



## Housing market: The finance side of the story

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Major concerns have recently arisen in Europe and in the United States about the behaviour of their housing markets. Surging prices seem to be far removed from their fundamental value, arousing bad memories of the time when the equity bubble burst. Valuable contributions have been made about the phenomenon but few have addressed the finance side of the housing bubble and its potential consequences on household balance sheets.

### What is so special about the housing market?

In housing markets, nominal price trends are mainly upward and are consequently highly persistent. This can be explained by the fact that houses are both consumer and investment goods. Hence, when the market is weaker, it is rarely prices that decline but mainly the volumes of houses sold that do.

On the supply side, the housing market differentiates itself from other markets through its short-term inelasticity – i.e. it takes a long time to expand the housing supply. This characteristic makes any adjustment of the housing market mostly demand-driven and strengthens the argument for controlled funding<sup>2</sup> to the sector.

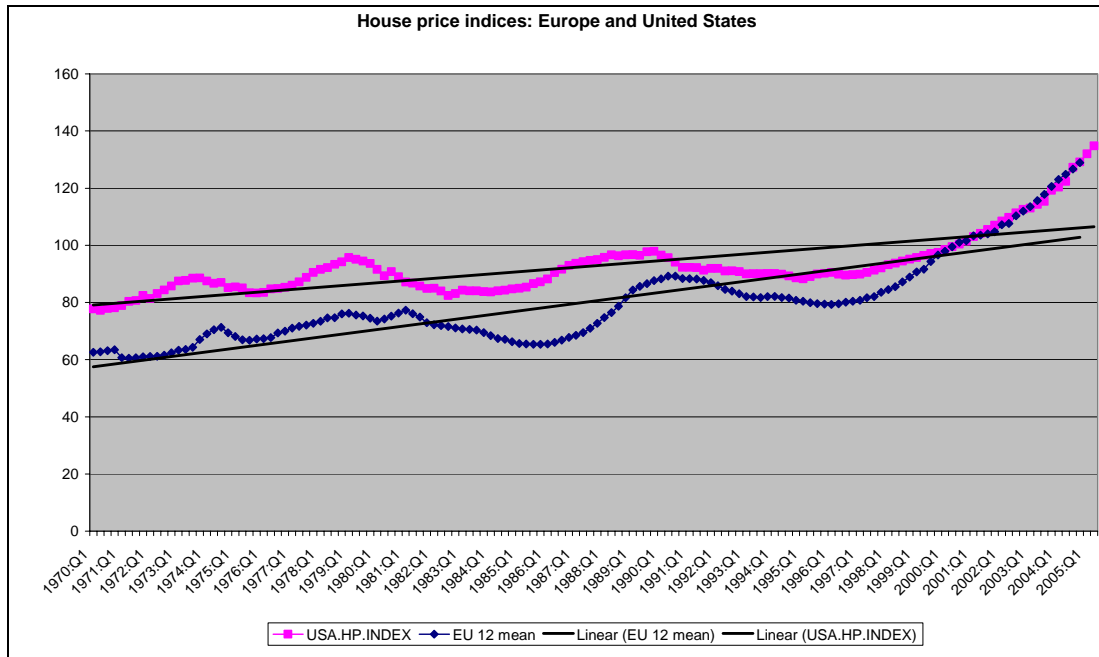
From graph 1, a surge in house prices above the trend can be observed over the past five years. This could amount to a bubble on both the American and European housing markets. The 'non-bubble' explanation would be that people are anticipating either lower interest rates or robust income growth. Given that expectations are currently heading in the opposite direction - i.e. monetary tightening and weak growth forecasts for EU economies - the 'non-bubble' explanation of house price trends is unsustainable.

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<sup>2</sup> As adjustments are mainly demand driven, the mortgage funding of housing should be accurate, in the sense that the risk has to be evaluated precisely and with even greater attention.

Graph 1: Housing prices index - a transatlantic perspective

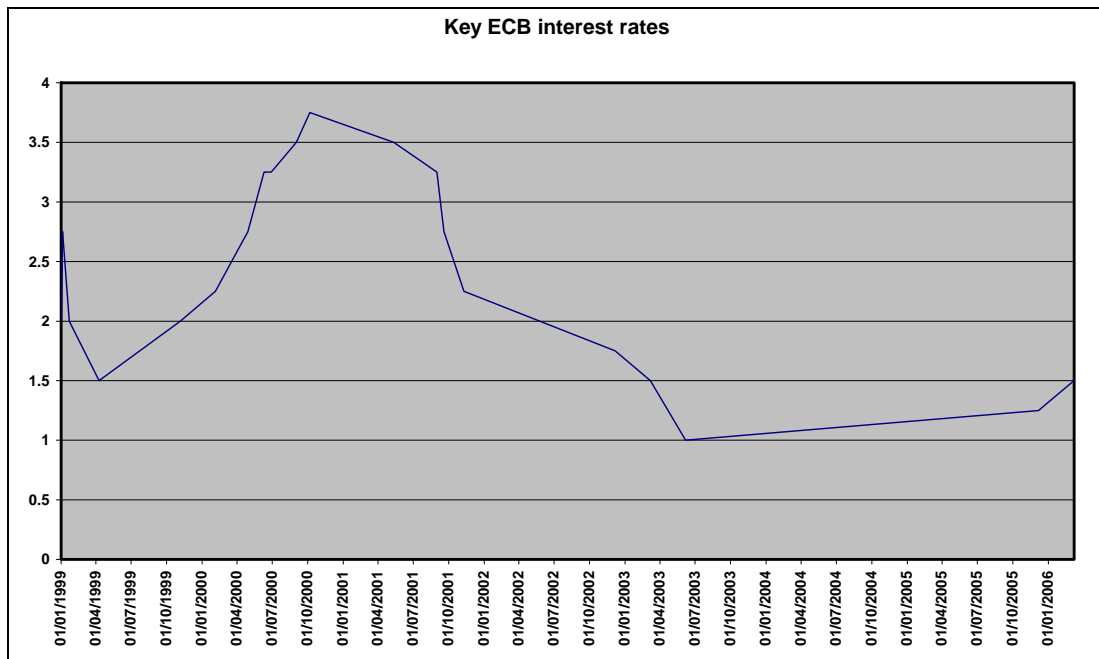


Source: OECD.

### Eurozone house price dynamics

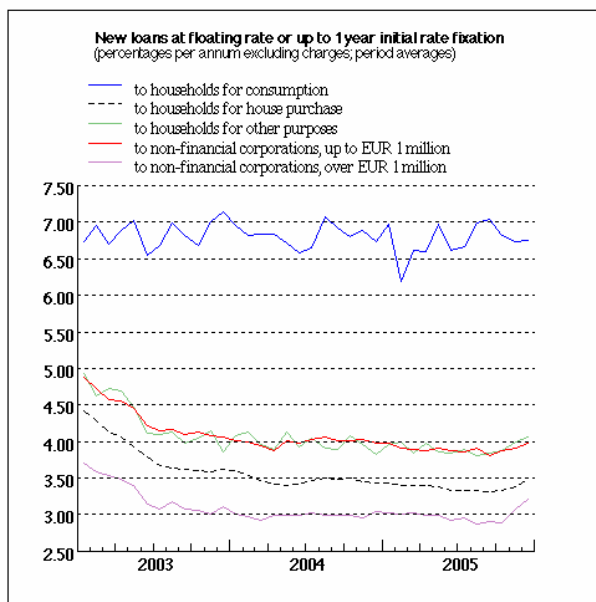
Since European Monetary Integration, interest rates have fallen to their lowest levels (see graph 2). This phenomenon, combined with the current 'liquidity overhang' on capital markets, laid the foundations for the housing boom. In fact, the low level of key ECB interest rates has trickled down and exerted downward pressure on the rate for new loans to households for house purchases (see graph 3).

Graph 2: Key ECB interest rates



Source: [www.ecb.int](http://www.ecb.int).

Graph 3: Interest rate granted to households in the eurozone

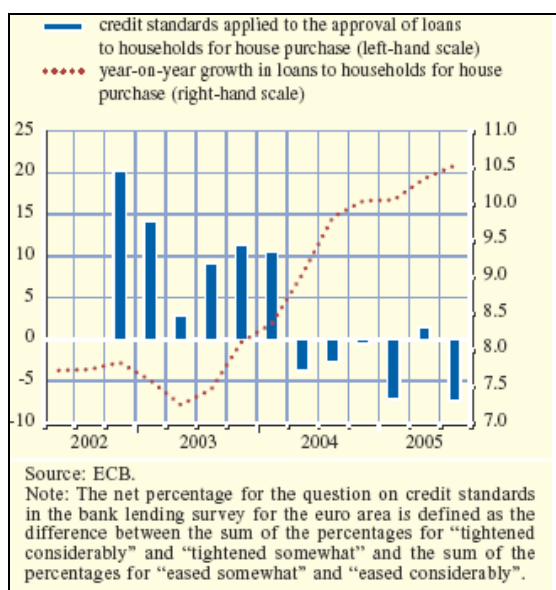


Source: [www.ecb.int](http://www.ecb.int).

Both effects have been reflected in interest rates for mortgages and pushed them to historically low levels. Consequently, the cost of housing capital fell below average and mortgage credit demand surged.

Excessive money supply in the eurozone resulting from the combination of the two above mentioned factors is the most relevant factor in residential mortgage dynamics. Indeed there might be scope for further 'credit deepening' in the eurozone economy, but current dynamics seem too abnormal to consider such movement as a deeply rooted structural trend. As graph 4 emphasises, loans to households for house purchases (dotted line) have increased considerably over the past year and a half and credit standards have been declining (bars). The data gathered for graph 4 is based largely on a bank lending survey done by the European Central Bank and is not exhaustive, but gives a good overall picture of credit standards in Europe.

Graph 4: Bank credit standards and loans for house purchases

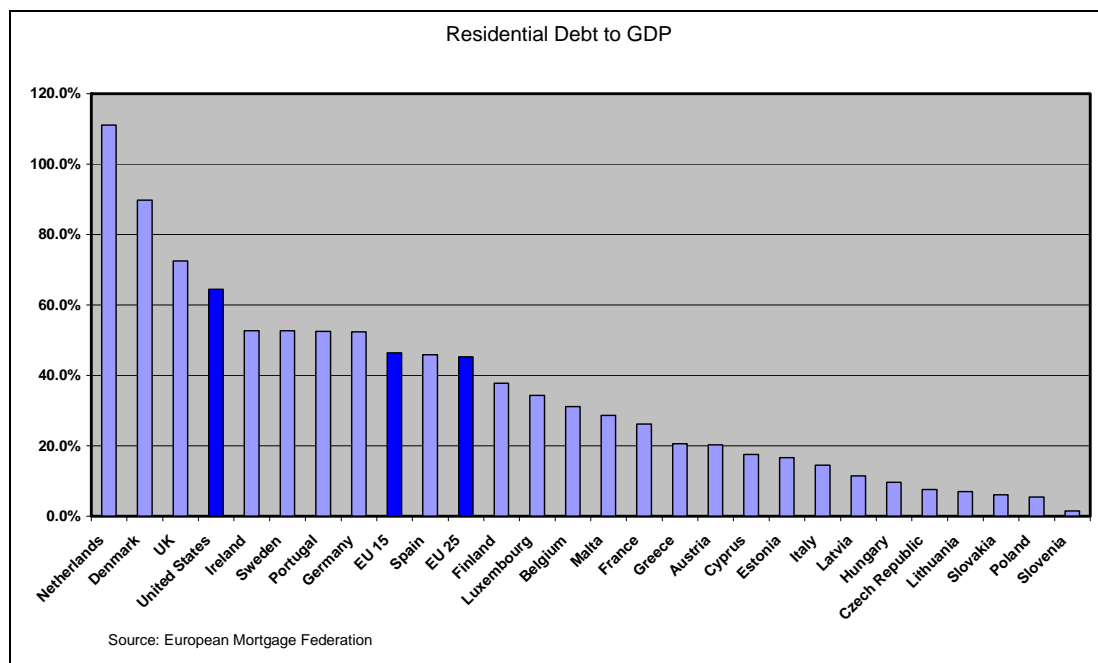


All conclusions from the above graphs point in the same direction - bad risk evaluation and widespread debt accumulation by households.

**A problem for countries such as Ireland, Spain & Portugal**

According to the OECD<sup>3</sup>, the situation is less straightforward and housing overvaluation is far from being a general phenomenon in the eurozone. Current concerns about the housing market vary from country to country but the following pattern is emerging - Anglo-Saxon countries which heavily rely on debt financing show high residential mortgages relative to their GDPs, followed by continental European economies and finally by accession countries.

*Graph 5: Residential Debt to GDP in the eurozone*



Comparing the amount of mortgage financing relative to GDP sheds light on potential imbalances in the housing sector if financial stress occurs. Latin countries (especially Portugal and Spain) seem to be more affected than Anglo-Saxon countries. In fact, they rely heavily on mortgage finance (as much as Anglo-Saxon economies) although they are traditionally less financially developed economies than Anglo-Saxon ones.

On the one hand, the Portuguese mortgage debt market has been expanding slowly in 2004, so concerns do not seem to be justified. By contrast, the Spanish market has continued its buoyant growth despite the fact that its share of mortgage debt relative to GDP is already high. The combination of heavy reliance on debt financing and surging prices (149% between 1997 and 2004) suggests exuberance in the Spanish housing market.

The growth rate of mortgage debt in Austria and Greece could also raise concern that it is unsustainable. But their residential debt to GDP ratios reveal that they are seeing more and more of their citizens take a step onto the property ladder (as both have low per capita mortgage debt) and that there is no imbalance.

<sup>3</sup> OECD working paper No 475, 2006



A more worrying trend can be observed in the Irish mortgage market. House prices have surged by 187% and mortgage debt has grown by 29.8% over the last year (cf. table1). Comparing this figure to GDP points to the sustainability of the trend, but a glance at the per capita figure raises doubts about its sustainability. A residential mortgage level close to that of Luxembourg has been reached although Ireland's GDP per capita remains far below that of Luxembourg.

Finally, house prices in France and Italy have been buoyant as well (around 70% growth), but the finance side continues to be less of a concern than on the Irish or Spanish markets. As can be seen in table 1, per capita mortgage debt is in fact far from its potential value and is thus presumably sustainable.

*Table 1: The mortgage arithmetic of the eurozone*

	Value of mortgage debt, million €	Growth in mortgage debt (year on year change)	Residential Debt to GDP <sup>4</sup>	Per capita Mortgage Debt
<b>Belgium</b>	88,434	8.2%	31.2%	8,506
<b>Denmark</b>	174,300	6.0%	89.7%	32,292
<b>Germany</b>	1,157,026	0.1%	52.4%	14,019
<b>Greece</b>	34,052	28.3%	20.6%	3,084
<b>Spain</b>	384,631	22.9%	45.9%	9,083
<b>France</b>	432,300	12.2%	26.2%	7,217
<b>Ireland</b>	77,029	29.8%	52.7%	19,125
<b>Italy</b>	196,504	13.4%	14.5%	3,395
<b>Luxembourg</b>	8,797	12.3%	34.3%	19,480
<b>Netherlands</b>	518,115	14.3%	111.1%	31,868
<b>Austria</b>	48,064	20.9%	20.3%	5,905
<b>Portugal</b>	70,834	6.9%	52.5%	6,762
<b>Finland</b>	56,522	10.8%	37.8%	10,829
<b>Sweden</b>	147,163	10.0%	52.7%	16,396
<b>UK</b>	1,243,261	11.1%	72.5%	20,835
<b>EU 15</b>	4,566,198	9.6%	46.4%	11,931
<b>EU 25</b>	4,670,736	9.7%	45.3%	10,223
<b>United States</b>	7,568,200	13.8%	64.5%	25,772

Source: European Mortgage Federation

### How the financial side of the story will pan out for households

Reassuringly, a sudden correction on the scale of a financial market bubble bursting is a highly unlikely scenario in the housing market due to its short term inelasticity and the special nature of a housing good. Instead, the volume of houses sold can be expected to remain static until the fundamental value of houses is more in line with current prices.

In such a case of exuberance in a particular market, the focus should be placed on the finance side of the story, especially given past trends in risk allocation. The emergence of mortgage-backed securities has enabled banks to shift risks from their balance sheets onto those of homeowners over the past ten years. Considering that mortgage-financed housing is more widespread among households than equity products, the consequences of a housing price slowdown will affect a wider share of households. The very nature of the housing market finance has contributed to generating the bubble.

<sup>4</sup> Residential debt: Loans given to individuals for housing purposes.



House prices are led by the banks' incentive to lend as much as possible when property prices are rising due to the positive effect on the value of their collateral. Consequently, prices are pushed upwards in times of house price rises. In times of economic slowdown, banks pull out of the business, potentially amplifying the disrupting effect of exuberance on the housing market. Such behaviour by the banking sector makes it harder for households to keep up with the interest payments on their mortgages. It thus deepens boom and bust cycles, especially where variable rate mortgages have been taken up. Furthermore, refinancing mortgages through asset-backed securities amplifies contagion from household to household and from country to country.

In addition, banks considerably gain in standing due to their mortgage activity. Spanish banks have played a major role in making Spain the European country with the highest rate of home ownership in Europe.<sup>5</sup> Considering that the current tensions on the Spanish housing market are based largely on credit expansion and on an 'interest rate mismatch'<sup>6</sup> at the Spanish national level, they are even more worrying. A potential decline in this national market may well have deep consequences at the household level, particularly on consumption and investment prospects.

Weakening housing markets may soon start to weigh on consumer spending as the experiences from Britain and Australia suggest. In continental Europe, the consequences can be expected to be less pronounced as numerous papers have emphasised the fact that continental Europe economies are less responsive to house prices than their Anglo-Saxon counterparts. The new ways in which housing is financed has shifted financial risk from banks to homeowners. In particular those who have opted for a variable rate mortgage could be severely affected by a collapse in housing prices.

Whether an active policy is needed to tackle pressure on housing markets is doubtful in the current environment of yield curve flattening. The EU's long term interest rate is currently not responsive to short term interest rates. Furthermore, interest rates in continental Europe are a less effective tool for propping up demand than in Anglo-Saxon economies. In the latter economies, interest rates tend to affect the economy through the housing market, which is not the case with continental economies as they rely more on fixed-rate mortgages. Furthermore the eurozone's fragmented mortgage market dampens the effect of the EU interest rate on national mortgage markets. Thus monetary tightening might not tame the credit/mortgage-led housing bubble in EU countries.

Placing the current housing bubble in a longer term context is cause for greater concern. It seems that we are currently jumping from one bubble to another. The equity market bubble, the bond market conundrum and the current house price bubble strongly suggests that the excess liquidity problem might have been wrongly addressed in previous years and that the bubble is just being pushed from market to market... suggesting high integration and accordingly even more disruptive effects.

The corollary is that, according to *The Economist*, the total value of residential property in developed economies has doubled over the past five years to reach an equivalent of 100% of those countries' combined GDPs. This dwarves any previous house market bubble as well as the dotcom stock market bubble of the late 1990s. To some observers it is the biggest bubble in history and in the current macroeconomic context it is highly doubtful if interest rate hikes will suffice to tame it.

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<sup>5</sup> *The Economist*, "Corporate conquistadors", 16 February 2006

<sup>6</sup> The term "Interest mismatch" is here used in the sense that the ECB's rate takes the average economic stance of the euro zone into account. Hence the interest rate of the Euro zone seems currently misaligned with the interest rate that a country experiencing a credit deepening (like Spain or Ireland) should have.