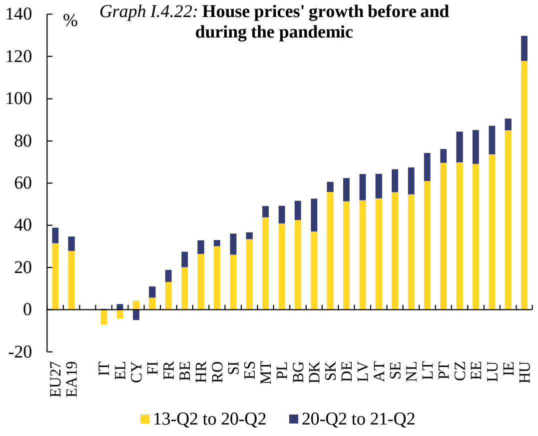
4.4. HOUSING MARKET

Housing prices in the European Union continued their dynamic upward trend despite the deep recession caused by the COVID-19 shock. This special topic looks at the EU housing price increases since 2013, identifies some of its key drivers and sheds some light on the macroeconomic and social implications for the economy going forward. While prices look overvalued in many countries, significant price corrections are unlikely due to strong demand and constrained supply. What's more, a possible downturn in prices would have limited impact on financial stability and economic activity because of the moderate credit cycle and subdued construction activity during this cycle. However, housing affordability has deteriorated with macroeconomic implications such as the need for higher savings and a lower share of income devoted to consumption.

EU house prices have been trending up since 2013, and grew at their fastest pace in the second quarter of this year. Following the resumption of economic growth in 2013, house prices have been rising in most Member States. By 2021-Q2, house prices in the EU were around 38% higher compared with the same quarter in 2013 (see Graph I.4.22). This represents an average annual rate of growth of 4%. Among large EU Member States, German prices in 2021Q2 were 62% above their mid-2013 values, compared to 40% for Poland, 37% for Spain, and 18% for France. By contrast, over this 8-year period, prices decreased in Italy (-7%), and remained broadly stable in Greece and Cyprus. This year has seen a marked acceleration in prices. In 2021Q2, EU aggregate residential property prices grew by 7.3% year-on-year. This means that of the total increase in prices that occurred since 2013, nearly a fifth has taken place in the last 12 months alone.

The recent price increase was broad-based across Member States, and exceeded the previous trend growth in most of them. Over the past year, prices have increased in all countries except Cyprus, and have accelerated relative to the post 2013 trend in twenty of them. Eleven Member States reported year-on-year growth exceeding 10%. The largest increases were observed in Estonia, Denmark, Luxembourg, Czechia, Lithuania and the Netherlands (see Graph I.4.22).

Graph I.4.22: **House prices' growth before and during the pandemic**

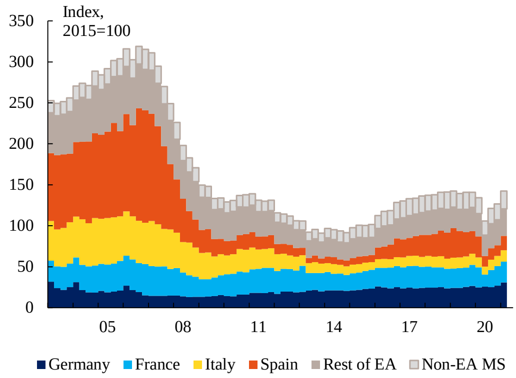


Drivers of house price growth

The recent growth of house prices has been driven by a variety of factors fuelling demand and constraining supply. Although housing markets differ strongly across Member States, supply-side constraints have been present across the board. With sustained demand backed by economic growth, historically high household savings and low interest rates, the result has been an upward trend in house prices.

Limited construction activity has been acting as a brake on the supply of housing for a number of years. Member States currently have stricter zoning and building regulations than in previous decades. Furthermore, building permits have remained at low levels in recent years (see Graph I.4.23).

Graph I.4.23: **EU Building permits**



The pandemic may have exacerbated supply constraints, but overcoming these will take more than just the recovery. While lockdowns exacerbated the supply-side constraints temporarily, there is little perspective at present for the pre-existing constraints to materially ease. Building permits typically take time to react to the increase in house prices, and while there has been a recovery of permits in recent months, residential investment will need time to materialise.

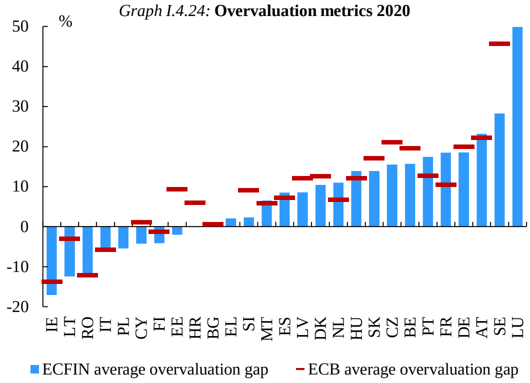
Demand for housing has been sustained in recent years, and continued during the pandemic. In several EU countries, favourable funding conditions and growing household disposable incomes have been supporting demand for residential space, particularly in urban and suburban areas, even before the pandemic. During the pandemic, a resilient labour market, income support measures and curtailed spending opportunities pushed up the stock of savings, part of which households are likely to devote to residential investment. These accumulated savings and demand for increasing living space to accommodate new working habits such as teleworking should continue to support housing demand.

House prices in perspective

House prices currently seem overvalued in around half of EU countries. House prices can be compared to their fundamental drivers in order to gauge whether they are at a plausible level. These fundamental drivers commonly include population, income, interest rates and housing investment, all of which are found to affect house prices in the EU. Estimating the long-term relationship among these indicators allows for estimating an 'equilibrium level' of house prices, to which the actual level can be compared to. This approach is accompanied by a comparison of price-to-income and price-to-rent ratios to their long-term averages. The results of this analysis suggest that house prices are currently overvalued in around half of EU countries (see Graph I.4.24). [68]

[68] The over/under valuation gap is computed as the average of three benchmarks: (i) price-to-income deviation with respect to its long-term average; (ii) price-to-rent deviation from its long-term average; (iii) deviation from regressions-based benchmarks taking into account demand and supply economic fundamentals. None of these methodologies is perfect, but they provide an overview of recent house price developments compared with the past.

Graph I.4.24: **Overvaluation metrics 2020**



Source: ECB, own calculations

Despite the high and increasing price level, there do not seem to be substantial risks to macro-financial stability. Though a house price correction triggered by a rise in interest rates cannot be ruled out, the price adjustments are likely to be muted in view of the strong fundamentals behind demand and existing supply side restrictions to the housing stock. The existence of biting supply-side constraints therefore mitigates the risks for aggregate financial stability as EU house prices are unlikely to quickly decline below current levels[69].

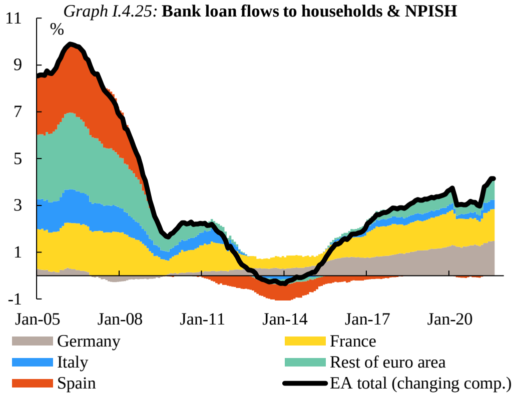
House price dynamics also poses limited risk to economic activity. As the house price surges in recent years added little to economic activity by way of residential investment, a downturn in housing prices, should it materialise, would also have limited spillovers to economic activity. Therefore, even in case of a house price correction, the macroeconomic implications would likely be more limited than those observed in the aftermath of the global financial crisis. At the time, the correction in house prices proved extremely damaging to economic activity, particularly in those countries where the bust in prices trigged an important re-allocation of resources away from a bloated construction sector.

Moreover, since 2013, mortgage credit has been more subdued than in previous phases of rapid price increase. House prices have increased faster than mortgage credit which can be related to low household residential investment in new dwellings which typically relies more on credit than the purchase of existing dwellings. In addition, the introduction of macro-prudential tools has constrained the amount of credit households can

[69] This does not rule out financial stability concerns in particular areas or Member States that are subject to particularly fast credit growth.

access. All that led to a more limited and less risky exposure of EU banks to the housing markets since 2013. In 2021, mortgage credit growth has accelerated, but still lags behind house price growth. In the euro area, the increase has mainly been driven by Germany and France (see Graph I.4.25 below).

Graph I.4.25: **Bank loan flows to households & NPISH**



Note: Flows over last 12 month as % of EA loan stock
Source: ECB

The house price dynamics since 2013 differ from the property booms of the 2000s. The sustained and synchronized house price increases over the past eight years may recall the price surges recorded in several Member States before 2008. However, in contrast to the situation today, in the early 2000s, house price increases were accompanied by rapid credit expansion and substantial residential over-investment. This was particularly the case for some countries such as Spain and Ireland, which accounted for the bulk of household mortgage credit and where sharp corrections in the housing markets spilled over to the real economy. In contrast, over the recent years credit growth remained moderate and residential investment fell short of demand. These differences moderate the macroeconomic stability risks going forward.

Housing affordability and its economic implications

Housing affordability is for now the main issue emerging from the recent acceleration in house prices. Recent home-buyers, who acquired mortgages at a time of high prices, may be faced with debt repayment risks, particularly in the event of a reversal in interest rates. Worsening housing affordability has significant macroeconomic and distributional implications such as hampering consumption, and hitting low-income groups especially hard. At the same time, home owners are enjoying positive wealth effects although evidence suggest a limited positive impact on consumption.

Rising price-to-income ratios across the EU render home-buying difficult. Between 2013 and 2021-Q2, growth of house prices exceeded growth of household income in 21 Member States and by more than 20 percentage points in 11 Member States. The largest increase was observed in Luxembourg (+57%) where a household needs roughly 14 years of income to purchase a 100m^2 dwelling. In Ireland, Austria, Portugal, Hungary, Germany, the Netherlands, and Sweden, price growth since 2013 exceeded cumulated household income growth by more than 30%. [70] These figures relate national average house prices to average income growth, and it is important to note that price-to-income ratios increase faster for certain population groups or cities within a country.

Rising house prices imply that home buyers will have to take out larger mortgages for longer periods of time, although at present the increase in monthly payments for households is mostly neutralised by declining interest rates. Furthermore, high prices entail a larger required equity portion to purchase a home, resulting in difficulties for lower income/wealth households to secure a mortgage. While the share of EU household income spent on housing costs remained broadly stable, on average, at ca. 20% during the first decade of this century, [71] new homeowners, especially those with low income, are likely to have to cope with a much higher share. The alternative of relying on the rental market is often complicated by the inefficiency and/or limited availability of rental properties in many Member States, where house ownership is the norm. The impact of rising house prices is thus likely salient for poor households who cannot secure a mortgage. [72]

(70) Note that price data expressed in years of income is tentative for the following countries, and might be revised substantially: IE, LU, FI, EL, CY. Data is not available for SK, CZ, RO.

(71) Data source: Eurostat EU-SILC. The definition of housing cost in this case includes the payment of interest, but not the repayment of borrowed capital.

(72) Data source: Eurostat EU-SILC. Note that among Member States, only LU has recorded a strong increase in housing expenditure during 2015-2020. Moreover, EU-SILC survey data suggests that 4% of euro-area home owners with a mortgage were overburdened by their housing cost in 2019, down from 8% in 2010. In contrast, 24% of renters were exposed to housing cost overburden in 2019, up from 22%

Worsening housing affordability has also macroeconomic implications. Besides the distributional implications, households having to devote an increasing share of their income to housing costs will need to adjust their consumption patterns. Insofar as these households are younger and resource constrained, they are more likely to have higher propensity to consume, adding economic significance to their actions. Finally, housing affordability and more in general income and generational inequality represent a potential threat to social cohesion.

in 2010. The housing cost overburden rate is the percentage of the population living in households where the total housing costs represent more than 40 % of disposable income, 'net' of housing allowances.