

## SPECIFICS OF THE REAL ESTATE MARKET DEVELOPMENT

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**Abstract:** The article examines the process of the emergence, shaping and functioning of the real property market in the Republic of Moldova and dwells on the factors that influence its shaping and development. The paper presents the market development dynamics, considers main problems and suggests their possible solutions.

**Keywords:** *real estate, real estate market, evolution, cycle.*

### 1. Introduction

The real property market is a core driver of the market economy and the state of the real property market reflects the development level of the nation's economy and market relations. The real property market is a vital component of any national economy because real property is the most important part of the national wealth; it would suffice to say that real property accounts for more than 50% of the global wealth. The role of the real property market is ultimately evidenced by the fact that other markets, such as the markets of capital, services, goods, etc. cannot exist without the real property market because the players of those markets need to own, rent or otherwise possess real property (premises, land) in order to be able to carry on their business. The local real property market is a sector of major importance for Moldova's national economy as the real property market accounts for a major portion of Moldova's gross domestic product (GDP). The real property market started taking shape in Moldova – similar to other former soviet republics – after the disintegration of the USSR. The former soviet republics were sovereign states after 1991 and they started changing their economic systems; the emergence and shaping of the market was one of the first processes to start.

The year 1991 is believed to be the point of departure for the development of Moldova's real property market when private property was enshrined as a notion in Moldova's laws and regulations. Earlier, back in the soviet times, individuals had no ownership rights to real property. That is why it is even more relevant to study the real property market development in a state in transit that has not yet gained much experience in that sphere. To that end, it would be necessary to examine the real property market in its infancy stage, its development and emerging problems – and then to search solutions for those problems. A major factor triggering the development of the real property market was enactment of the law on privatization [1] and of the law on privatization of housing [2], which underpinned the transfer of state property to private owners. Initially the off-plan (primary) property market was emerging on the basis of housing privatized by its residents for free as well as on the basis of non-housing premises and land privatized for free or against consideration and newly constructed real property. The secondary property market started taking shape at a later stage as reselling of privatized and new pieces of real property.

The real property market structure and infrastructure was emerging and taking shape spontaneously in the economies which had a transit stage. At the same time, extensive use was made of the experience of developed market economies (primarily the USA as well as the UK, Germany, Sweden, Canada, etc.) – with efforts made to adapt that experience to the

actual situation of Moldova's economy in transit as much as possible while developing the legal and regulatory framework for the real property market. Gradually the real property market was becoming more and more active with arrival of the professional market players (brokers, realtors, valuers, developers, lawyers, etc.).

The above-mentioned market reforms resulted in the emergence of multiple ownership types – and so it became necessary to recognize ownership rights as the first step and to protect and guarantee such rights as well as other property rights. These changes resulted in the acute need to create a system of databases with the relevant information.

Shaping of the institutional and legal environment is still in progress for the real estate market and Moldova has adopted a number of documents important for its operation. Enactment of the law *On Real Estate Cadastre* [3] created the foundations for a system for state registration of real estate. The emergence of such a system contributed to collection and registration of data regarding the qualitative and physical characteristics of real property pieces and their appraisal. In Moldova, the multi-purpose cadastre of real estate comprises three sections (registers): information about the rights holder and the basis for the property rights to real property pieces; technical characteristics (specifications); and appraised value of the real property pieces. It developed the legal framework for registration of mortgages which are subject to registration in the Land Register. From this perspective, the registration system provides confidence to commercial banks to accept property as collateral that secures loans [4].

## 2. The real estate market and its specifics

*The real property market encompasses the entire range of transactions performed with real property between individuals or legal entities within a certain space where the demand for real estate meets with the offer of real property, prices are formed, negotiations and sale/purchase transactions take place on competitive terms and conditions.*

The real property market has certain specific features which differentiate it from other markets. This real property market specific is inseparable from the characteristic traits of real estate as such. Each piece of real property is unique, but its location is fixed. Real estate markets are not efficient markets: the number of sellers and buyers operating at the market is relatively small, real property pieces have a high value which requires considerable purchasing power – and therefore such markets are affected by the offered financing type, loan amounts which can be procured, the amount of the market advance, interest rates, etc. Different from efficient markets, real estate markets are not self-regulating – on the contrary, they are often affected by regulations enacted by central and local governments. Demand and offer of real property can strive to achieve a balance, but that balance is theoretical and can hardly ever be achieved because there is always a discrepancy between demand and offer. Offer develops slowly to satisfy demand of a certain type, but demand can change very rapidly – and so the probability of excessive offer or unsatisfied demand is much higher than that of market balance. Buyers and sellers are not always well informed and sale and purchase transactions are not frequent. Quite often, information about the current transaction prices or about the level of offer is not readily available. Real property pieces are durable and can be viewed as investments. Their liquidity is low and usually the process of sale takes time.

The behaviour of the real estate market is hard to forecast in view of all the above-mentioned factors. Of importance are motivations, interactions between the market players and the extent to which these players are affected by endogenous and exogenous characteristics of the concerned real property. So diverse types of real property markets (residential real estate, commercial real property, industrial real property, agricultural

property, special types of property) emerged depending on the needs, desires, motivations, location, type and age of the market players on the one hand and on the type, location, design and limitations of the real property pieces on the other hand. The above market types can be additionally broken down into smaller and more specialized markets (so-called sub-markets); this process means market segmentation and disintegration of property.

All real property markets are affected by the behaviour, motivations and interactions between the buyers and the sellers of real property - which are determined, in their turn, by social and economic factors, regulations and restrictions imposed by the state or by the environment. Real property markets can be studied depending on their geographical characteristics or competition, demand and offer, - and all of these are linked with the general conditions at the real property market in its integrity.

Real estate markets are characterised by their heterogeneous nature. Each property is different from others in terms of its characteristics such as location, size, use, etc. Accordingly, one should keep in mind that there are not one, but many markets for real estate property.

Development of the real estate market is determined by:

- Economic growth or its forecasts. Although the market may experience short-term periods of beneficial conditions in the absence of any growth, such situations do not emerge often;
- Financial capacity to acquire real property – which is determined, in its term, by the economic growth rates (crisis, stagnation, industrial development) of the region as well as availability and nature of jobs;
- Links between real property prices and economic promise of this or that region.

### 3. Cyclical nature of real estate markets

Real estate markets – just as any other asset markets – are cyclical and exhibit the typical four phases of recovery, boom, downturn and bust.

Real estate markets are closely related to economic development. During an upswing in the business cycle, economic activity and the demand for real estate space will increase. By contrast, in a downswing, demand for it will decrease.

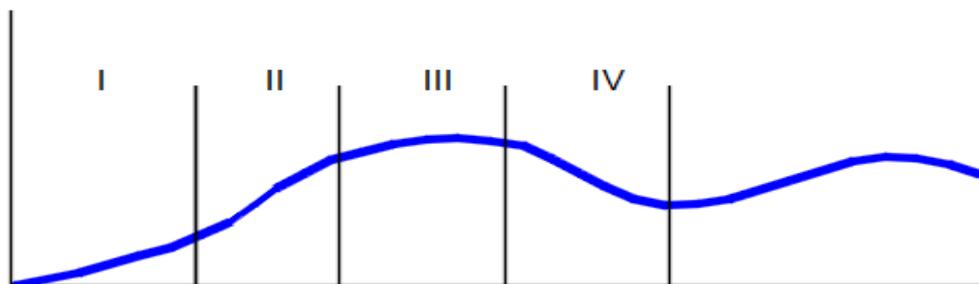


Fig. 1. Real estate cycle

The real estate cycle can be characterised by four distinct phases:

- I. In a recovery, demand begins to rise, while supply is less flexible owing to the lag in construction. Even though some of the extra demand is absorbed by existing vacant real estate, prices and rents tend to rise. Availability of loan funds begins to increase while lending standards are still strict, but relaxing slightly. Accordingly, leverage begins to rise.

- II. This phase is followed by a boom period which is characterised by strong demand. Supply is now following demand, but still not to a sufficient degree. Therefore prices continue to rise and reach high levels relative to rents, fostered by strong positive sentiment on the part of market participants. The price movement is strengthened by the (positive) feedback loop featuring abundant loan funding. Furthermore, competition drives banks to lower their lending standards.
- III. At some point demand decreases, while supply is still expanding – owing to the lag in construction; the downturn phase is characterised by decreasing prices. Banks react to these market developments by tightening loan funding supply and lending standards. These stricter financial conditions put extra pressure on real estate markets (a negative feedback loop) and result in further price falls.
- IV. This process continues during the bust period, in which demand is low and unable to absorb the existing supply. Large price decreases are accompanied by a significant rise in vacancy rates. Since expectations and credit ratings of market participants tend to be negative, loan funding is costly and not freely available. Market participants attach significant risk premia to investing in real estate.

The real property market is affected by multiple external drivers such as:

- Changes in the general social-economic situation and the region’s economic competitiveness;
- Changes in the government’s monetary policy as well as in the policy of commercial banks that determine the availability of funding to finance real property sale and purchase transactions;
- Changes in laws regulating the real property market and in tax laws;
- Changes in situation at the capital market, etc.

Many scientists of global repute were studying the issues of cyclical development in economy, including the real property market. In the 1930s, the US scientist Homer Hoyt examined for the first time cyclical development models for real property market, using land prices as an example.

Diverse researchers and in particular US scientists examined this topic in sufficient detail, analysing the US market, but were not able to arrive at clear and unanimous conclusions. At the same time, their theories had to be tested in practice to be able to take into account the additional external drivers arising as a product of globalization processes in economy.

#### **4. Real estate market in the Republic of Moldova**

The emergence and shaping of the real property market started in the environment of economic liberalization changes and of the processes that took place in the economy during that period such as deep economic decline, high inflation rates, decreased consumption levels for most of the population, a dramatic differentiation in the population in terms of their income levels, the lacking legal and regulatory framework necessary for transit to the market, - which factors could not help but affect the peculiarity of shaping market relations in the real property segment.

The history of the real property market is believed to start with the enactment of the Law of the Republic of Moldova on privatization. Currently most analysts identify three main

chronological stages in the history of development and shaping of the real estate market the, which stages are subdivided in their turn into shorter intermediate periods.

*The first stage represents a period when the rules of residential real estate market have been established (1991 -1998).* During that period, the cost of one square meter of housing was about \$ 100. In 1992, mass privatization of housing began in Moldova. The market started to develop at an accelerated pace due to the increase in supply. More than 86% of the total apartments, about 80% of commercial sites and 70% of industrial facilities had been privatized by the end of 1996.

Between 1994 and 1997 there was a marked increase in housing prices (about 50-60%). However, a serious impact on prices in the housing market took place during the financial crisis of 1998, resulting in a massive and fairly dramatic drop in prices, which has not been observed since the emergence of the market. Prices for standard properties decreased by 40% by 1999.

Thus, the characteristic feature of the first period in the process of emergence and development of the real estate market has been a rapid rise in prices in the early stage and a significant reduction or even significant fall down towards the end of the period.

*The second stage of the real estate market development in the Republic of Moldova began in 2000 and ended with the beginning of the global financial crisis in 2008.*

The beginning of the second period was still characterised with a decrease in prices for residential real estate. However, the situation had changed by 2002 and prices returned to their pre-crisis level. There followed a prolonged period of rising prices with a slight stabilization in 2004 and 2007. As a result, according to real estate agencies, a historic maximum in prices for apartments at around \$ 930 per square meter was reached in autumn of 2008. Soon, however, real estate became much cheaper in the same year as a result of the global financial crisis (Fig. 2).

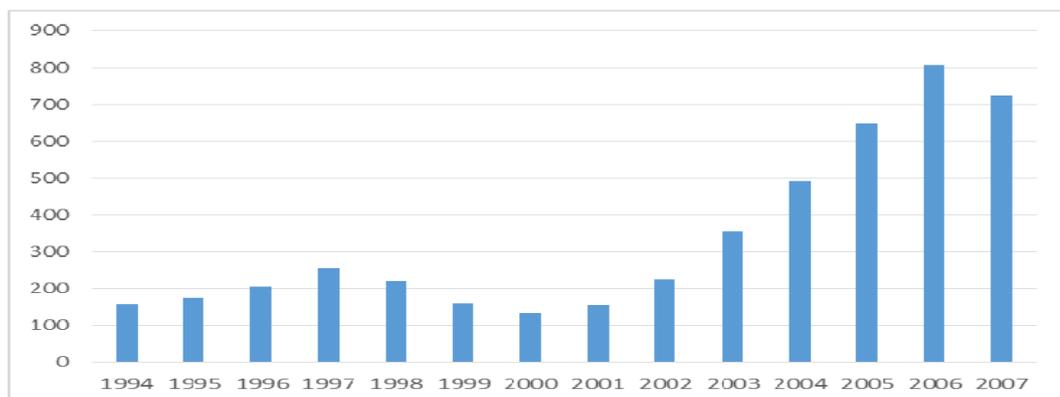


Fig. 2. Dynamics of the real estate price (apartments) in Chisinau, USD per square meter (1994-2007)

The overall social-economic situation in the country has significantly changed since the beginning of the 21<sup>st</sup> century: political and economic stability was strengthening; the country went to high economic growth rates from the period of economic downturn, significantly increasing the role of the government in economy, and incomes of the population were rising.

While the real property market had a pronounced redistributive feature in the preceding period, it could be called the development market in the first decade of the 21<sup>st</sup> century.

This conclusion is based on the following arguments. As compared with the previous period, the volume of construction increased significantly. Thus, during 2000 - 2007 the volume of contract work carried out by construction and assembly organizations increased 6.3-fold as referenced to the constant prices of 2000 [6], returning the most prominent growth to the new construction, the value of which increased 7.1-fold during this period (Fig. 3).

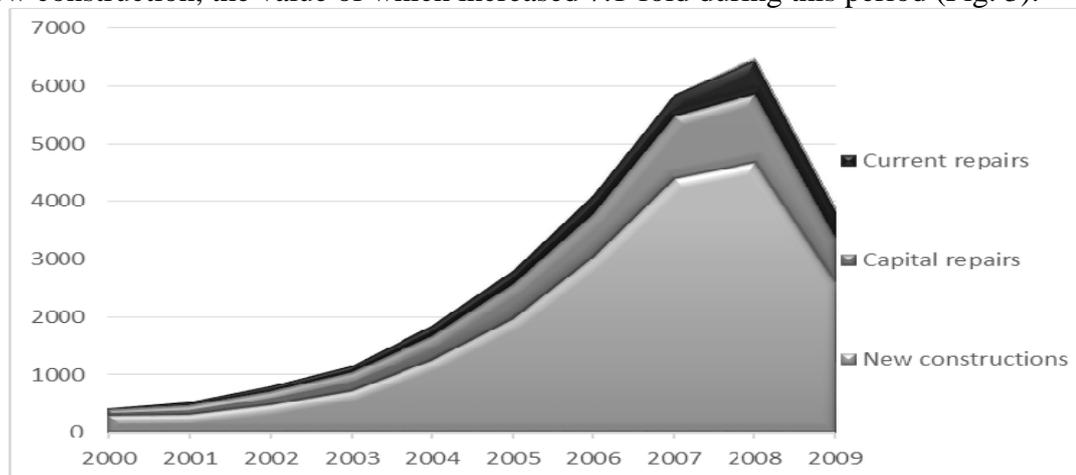


Fig. 3. Value of construction work performed under contract, in MDL millions

During 2000 to 2008, the number of built apartments increased from 2.3 thousand to 6.8 thousand. In the subsequent period, the volume declined slightly; nevertheless, it makes more than 5.4 thousand apartments per year [6].

The global financial crisis impacted the mortgage system first of all. Many banks discontinued their mortgage programs, and those who continued to offer mortgages significantly revised their programs (the rates and the size of down payment have been increased, the requirements for the borrower have been tightened, mortgage loans were mainly extended to finance only secondary market property, etc.). The number of mortgages recorded in the real estate register during 2009 was 12664, which is 33% less than in 2008. Chisinau accounted for 41% of all mortgages registered in Moldova [7].

The surveys of real property market have demonstrated that significant drivers affecting the real property market development since 2001 and intensifying the turnover of real estate among individuals are:

- Political stability;
- Stable growth patterns registered for social-economic and macroeconomic indicators;
- Financial market stabilization;
- Regulation of the legal framework and the relevant regulations;
- Free issuance of ownership titles as part of the first state registration;
- Licensing of professional market players in the real property market and in particular of valuers and experts performing cadastral work.

*The year 2010 can be considered the beginning of the third stage.* A distinctive feature of this stage is building of low-rise housing of small dimensions. Interest rates on loans are high, mortgages remain inaccessible for most of the population. Table 1 shows the development of housing in the Republic of Moldova during 2009-2016.

The decline in housing prices began in the autumn of 2013, after three years of stabilization (2011 - 2013), during which the average cost of 1 sq. m of housing was about EUR 650. At the end of 2013, the price fell by 7% - down to EUR 615 for 1 sq. m. In relation

to the maximum level of prices for residential real estate, which was achieved in 2008 and stood at EUR 910 per 1 sq. m, the price decline was about 32% in 2013.

Table 1. Number of built flats and their average size

	2009	2010	2011	2012	2013	2014	2015	2016
Number of flats, thou	4.8	4.9	5.2	5.1	5.5	5.4	7.6	6.1
including, %:								
1 room	16.3	19.6	17.6	17.7	28.7	23.6	33.2	30.7
2 rooms	31.6	32.5	33.1	32.6	33.4	37.9	40.1	41.0
3 rooms	31.0	28.5	29.7	30.6	26.0	24.1	16.7	18.9
4 rooms and over	21.1	19.4	19.6	19.1	11.9	14.4	10.0	9.3
Average size of built flats, sq. m	103.7	110.7	113.5	99.1	93.3	92.6	80.4	84.9

Today we can see a new round of the crisis which has less in common with the global trends, unlike 2008-2009. National currency has been devalued against the major currencies of reference – US dollar and Euro. Remittances transferred in the country by labour migrants working abroad have decreased. The crisis in the banking sphere, followed by the exodus abroad of important financial resources from the country, has also aggravated the already difficult situation. Fig. 4 shows the evolution of prices for real property during 2007 - 2016.

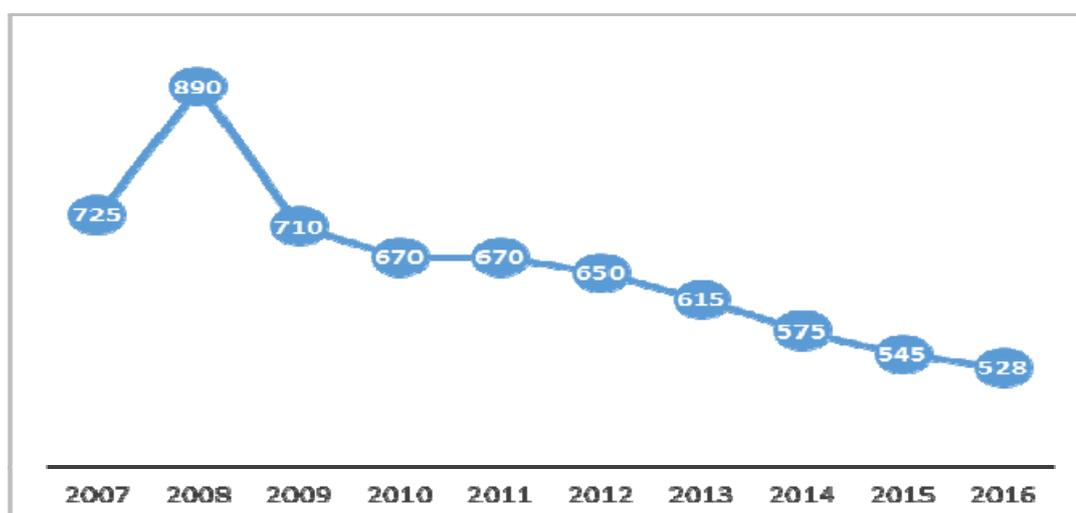


Fig. 4. Dynamics of the average market price of 1 sq. m of apartment area during 2007-2016 (in Euros)

It follows from the analysis performed that the real estate market is very sensitive to economic as well as political changes taking place in the state and also to the macro-economic situation as a whole.

At present, the factors that impact the real estate market are:

- Political and economic instability;
- Reduction of mortgage lending;
- Devaluation of the national currency;
- Reduced purchasing power of the population;
- Pessimistic expectations of market participants.

## 5. Conclusions

Real estate is a major component of the economy and has been subject historically to large and widespread fluctuations. The construction industry plays a major role in creating the boom and subsequent bust.

The emergence and shaping of real property market as a segment of economy started at the turn of the 20<sup>th</sup>-21<sup>st</sup> century in the new history of the Republic of Moldova.

The real property market evolves through a number of complex economic stages associated with multiple internal as well as external economic, political and social drivers.

Mainly the institutional and legal environment of real estate market was formed during the period under review; a minimum of regulations necessary for proper functioning of the market has been adopted, the basic institutional arrangements have been established for the development of market relations (the system of real estate registration, valuation, registration of the associated rights, development of mortgage lending, urban planning activities, etc.).

The emergence of internal market has shaped the real estate market structure, developing all its major segments associated with real estate types (residential market, commercial real estate, land) and the phases of the real estate life cycle (creation, handling, use (control)).

An indicator of maturity of the real estate market was the completed emergence of the professional market environment, shaping of the main groups of professional real estate market players, enabling more efficient functioning of the market.

The most serious problems of market development are: its lack of transparency and the complexity and incomprehensibility of pricing, which, combined with a low overall level of household income, makes housing inaccessible as a commodity for the vast majority of citizens.

The most important issues were identified to improve the situation existing at the real property market. It became clear in particular that long-term plans for the development of Moldova's market should be based on reliable information and strong legal framework.

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