The impact of foreign demand on Cyprus house prices±

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Abstract
We examine the drivers of house prices in Cyprus, paying particular attention to the impact of foreign demand and its contribution to the recent boom and bust cycle observed in Cyprus’ house prices. To this end, we use two different series to proxy foreign demand for real estate: FDI flows in the real estate sector, and the share of foreign buyers in total property transactions. We employ a Bayesian vector autoregressive mechanism to examine interlinkages between house prices, foreign demand, income growth, credit, interest rates, cost of construction and inflation. The results suggest that the share of foreigners in total real estate demand has a strong effect on house prices, while the effect of overall FDI flows to real estate is small. The timing of increases in both FDI flows and the share appear to be the cause of the recent housing bubble in Cyprus, while flow reversals are key to understanding the downturn and, eventually, the collapse in prices. The impact of foreign demand is qualitatively similar to that in other countries such as Japan and Australia. Simple policy measures to avoid a reoccurrence of this situation are overviewed.

Keywords: House prices, foreign demand, real estate, Bayesian.

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