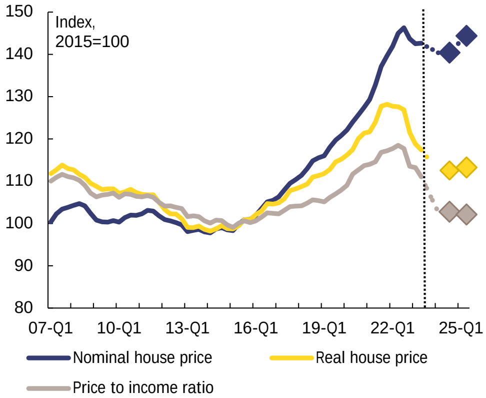
4. SPECIAL ISSUES

4.1. A COOLING HOUSING MARKET AMID MORTGAGE RATE INCREASES

European housing markets have been cooling since mid-2022, alongside the significant slowdown in credit flows. Following their steep rise during the pandemic-induced housing boom, house prices decelerated in 2022. By 2022-Q4, the majority of EU Member States had seen house prices decline, and this trend continued into 2023. In 2023-Q2, the euro-area house price index posted its first year-on-year drop since 2015, of 1.7% compared to 2022-Q2. Based on available evidence, a further slight decline in prices (in y-o-y terms) is expected in the second half of the year. While the real house price index and the price-to-income ratio in the euro area declined even faster than the nominal house price index (see Graph I.4.1),[31] the increase of mortgage rates significantly eroded housing affordability. This section reviews house price drivers and discusses their role in determining future trends.[32]

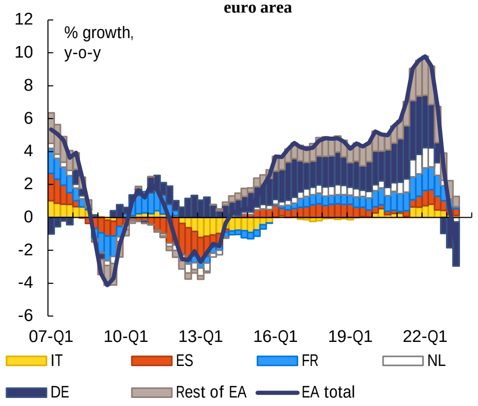
Graph I.4.1: **Euro area house price index**



House prices reverse trend after a decade-long climb

House prices grew robustly across the EU over the last decade, especially during the pandemic. House prices started to increase during the 2010s economic recovery, albeit with notable differences across Member States. Since 2010, prices have doubled in Germany and the Netherlands, while Portugal, Ireland, Czechia, Austria, Luxembourg, Latvia, and Lithuania have seen even stronger price growth. Prices in Estonia and Hungary have even tripled since their trough in the early 2010s. During the pandemic, house prices strongly outpaced income growth in all Member States except Italy.

Graph I.4.2: **Contributions to house price growth in the euro area**



Nominal house prices in the EU and the euro area peaked in mid-2022. As inflation soared last year, a large gap opened up between nominal and real prices, with the latter peaking earlier (see Graph I.4.1).[33] The decline in prices differs across Member States, even within the euro area. The drop of the nominal house price index for the euro area is mainly driven by significant decline of prices in Germany and the Netherlands, as well as in some smaller Member States (see Graph I.4.2).[34] House prices in France and Spain

(31) Real house prices are computed using the consumption deflator and the price-to-income ratio is based on gross disposable household income. Forecasts of annual averages for nominal prices are based on Commission services calculations.

(32) This section focuses on recent housing market dynamics, mainly for the euro-area aggregate. For more details on risks in specific Member States, please see the Commission's forthcoming Alert Mechanism Report.

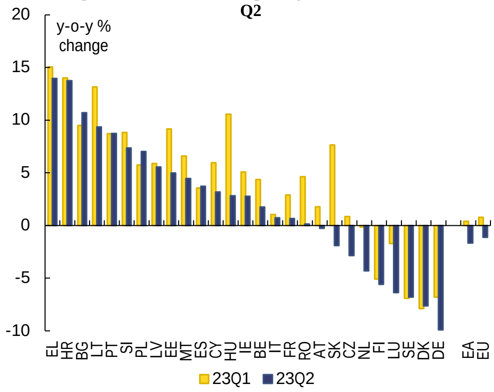
(33) By 2023-Q3, only Greece, Portugal and Cyprus recorded positive year-on-year house price growth in real terms.

(34) Contributions to nominal euro area house price growth follow Eurostat data using weights based on market-value GDP in PPS terms.

appear more stable. The Italian housing market has broadly stagnated since the mid-2010s and has little impact on the euro-area aggregate.

Latest year-on-year growth rates across the EU confirm that cooling continues. House prices are declining further in several Member States where they peaked in 2022-Q2. Besides Germany, this is the case in Czechia, Slovakia, the Netherlands and Luxembourg (see Graph I.4.3). House prices continue declining also in Denmark, Finland and Sweden where a slowdown already started in 2021. In other countries such as Estonia, Lithuania, and Hungary, house prices are still rising in annual terms, but the growth rates are slowing down rapidely. Conversely, steady price growth continues in Bulgaria, Croatia, Greece, Portugal and Slovenia.

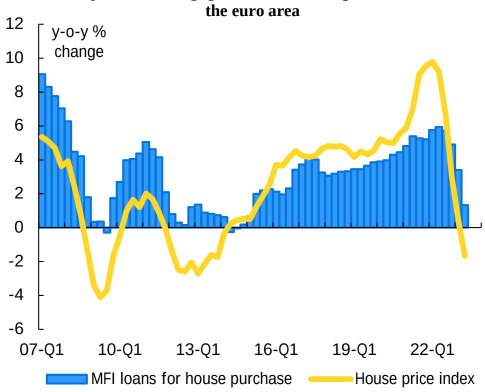
Graph I.4.3: **Nominal house price growth, 2023-Q1 and Q2**



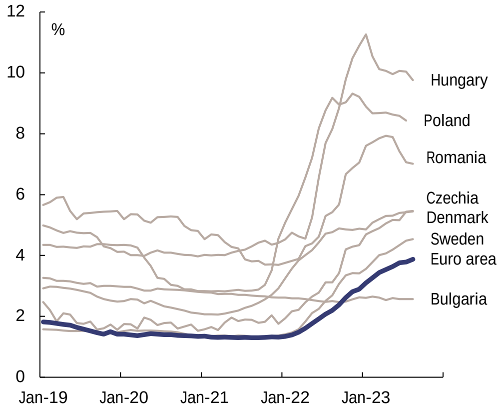
Rising mortgage rates affect house prices, domestic demand and the construction sector

Interest rates and credit markets are the obvious trigger of the price correction, affecting household finances and the construction sector. During the pandemic, mortgage credit flows in the euro area accelerated to levels unseen since the Great Financial Crisis, though lagging behind the surge in house prices. Monetary tightening as from Spring 2022 translated into a rapid increase of mortgage rates, which in turn led to a tightening of bank credit standards. As a result, household credit flows dropped rapidly from their peak in early 2022 (see Graph I.4.4). In several non-euro area countries, mortgage rates increased even more dramatically (see Graph I.4.5). In 2023, credit flows even turned negative in several EU Member States, as mortgage repayments exceed the incurred new loans.

Graph I.4.4: **Mortgage flows and house price index in the euro area**



Graph I.4.5: **Mortgage rates across Member States**



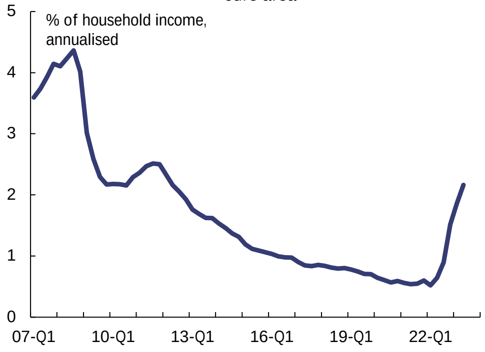
The interest rate increase affects housing markets and real activity through three channels:

1. In countries where floating-rate mortgages are prevalent and household debt is widespread, higher interest rates directly affect households' finances, with the potential to dampen consumption.
2. Financing real estate purchases becomes more challenging for new home buyers, with a direct impact on housing transactions and house prices.

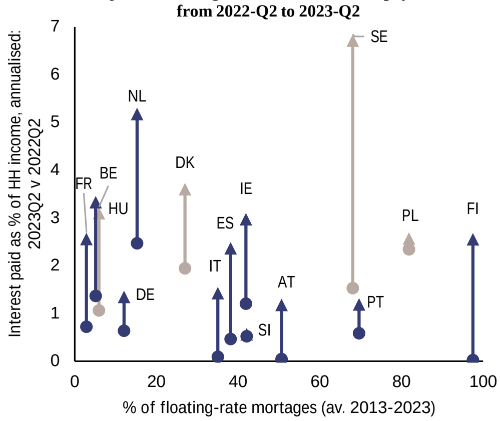
3. Funding new construction or renovation projects becomes more difficult, with negative impact on capital formation and construction activity.

First, the interest rate increase affects home-owners. Euro area quarterly sectoral accounts for the past four quarters report a steep rise in interest payments by households on all household debt (see Graph I.4.6).[35] The impact is particularly notable in countries where mortgage debt is i) widespread, also due to tax incentives, ii) held over very long durations, and iii) predominantly subject to variable-rate adjustments. Among the non-euro area countries, Sweden is a good example for a country that scores high on all of these three dimensions. Consequently, annualized interest payments by Swedish households rose from 1.5% of household incomes in 2022-Q2 to 6.8% in 2023-Q2 - an increase that is larger than in all other Member States where such quarterly data is available.

Graph I.4.6: Household interest rate payments in the euro area



Graph I.4.7: **Change in household interest payments from 2022-Q2 to 2023-Q2**



Graph I.4.7 shows that high debt levels and long mortgage maturities both induced a strong increase in the Netherlands and Denmark, but this was likely mitigated by long interest fixation periods that are common in those countries. Despite a prevalence of long-term fixed rates on mortgages, France and Belgium also report significant increases in household interest payments, due to strong new mortgage dynamics in the latter and expansion of other loans in the former. In contrast, increases in interest payments in Germany and Austria have been far more contained so far, amid a general decline of household loans dynamics.[36] The increase of interest spending was negligible in Poland and Portugal despite the prevalence of variable-rate mortgages, due to government interest rate relief measures that put a lid on the increase in interest spending.

Second, the borrowing capacity of new home buyers has been reduced as the interest rate increase has outweighed nominal income increases. The declining price-to-income ratio (see Graph I.4.1) may suggest improved house affordability over recent quarters. However, this indicator disregards that most buyers depend on mortgage financing. Graph I.4.8 represents the real estate price growth a buyer can accommodate when devoting a fixed share of his income to mortgage payments, based on a standard asset pricing model that combines information on mortgage rates and income data with some structural factors of mortgage markets.[37]

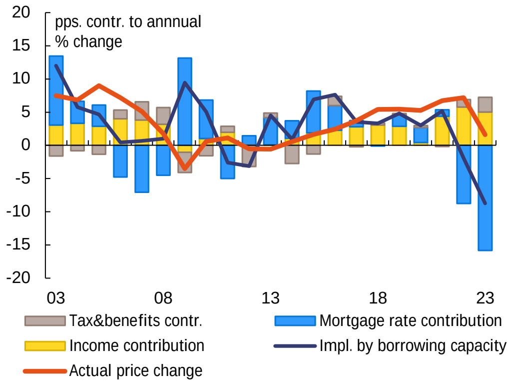
(35) Note that housing loans account for almost 90% of household debt in the euro area.

(36) Households in Portugal and Poland seem to have benefited from policy, with temporary interest rate moratoria affecting Polish data and Portuguese mortgage rate increases being delayed by regulatory settings.

(37) For a description of the methodology, see European Commission (2023). “Housing Market Developments: Thematic Note to Support In-Depth Reviews.” *European Economy Institutional Paper 197*. The structural factors such as tax regime and common loan-to-value ratio come from the European Commission Joint Research Centre's Housing Taxation data and other information used for calculation of user cost of housing.

The borrowing capacity of a household increases when incomes rise, interest rates decline and taxes decrease. The graph shows that since the 2010s, the decline in mortgage rates allowed euro area borrowers to pay more for a dwelling every year. Housing affordability was also supported by rising incomes. However, in 2022 and 2023, the increase in interest rates far outweighed incomes growth, leading to a decline in households' borrowing capacity.[38]

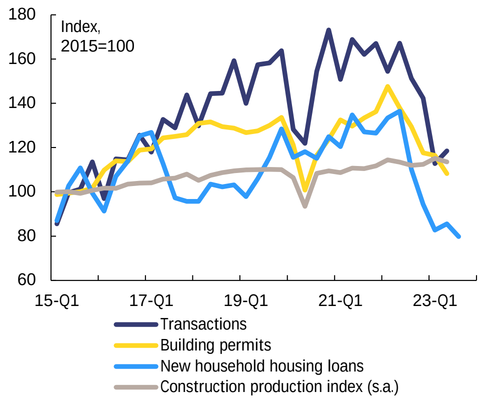
Graph I.4.8: **Actual house price growth vs. growth implied by borrowing capacity, euro area**



Despite falling house prices, housing affordability has continued to deteriorate. Graph I.4.8 shows that whereas actual house prices often deviate from the price implied by the borrowing capacity, the increase of mortgage rates appears as a key factor for the recent price declines.[39] However, house prices did not decline as fast as warranted by declining borrowing capacity of new buyers. In all EU Member States but Bulgaria and Croatia, new borrowers cannot afford as many residential square metres as they could in 2019. In Belgium, Germany, Luxembourg, Austria, Portugal and Sweden new borrowers can fund less residential space than ever since 2000. Standard asset pricing suggests a similar dynamic for rental markets. Rising interest rates imply that price-to-rent ratios should decline; with stagnating housing prices, rents should, thus, increase. Also given that consumer inflation often plays a role in rental prices, it is likely that rents rise considerably faster than house prices. Moreover, tighter terms on mortgages are also likely to add demand pressure on urban rental markets. The decline in house prices hence does not provide respite to households in countries with structural housing shortfalls.

Third, the housing price reversal is also affecting expectations in the construction sector. Amid deteriorated economic sentiment (see Section 2.3), the issuance of new residential building permits has slowed considerably. While construction activity has held up relatively well so far (see Graph I.4.9), it is expected to decline somewhat, reacting with a lag to the fall in building permits. However, the decline in the construction activity is expected to remain moderate as existing residential supply lags behind structural demand factors such as the i) increasing number of households and demand for living space in metropolitan areas and ii) the need for renovation, notably for energy efficiency as well as for demographic reasons. Combined with an expected plateau for interest rates, this contains the risk for a significant decline in real construction activity. Weaker demand and easing supply chain shortages might induce a drop in construction prices in the short term, which should be beneficial for construction activity.[40]

Graph I.4.9: **Housing market activity in the euro area**



[38] Taxation changes recently play a minor role. Note that, by design, recurrent property taxes act as a small moderator on interest rate increases due to to a leverage effect.

[39] This model also implies that with stable interest rates going forward, their negative impact on the borrowing capacity should fade in 2024.

[40] Observed developments seem to be consistent with historical patterns (see Vašíček, B. and V. Žďárek (2022). "Links between housing and real economy in the euro area." In Quarterly Report on the Euro Area, Vol. 21?, No. 3?, *Institutional Paper 185*), but some recent shocks are of an unusually large magnitude. Namely, a negative shock to house prices normally induces a quick decline in building permits and mortgage credit, which is commonly also accompanied by tightening of credit conditions with adverse impact on GDP. A negative shock to GDP (and income) has a dampening

Going forward, constraints to the borrowing capacity of households suggest that house prices will remain under pressure over the next quarters before resuming growth. This forecast expects euro area long-term interest rates to stabilise and projects wages to increase further in both 2024 and 2025. The resulting improved borrowing capacity of households is set to allow house prices to broadly stabilise in nominal terms over the next quarters before resuming moderate growth in the outer year of the forecast horizon (see Graph I.4.1). High-frequency house price indicators are supporting this scenario as they suggest that by summer-2023 price levels had bottomed out in Germany, the Netherlands and France.[41]

effect on building permits, induces tightening of credit conditions and dampens housing prices. An inflation shock triggers a gradual decline in economic activity (evidenced by reductions in GDP and building permits) and an increase of mortgage lending rates, leading to tightened credit conditions and, with a certain time lag, to a decrease in house prices.

(41) See the CBS statistical index for the Netherlands, as well as the private data provider Europace for Germany and meilleursagents.com for France.