sustainable basis for the future.

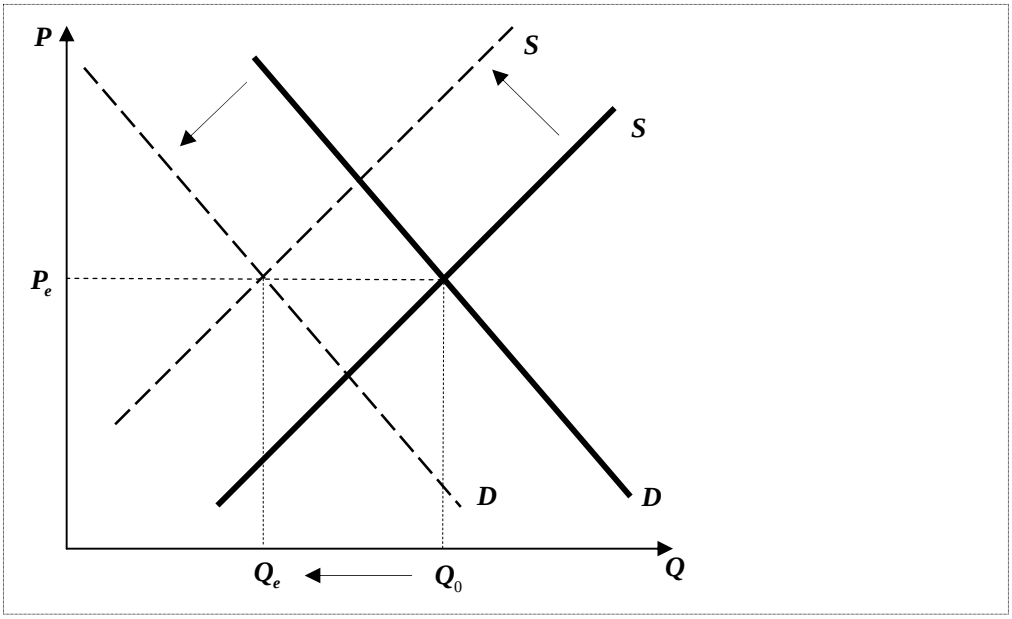
Annex: The housing construction sector depicted in a supply and demand schedule

A simple, yet consistent way to illustrate our analysis and policy recommendations regarding the housing construction sector in Ukraine is by using the traditional supply and demand curves. The supply curve (*S*) has a positive slope, as price increases will induce construction companies to supply more housing. The demand (*D*) is downward sloping, as people tend to demand more housing with declining prices. The market is in equilibrium at the intersection of demand and supply, at which the price P_e and the quantity Q_0 is established.

As explained in Part 3, demand for housing decreased due to higher cost of finance and due to negative price expectations. In technical terms, the demand curve shifted to the left, as shown in Figure 8. At the same time, construction costs increased, thus also pushing the supply curve to the left. As a result, the price for housing remains rather stable at P_e, but construction activity declines significantly (from Q_0 to Q_e), which is a good depiction of recent developments.

Figure 8

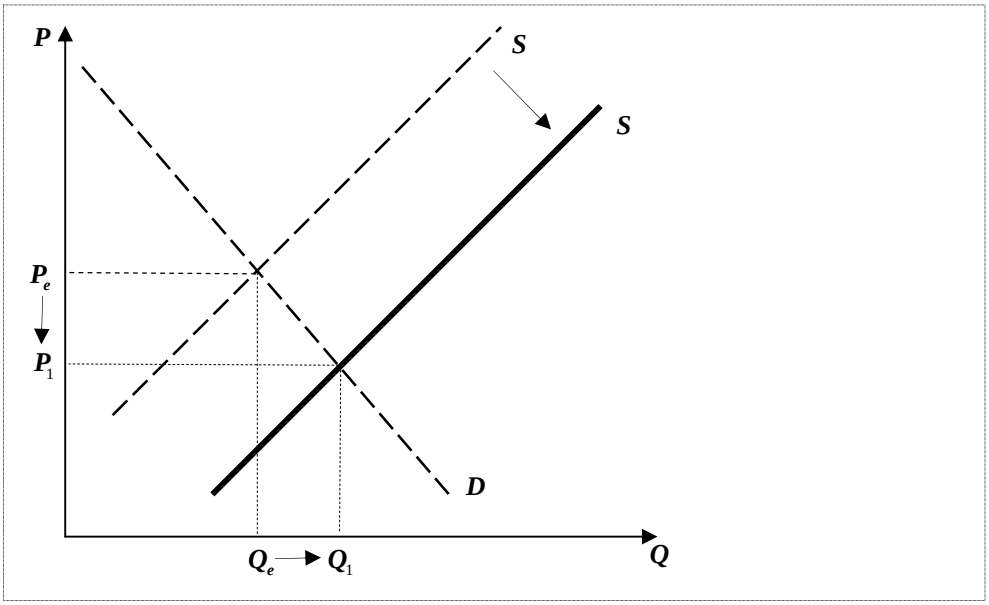
Simplified analysis of recent supply and demand changes in the construction sectors



Let's turn now to the policy implications. The supporters of a macroeconomic response wish to increase demand for housing by lowering interest rates (i.e. expansionary monetary policy) or by increasing income (i.e. expansionary fiscal policy). In technical language, they would like to shift the demand curve to the right (the effect of lower interest rates would also shift slightly the supply curve to the right). As can easily be shown, such a move would indeed increase activity in the construction sector. But as explained above, under current macroeconomic conditions such a move would be extremely detrimental for the whole economy. That is why the only solution lies in the supply side of the market. By implementing structural reforms the cost of construction goes down, which implies a move to the right of the supply curve. As can be easily seen in Figure 9, a successful implementation of structural reforms would not only contribute to increase the activity in the sector (and thus employment and output, which increases from Q_e to Q_1), but also to lower prices (from P_e to P_1), thus making housing more affordable for the population.

Figure 9

The effect of structural reforms on the construction sector



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