Deutsche Bank
Research

Talking Point

May 26, 2017

Fewer crisis spots on the euro-area housing market

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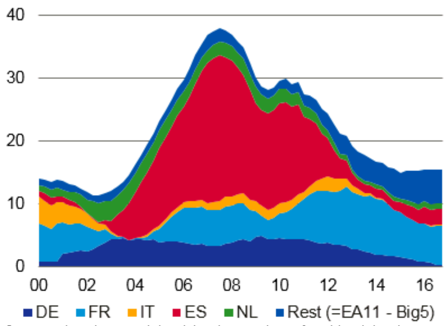
The massive overvaluations on the euro-area market for residential real estate (as measured by the price-income ratios for 2007 and 2008) are a thing of the past. Currently, house prices are excessive only in several smaller countries. However, this situation is likely to change towards the end of the decade if the dynamic uptrend in German house prices continues as expected.

European housing market: Price-income ratio

RMSE, deviation from the historical average (long-term average = 100)



Country devations weighted by the number of residential units

Source: OECD, Deutsche Bank Research

Mispricings in the euro area as a whole are small

While euro-area house prices went through the roof in 2007 and 2008, the overvaluations have been reduced almost to zero in the last few years. Despite large-scale bond purchases and zero interest rates in the past two years, residential real estate has been fairly valued on the whole. Beyond the subdued growth momentum, the new macroprudential rules and stricter banking regulation probably helped to slow credit growth and thus to prevent new price bubbles. And against the background of macroeconomic coordination, the euro-area governments will continue to work towards preventing a major uptrend in property prices. Excessive tax incentives for homebuyers have been gradually reduced. All this has considerably dampened the uptrend in prices.

Significant mispricings in large euro-area countries have been corrected

In Spain, major overvaluations have been reduced to zero in the last few years. Between 2008 and 2013, Spanish house prices dropped by almost 40%; since then, they have slightly recovered. In Italy, too, house prices have declined quite steadily by an aggregate of 20% from 2008 through today. Minor mispricings in comparison to available income have been corrected. France is the large euro-area country where the price correction has been smallest. With house prices moving sideways and income growth low, house prices continue to appear excessive. With income growth likely to be slow in the coming years, it will take a very long time for the French market to “outgrow” this problem – if such a development is possible at all. Since the launch of the euro, French household debt has risen considerably, to almost 60% of GDP. This means that many French households really cannot take out much new debt. In turn, there is still a considerable risk of price declines, at least in comparison to the other large euro-area countries.

German residential properties fairly valued

The OECD affordability indices suggest that German residential properties are currently fairly valued. Price increases by roughly 50% since 2008 have simply made undervaluations vanish, as disposable incomes have risen, too. Only recently have German house prices risen above the historical averages in comparison to disposable incomes. Overvaluations appear inevitable, as available residential space is limited and policymakers have taken several ill-fated intervention decisions. In addition, migration to Germany and capital inflows look set to continue in the coming years. This will fuel demand and drive prices up. We therefore expect Germany to see the biggest mispricings of all euro-area countries by the end of the decade.

Significant price excesses in Austria and Belgium

House prices in Austria and Belgium have doubled since 2000 and thus risen much more strongly than disposable income. As a result, the price-income ratio has reached new all-time highs. According to the most recent ECB financial stability report, both markets are overvalued. The ECB also underlines the high risk of a mutually reinforcing price and lending spiral. National regulatory authorities are trying to limit the potential fallout of price declines for banks and the economy as a whole by encouraging conservative lending policies. In view of the considerable mispricings, small yield increases – which might, for example, be triggered by the termination of the ECB's bond purchasing programme expected for 2018 – might be sufficient to cause a major price correction.

ECB is also skeptical about the Finnish and Dutch housing markets

According to the ECB, high household indebtedness has led to imbalances in Finland and the Netherlands, too. Excessive tax incentives have driven the Dutch debt ratio to 110% of GDP. This means that price declines might result in significant turmoil, as the 20% price drop and the extremely long recession from 2011 to 2013 have shown. The debt trend in Finland also gives rise to concerns. Since the launch of the euro, household debt has doubled to almost 70%. Subdued rent growth is another warning signal. In both countries, there is only limited potential of strong price increases, even though prices in the Netherlands are currently on a steep upward trend. If prices rise too much, subsequent corrections should be even larger.

Fair valuations in former crisis countries: Ireland, Portugal and Greece

Prices in Ireland collapsed, similar to those in Spain, which means that residential properties were considerably undervalued when prices reached their low in 2013. However, this undervaluation was reversed thanks to a price increase of more than 30%. Today, the price-income ratio has returned to its historical average and points to relatively good return opportunities, as economic growth is healthy. In Portugal, residential properties are cheap in comparison to income. Credit growth is unlikely to accelerate, as household debt is still high, at 75% of GDP, even though it is declining. Moreover, the long-term growth outlook is subdued, despite the pick-up in growth. Lower productivity growth and challenging demographics – high emigration and a quickly ageing population – limit potential income and price growth. The outlook for the Greek housing market is subdued, as is the overall growth outlook. Since 2007, prices have declined much more strongly than incomes, which is why the price-income ratio has dropped below its historical average. While prices currently seem to be bottoming, they are unlikely to rise until growth accelerates palpably again.

Conclusion: Significant overvaluations in Austria and Belgium and, in the longer run, possibly in Germany

The mispricings that existed ten years ago across the euro-area housing market have been largely reduced, apart from several smaller countries, above all Austria and Belgium. Moreover, thanks to improved regulation, price shocks will probably have less devastating systemic and economic effects than before the crisis. Still, by the end of the decade we are likely to see considerable overvaluations in Germany, the biggest real estate market in the euro area. Major overvaluations appear inevitable, seeing that there is a demand overhang of about one million residential units. Banks and regulatory authorities might well be faced with new challenges in the near future.

Footnote: The quotient of house prices and disposable incomes (affordability) is a key measure which helps to make a structural assessment of the house price level. The historical average, which the OECD indexes at 100, is used as a fair price level for each country. The OECD calculates this index for the eleven largest euro-area economies. Based on national mispricings and weighted by the number of residential units, we have calculated the contribution of each country to the overall risk profile for the euro area.

Presentation: Fewer crisis spots on the euro-area housing market - Appendix for Deutsche Bank Research's Talking point