

# Focus on Economics

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## European housing markets: are overheating concerns justified?

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The sharp increase in global liquidity has driven up prices of many asset classes. Residential real estate is considered a preferred investment category. Warnings about the potential overheating of these markets are increasing. The following study of selected real estate markets will examine whether these concerns are justified, but it is clear that the situation is anything but homogenous. In some countries corrections on real estate markets are still underway, while in others, alarming price developments can be observed again and corrective measures must be taken.

### Housing prices back at pre-crisis levels in some markets

The crises of recent years have had a major impact on European housing markets. The biggest corrections were suffered by the previous high-flyers Ireland and Spain. Prices of existing homes in these countries dropped by more than 30% from its peak. But now a recovery seems to be in the offing with prices rising again on the Irish housing market and stabilizing in Spain.

In recent years, the clear front-runners regarding prices were UK, France and Sweden. In these countries, real estate prices are approaching or even far exceeding the levels recorded before the outbreak of the world financial crisis, and are more than twice as high as in 2000. Price trends in Germany have been moderate in comparison to other European countries. In the first quarter of 2014, average prices for existing properties in Germany were only 20% higher than in 2000. However, this average approach does not rule out, not only for Germany but also the other

countries, worrying price trends on some regional sub-markets.

In Germany such trends are particularly observable in some metropolitan areas. Similar developments have emerged in other countries too. For example in the Greater London area prices rose twice as fast (more than 20% year-over-year) as on average in the UK.

### Are properties currently overvalued?

Looking at price trends alone does not allow a judgement to what extent these increases are fundamentally justified. One common way to identify over- and undervaluations of real estate is by comparing house price developments with long-term income and rental trends. Based on these criteria, the OECD recently identified marked overvaluations

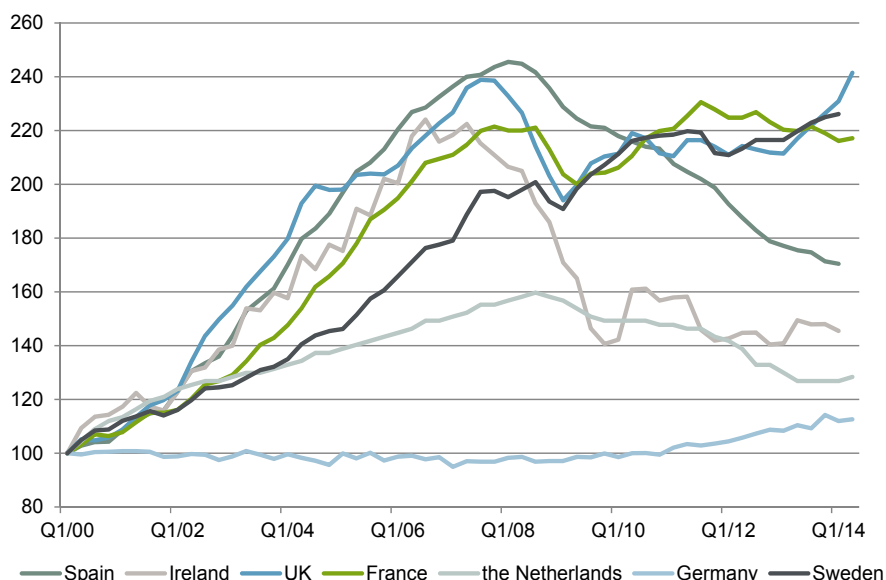
particularly in Scandinavian countries (see figure 2). In Sweden's case, they amounted to around 30% on average in relation to incomes and rents. Overvaluations of a roughly similar magnitude are found on British and French real estate markets, too.

The situation in the formerly booming country of Spain is different. After extensive corrections, residential real estate prices are almost back in line with long-term rental and income trends, while there is currently an undervaluation of around 5% in Ireland. Regardless of recent increases in residential property prices, Germany continues to belong to the group of undervalued countries. In relation to incomes and rents, the undervaluation amounts to around 13% on average.

### Building permits and completions still undergoing corrections

The sharp decline of house prices and the increasing number of unsold residential real estate triggered strong adjustments on the supply side. Especially in Ireland and Spain, building permits have

Figure 1: House prices in selected European countries\* (indexed, Q1 2000=100)



\*Spain, Ireland, France, the Netherlands: prices of existing real estate properties.

Source: Feri, Datastream

slumped. In the first quarter of 2014, they were down by almost or more than 95 % compared to their respective quarterly highs in 2005 and 2006. First signs of a recovery have recently emerged in Spain. With the exception of France, building permits are lower than in 2000 in the other reviewed countries, too.

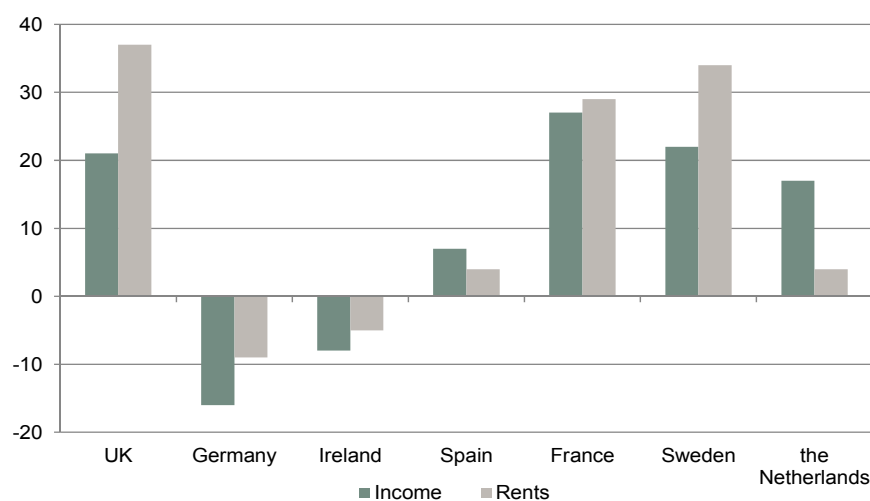
Not surprisingly, building completions followed a trend very similar to building permits. Figure 3 shows that here too, the strongest corrections were seen in Ireland and Spain. Between 2000 and 2006, building completions almost doubled in Ireland. Currently, they amount to just one sixth and in the case of Spain around one third of the level recorded in 2000. In the UK and Germany building completions are almost 25 % respectively roughly 50 % lower than in 2000. Only in Sweden the number of building completions has more than doubled since 2000.

The assessment of these developments differs for the respective countries. The sharp decline in building permits and completions in countries like Spain and Ireland was necessary to initiate a market consolidation and pave the way for a gradual stabilisation of these residential real estate markets. By contrast, for countries like Germany and the UK that have been experiencing increased demand for residential properties over a longer period, it is rather alarming that the expansion of supply is far lagging behind the upturn in demand. Addressing the causes of the slow expansion in supply is therefore an important factor for reducing the risk of excessive price increases in future.

**Marked fall in construction investment relative to GDP in Spain**

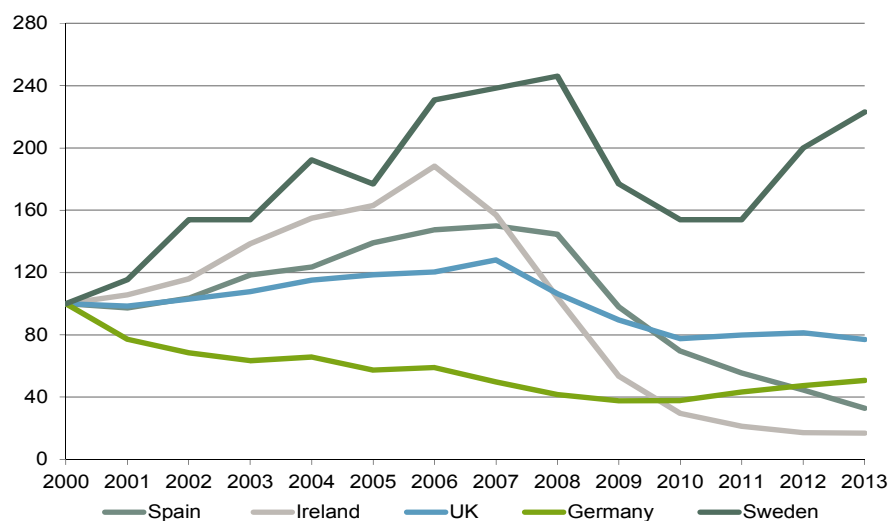
During the property market boom in the pre-crisis years, the proportion of construction investment in gross domestic product (GDP) increased significantly in Spain and Ireland, recording their respective highs of 22 % and almost 14 % in 2006. A painful contraction process began with the onset of the global financial crisis. As a result the ratio of construction investment slumped to 6 % in Ireland and less than 12 % in Spain in 2013. Developments in the other selected countries were much smoother with construction investments in relation to

**Figure 2: Over- / undervaluation in relation to long-term income and rental trends (in per cent)**



Source: OECD

**Figure 3: Building completions in selected countries (indexed, Q1 2000=100)**



Source: Feri, Datastream

GDP ranging between 7.5 and 10 % in 2013. Hence there is no evidence of excessive developments here.

**Very high mortgage debt ratios in some countries**

One side-effect of the real estate boom in the pre-crisis period was the sharp increase in mortgage debts. Between the end of 2002 and the end of 2006, outstanding mortgage loans almost tripled in Ireland and more than doubled in Spain. The resulting negative consequences for private households and the financial sector are well known, and require us to cast a critical eye on current debt ratio devel-

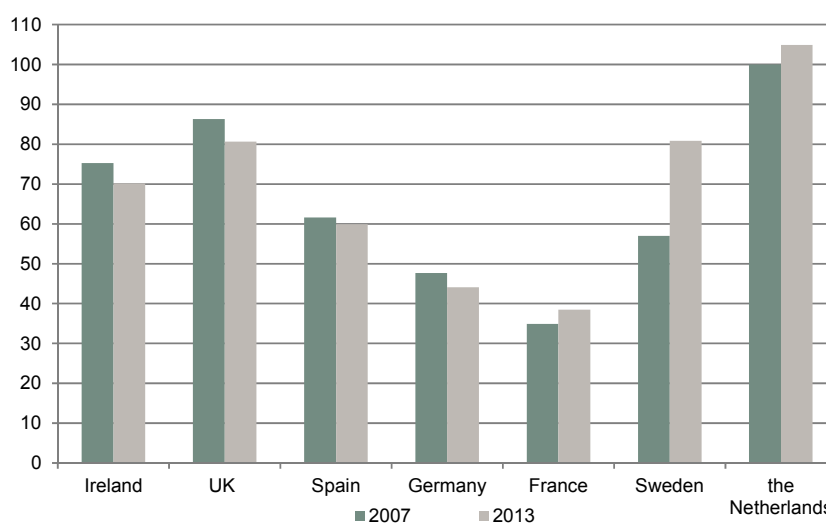
opments. In relation to nominal GDP, outstanding mortgage loan levels were highest in the Netherlands at 107 % in 2013. Over a long period of time, the debt financing of properties was very attractive in the Netherlands, as there was an unlimited tax deductibility of interest on mortgage debt. Countermeasures were only taken in the past few years. Sweden, the UK and Ireland also recorded debt ratios higher than 70 % in 2013. The figures in Germany and France hover either above or below 40 %, putting them in the non-critical category. While an albeit limited decline of debt ratios took place in some countries

between 2007 and 2013, the very dynamic increase in mortgage debt particularly in Sweden stands out.

**Low interest environment still supportive**

The low interest environment will remain **one** major driver for house price increases in future. In addition, residential property prices will continue to benefit from the lack of attractive investment alternatives and will therefore remain a preferred investment for private households and international investors. Nevertheless, these driving forces will only exert their full impact in a solid macroeconomic environment. Of the countries reviewed, this currently applies for the UK, Germany and Sweden. Further price increases are therefore expected in these markets. By contrast, the consolidation phase observed on the French real estate market in the last few quarters is likely to continue against the backdrop of a rather bleak macroeconomic outlook. The countries which have been suffering from marked price corrections in recent years, such as the Netherlands and Spain, can hope that their real estate markets will slowly recover thanks to improved macroeconomic growth prospects. Ireland already seems to have turned the corner. In Dublin especially, prices have recently risen by more than 20% year-over-year, yet the overall market in Ireland is much less dynamic and pre-crisis price levels are still a distant prospect. A different situation can be observed in the UK and – representing the Scandinavian countries – in Sweden. These markets are characterised by high overvaluations relative to long-term income and rental trends, as well as by dynamic growth of mortgage debt in Sweden's case. For the UK, controversial government programmes to stimulate demand and restrictive construction

**Figure 4: Outstanding mortgage loan liabilities in selected European countries (as a percentage of nominal GDP)**



Source: European Mortgage Federation, author's calculations

planning laws are tightening existing supply bottlenecks. By comparison, developments in Germany give no cause for alarm. In terms of valuation and financing there is no evidence of excesses: the lights in Germany therefore are still all at green, at least from an overall market perspective.

**Outlook**

The above analysis shows that there is no uniform European housing market. Developments are very heterogeneous when comparing countries, but also within the countries themselves. This is particularly true for the eurozone with its highly divergent economic conditions in the various member states. Against that backdrop it is clear that interest rate policy is not the best instrument to take corrective actions in the housing markets. Due to the rather fragile economic environment, central banks also fear possible negative side effects of interest rate hikes, such as an unwanted downturn in economic activity in other sectors or a

marked appreciation of their own currency. To avoid housing price bubbles instruments that have a direct impact on the real estate market are therefore the preferable choice. In this respect, UK is the forerunner in Europe. First macroprudential measures have been taken there, though they are not yet binding. British banks were instructed to limit the disbursement of mortgages with particularly high leverage and to examine whether their customers could still also service their loans if there were a sharp increase in interest rates. However, measures that tackle the financing side are only one part of the solution. How to solve bottlenecks in supply must be addressed at the same time. One of the challenges is that the high demand for residential property is found particularly in some large metropolitan areas. An increase in construction activity will help, but it is unrealistic to expect that this can fully satisfy demand in the highly coveted urban markets. ■