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ECONOMIC AND FINANCIAL AFFAIRS

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HOUSING MARKET DEVELOPMENTS IN THE EURO AREA: FOCUS ON HOUSING AFFORDABILITY

Technical note for the Eurogroup[1]

[1] This is a technical background paper prepared by the Commission services. It does not represent the Commission position and does not bind the Commission in any way.

1. Recent house price growth

House prices have been growing steadily across the euro area for nearly a decade. Following the strong correction in house prices that took place in global financial crisis, the resumption of growth from 2013 was accompanied by rising house prices (Graph 1). Since then house price growth has gradually built up to attain a cumulative increase of some 40% by 3Q 2021, around four times higher than the increase in the overall price level. Within this total, there has been variation across countries, with some of those most affected by the global financial crisis showing more modest growth, while other countries have seen cumulative growth approaching 100% (Graph 2).

Throughout the pandemic, house price growth has further accelerated and current prices are higher than at the outbreak of the global financial crisis in 2008. Of the overall increase in house prices since 2013, around half has taken place since 2019, which marked a change in trend. The annual house price growth in the third quarter of 2021 has been the highest since 2013, coming in at 10% overall for the euro area, and reaching over 30% in eight countries. The Commission estimates that house prices are currently overvalued in over half of the euro area countries (Graph 3). A similar assessment has been recently provided by the ESRB.[2]

The current increase in house prices is part of a longer trend, rooted in the particular characteristics of housing. The current increase in house prices can be seen within a broader trend across developed countries; this started in the 1950s and has been driven by rising land prices.[3] Land has particular properties that are economically very different to other forms of capital: it is permanent, it does not depreciate in value over time, and its supply is fixed for all intents and purposes.[4] These characteristics enable land owners to extract economic rent, receiving income without any additional investment made on it or effort as land increases in value by extracting the productivity increases of other economic agents.

Over the short and medium-term, there are many supply and demand factors that determine house prices. As far as the supply is concerned, while land is in fixed supply, housing is not. The construction of housing leads to increases in supply which mutes the price response to strong demand. Demand factors also play a role. Changing demographics, including changes in household composition, population size and regional migration affect the demand for housing, as does income.[5].[6] Financial conditions determine both the discounted cost of housing for households and the budget constraint they face. The decline in real interest rates since the mid-1990s increased the maximum obtainable loans households could afford, playing a determining role in house price growth.[7]

The current build-up of house prices is different to prior to 2008 as it is driven by limited supply, rather than mortgage growth. The boom in house prices prior to the global financial crisis had been fuelled by sharp increases in mortgage lending; in recent years, credit growth remained moderate. The application of macroprudential tools has arguably constrained the amount of credit households can access. Conversely, monetary conditions have themselves been favourable to increased house price growth, providing incentives to purchase or keep housing as an asset, and reducing the cost of

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[2] ESRB (2022): *Vulnerabilities in the residential real estate sectors of the EEA countries*. February 2022.

[3] Knoll, K., M. Schularick and T. Steger (2017): No Price Like Home: Global House Prices, 1870-2012. *American Economic Review*, Vol. 107, No. 22, pp. 331-353

[4] Ryan-Collins J., T. Lloyd and L. Macfarlane (2017), *Rethinking the Economics of Land and Housing.* Bloomsbury Publishing, pp. 11-12.

[5] Cheshire P. and Shepard S. (1998): Estimating the Demand, Housing and Neighbourhood Characteristics. *Oxford Bulleting of Economics and Statistics*, No. 60 (3), pp. 357-82.

[6] Turner A., (2015): *Between Debt and the Devil: Money, Credit and Fixing Global Finance.* Princeton, NJ: Princeton University Press, pp. 7.

[7] Madsen, J.B. 2012: A behavioral model of house prices. *Journal of Economic Behavior & Organization*, Vol. 82(1), pp. 21-38.

financing. In parallel, increases in housing supply has been constrained in the last decade, translating demand into higher prices.

House price growth has been affected by the COVID-19 crisis. As the COVID-19 impact on the economies has been perceived as temporary and governments implemented a series of income-supporting measures, housing demand remained strong. Reduced consumption opportunities may have played a role in freeing up household income. The pandemic may have changed some preferences, as teleworking and working from home drove demand for more spacious housing, in alternative locations. The delivery of building permits was further limited by pandemic-related measures and trade disruptions caused shortages of building materials, adding a further temporary break to construction.

2. Worsening housing affordability can have adverse economic implications

The economic and financial crisis highlighted the risk that a house price correction can pose for the euro area; however deteriorating housing affordability is also damaging through reduced growth and investment. The financial crisis showed the risk that high house prices can pose to the euro area. At present, the constrained supply of housing limits the prospects for a significant price correction. This limits, but does not eliminate, the risk of the types of feedback loops seen in the financial crisis between house prices, mortgage financing, the financial sector and the construction sector, materialising. However, given the prospect of increased interest rates and loss of purchasing power due to inflation, the ability of households to meet their interest payments could become a concern. Nevertheless, increased house prices are a concern for the euro area, due to impact that reduced housing affordability can have on growth and investment.

Increased house prices have an important impact on housing affordability. Since 2013, the increase in house prices has exceeded household income growth in 21 Member States and by more than 20 percentage points in 11 Member States, with most of this increase having occurred recently (Graph 4). Even before the acceleration in prices in 2019, the number of years of income needed to purchase a 100 square metre apartment was substantially higher than 10 years in many countries. Affordability is a stronger concern in urban areas, where price to income ratios are significantly higher throughout the euro area, even when controlling for the higher local wages (Graph 5). In nearly all countries, tenants renting at market prices face the highest rates of overburden, and in a number of Member States, a substantial share of renters spend over 40% of their income on housing.

The house price surge since 2019 has stretched households' capacity of servicing borrowing costs. Commission estimates show that house price increases between 2019 and 2021 rose above the change in debt service capacity of household in all but five euro area countries. This represents a break from the estimates between 2013 and 2019. While low interest rates have reduced the financing costs of mortgages, they have driven up total prices and hide repayments risks if and when yields rise, for mortgages with floating rates or short fixed periods. Higher prices also mean a larger required equity portion to secure a mortgage to purchase a home, which can price households out of the housing market. In most of the euro area Member States the required down payment exceeds the annual disposable income, reaching even over 350% (Graph 6).

Deteriorating housing affordability can have important economic consequences, including for the overall euro-area in terms of contained aggregate demand. House prices affect household decision-making in a manner that can undermine aggregate demand in the shorter term, and negatively affect growth over a longer time horizon. Increasing house prices can lead to more and more saving from households and can lead to a misallocation of resources away from productive investment. Increased rental prices reduce the amount of income available for household consumption (and investment) among households with higher marginal propensities to consume. New buyers may need to stretch themselves financially to be able to buy a home, to save the necessary deposit and then meet the monthly payments reducing their consumption. The transfer of income from those at the lower to those at the higher end of the income distribution has the effect of reducing aggregate demand, at a time when persistently weak aggregate demand is a concern for the euro area.

The incentive to borrow to benefit from rising prices can displace productive investments and, as a result, undermine growth. The rent extraction characteristic of property delivers capital gains, despite property in itself not becoming more productive. The euro area banking system provides a greater share of financing as mortgage credit than it does to non-financing companies for productive investment.[8] A range of economic studies shows that credit to non-financial firms is correlated with increased output, in a way that mortgage credit it not.[9] Given the clear need for investment to fund the economic and climate priorities under the green transition, any displacement of investment credit into non-productive mortgage credit presents economic costs.

The regional dimension of housing affordability is economically important at both the national and euro area level. Cities are marked by increasing productivity differentials relative to rural areas.[10] Lower housing affordability can reduce labour mobility towards more developed, productive regions, with valuable workers choosing to move to less dynamic places where lower wages are more than compensated by lower housing costs[11]. In this way, regional conditions can have national but also euro-area wide consequences, through the effect that have on growth rates and spillovers.

The social implications of reduced housing affordability are important themselves and can have additional economic consequences. Rising house prices and reduced affordability have implications for intergenerational aspects of inequality, primarily affecting new – and therefore young – households. The inability to access housing, and the financial impact of affordability pressures, can lead to delays in, or constraints on, household formation for younger generations, exacerbating demographic pressures linked to lower birth-rates. The current generation of young adults may reach retirement with fewer savings, other than the value of their home, putting fiscal pressure on the state.

The extent to which the present situation affects social and economic outcomes will be significantly different across euro area countries, but there are gains to be achieved at the euro area level from addressing affordability issues. There are important differences in housing markets across countries that include but also go beyond the level and growth of house prices and associated pressures on housing affordability, such as rates of home ownership (which range from 50% in Austria and Germany to 90% in Lithuania and Slovakia), differences in the size and regulation linked to rental markets, the relative level of mortgage debt and its structure (which ranges from 20% of GDP in Latvia and Lithuania to more than 100% in Cyprus and the Netherlands), and the ratio of financial assets held by households (ranging from 80% of GDP in Slovakia to 340% of GDP in the Netherlands). Mortgage contracts differ significantly, both in terms of the average loan-to-value ratios (LTV), which range from 50% in Italy to 90% in the Netherlands, and their type. There is a predominance of fixed interest rates in some countries (e.g., Germany, France) and variable interest rates in others (e.g., Greece, Spain). All these factors may affect spending patterns of households. Despite these differences, there are clear benefits to the euro area of addressing housing affordability, in terms of potential common benefits of growth and investment.

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[8] Martins V., A. Turrini, B. Vašíček and M. Zamfir (2021): Euro Areas Housing Markets: Trends, Challenges and Policy Responses, European Economy, Discussion Paper No. 147.

[9] Ryan-Collins J., T. Lloyd and L. Macfarlane (2017): *Rethinking the Economics of Land and Housing,* New Economics Foundation, p. 150

[10] OECD Regional Outlook (2019).

[11] Hsieh, C. and E. Moretti (2015): Why do cities matter? Local Growth and Aggregate Growth. NBER working paper, No. 21154.

3. Addressing housing affordability

House prices are affected by various public policies implemented both at national and sub-national level. At a national level, house prices are affected by policies whose primary aim may not be the housing market, but may have other objectives such as macroeconomic or financial stability.[12] Tax and benefit measures can and do affect the cost of housing, acting on both the supply and the demand side. Many structural policies and regulations aimed directly at housing markets are implemented on regional and local level, making national housing objectives difficult to achieve.[13] Several European countries with a strong welfare state tradition have a long history of specific housing policies, supporting both owner occupation and rental housing by demand and supply-side programmes. As a result, housing markets are heavily regulated in many European countries, but in a range of different ways.[14]

There can be a trade-off between the short- and longer-term impact of policies aimed at protecting housing affordability on the demand side. Policies that aim to reduce the cost of housing through subsidies to particular groups of individuals in the rental or housing markets may be effective at supporting affordability for these groups in the short term. However, these subsidies are at least partially transferred to homeowners, feeding into either house prices or rental costs. The extent to which they do so depends on the dynamics and structure of national housing markets, the types of subsidies, and who they target.

In order to effectively manage the gradual increase in housing costs and the resulting affordability pressures, policies are needed on the supply side. These policies are needed to ensure that there is sufficient supply in order to counteract the shortage that translates demand into high prices. In order to be effective, supply-side policies targeted at particular areas where there is a build-up of pressure are needed, meaning that regional aspects are important. Supply-side policies cover a range of possible interventions aimed at increasing the amount of accessible housing.

The taxation of property offers the possibility of providing the public sector with much needed tax revenue without distorting economic activity. The appropriation of economic rent by home owners leads to suboptimal economic outcomes and raises affordability concerns**.** Measures to reduce the ability of homeowners to extract this rent could be part of a durable solution to house price inflation and housing affordability, and could provide much needed funds for the state while increasing economic efficiency, replacing more distortionary taxes and being difficult to evade. While the first best policy response in economic terms is the imposition of a land-value tax, this may not be easy to implement politically as it involves taxing a well-defined group, some of which may be highly leveraged or income constrained. The taxation of land value also presents technical challenges, requiring up-to-date information on land values. However, while being mindful of their short term impact, it may be possible to introduce a range of improvements related to land-values, recurrent property taxes, and capital gains taxes, to remove some of the more perverse incentives for the economy to divert resources to the accumulation of property at the expense of affordability for larger parts of the population. In addition, housing provision by the state could address housing scarcity, and potential housing value gains would accrue to the society as a whole.

Increasing supply is not just about building, but also about adapting the existing stock for residential housing. The conversion of retail or business properties into housing could be prioritised in locations

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[12] Macroprudential policies were discussed in detailed in previous a background material for the Eurogroup thematic discussion on growth and jobs – Housing markets – on 11 March 2019, which appeared in revised and updated form as Martins et al. (2021). A paper on the tax treatment of immovable property, focussing on issues of sustainability and inclusivity was presented in March 2021 (Leodolter A., S. Princen and A. Rutkowski (2022): Immovable Property Taxation for Sustainable and Inclusive Growth. European Economy, Discussion Paper No. 156)

[13] OECD (2021): Brick by Brick (Building better housing policies).

[14] Ball, M (2016): Housing provision in 21st century Europe. *Habitat International*, Vol. 54, Part 3, pp. 182-188

subject to shifting preferences that have accelerated under the pandemic. Measures could be taken to increase the incentives for vacant housing units to be occupied. Investing in fast and effective green transport solutions can make access to more locations attractive to households, easing the pressure on urban housing. Addressing the mismatch between needs and occupation as demographic change results in large houses being occupied by small elderly family units could also offer venues for easing pressure. Adapting the existing stock but also increasing the supply of new buildings should be in line with the drive to climate neutrality, e.g. by fulfilling the energy efficiency requirements. They are the main goals of the European Commission's initiative called Renovation Wave Strategy for climate neutrality and recovery

The political economy of housing policy complicates the solution. Homeowners have an interest in protecting the economic rents that accrue from the ownership of their properties, and they may try to block or soften the implementation of policies that could be against their economic interests. Conversely, those that stand to benefit from policies that aim to limit house price increases are often more diverse, and their benefit is indirect. Moreover, the longer-term impact of policies that subsidise costs is also not direct and is therefore politically less visible than the immediate attractiveness of subsidies. In summary this makes it difficult for policy makers to prioritise and drive positive changes, despite the very real and growing economic costs of pressures on house prices and affordability.

The economic and financial crisis highlighted the risk that a house price correction can pose for the euro area. Despite differences in housing markets across the Member States, there are clear potential common benefits to the euro area addressing housing affordability, in terms of growth and investment.

The following common policy messages are presented:

1. The evolution of house prices should be considered not just in terms of the financial stability risks linked to substantial corrections, but also in terms of the impact on affordability for households.

2. Worsening housing affordability can have negative economic and social consequences and is of euro area concern. The Eurogroup should keep a regular view on the evolution of housing affordability.

3. Member States should consider the long-term effect of measures they can take to ease pressures on housing affordability, in line with the specificities of their housing markets. As such, measures that aim to reduce the cost of housing through subsidies should be accompanied by supply side measures.

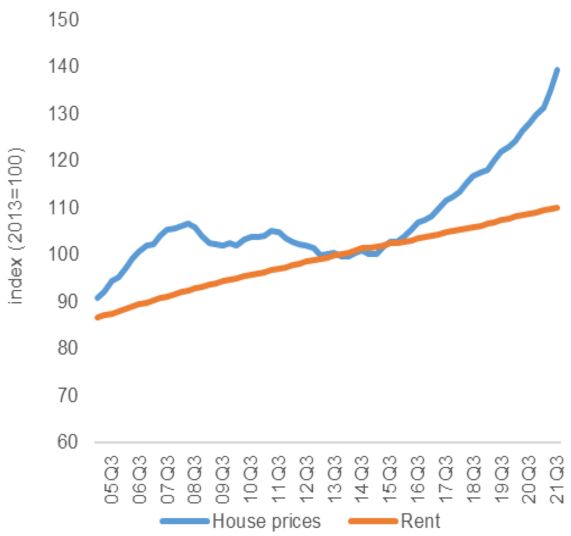
4. Member States could consider whether less distortionary housing taxes (such as recurrent property taxation based on land-values) that improve housing affordability could be economically attractive.

5. Member States could consider whether the simplification of the regulation and approval process for new real estate developments should be pursued, while being mindful of environmental concerns.

Issues for discussion:

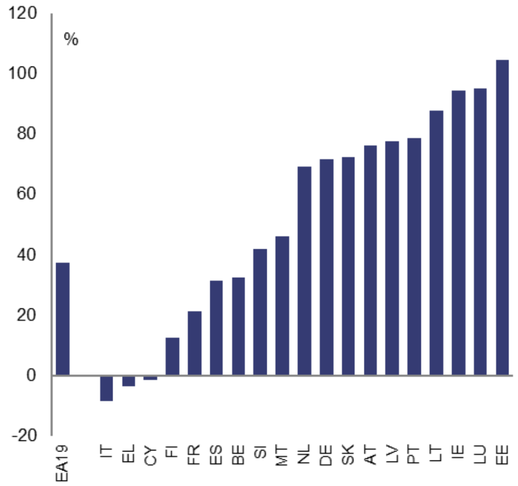
- *What are Ministers' views of the extent to which housing affordability has economic consequences in their own country?*
- *What are Ministers views on the possible economic benefits for the euro area of addressing housing affordability?*
  What are Ministers' views on the common policy messages outlined in the note for giving housing affordability a more central role in Eurogroup discussions?

Graph 1: House prices and rents in EA-19, 2005-2021



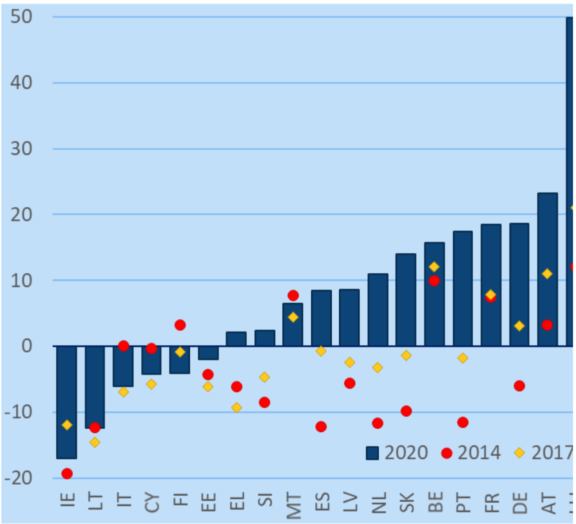
Note: The House Price Indices (HPI) for EA19 is calculated as weighted averages of the national HPIs, currently using as weights the GDP at market prices (based on PPS) of the countries concerned. 2013=100.
Source: Eurostat

Graph 2: House prices, cumulative changes 2012Q4 to 2021Q3



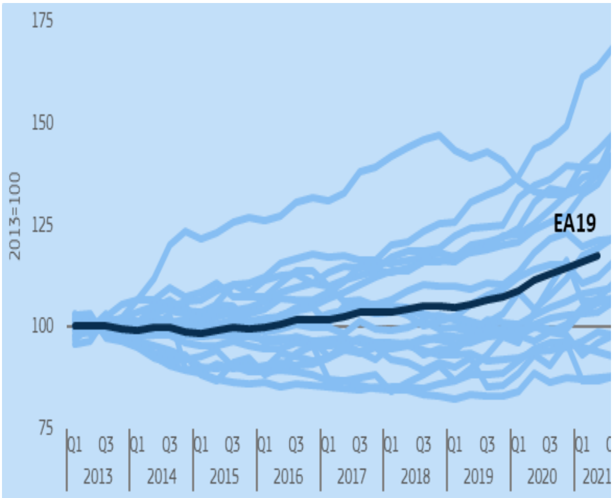
Note: The House Price Indices (HPI) for EA19 is calculated as weighted averages of the national HPIs, currently using as weights the GDP at market prices (based on PPS) of the countries concerned. 2013=100.
Source: Eurostat

Graph 3: Average house price valuation gaps (% difference to estimated benchmark)



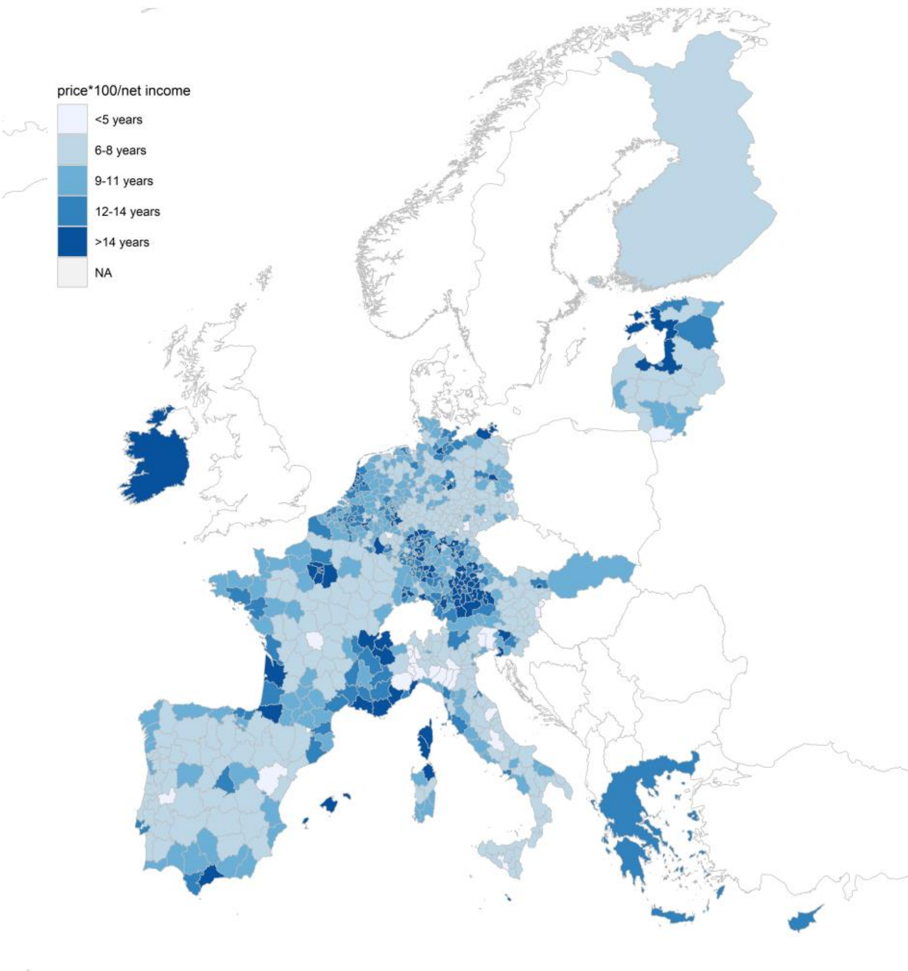
Note: Positive (negative) value overvaluation (undervaluation). Figures relate to the average level in a given year, and therefore do not take on board the three quarters of available data for 2021. Note that figures for IE are influenced by very dynamic income growth and a history of high house prices.
Source: Eurostat, European Commission Services calculations

Graph 4: Price to income ratio, EA countries, 2013-2021



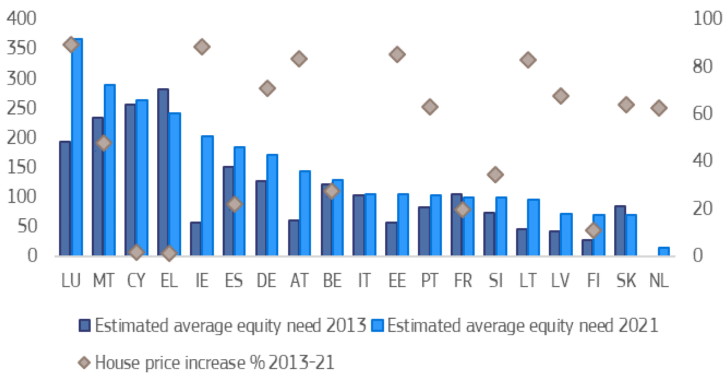
Source: Eurostat

Graph 5: Years of income to purchase 100 sqm, EA countries by NUTS3, 2019



Note: NUTS3 level data are not available for EL, FI, IE.
Source: European Commission Services calculations

Graph 6: Equity need for access to mortgage



Note: Estimated equity needs 2013 are missing for NL.
Source: European Commission Services calculations