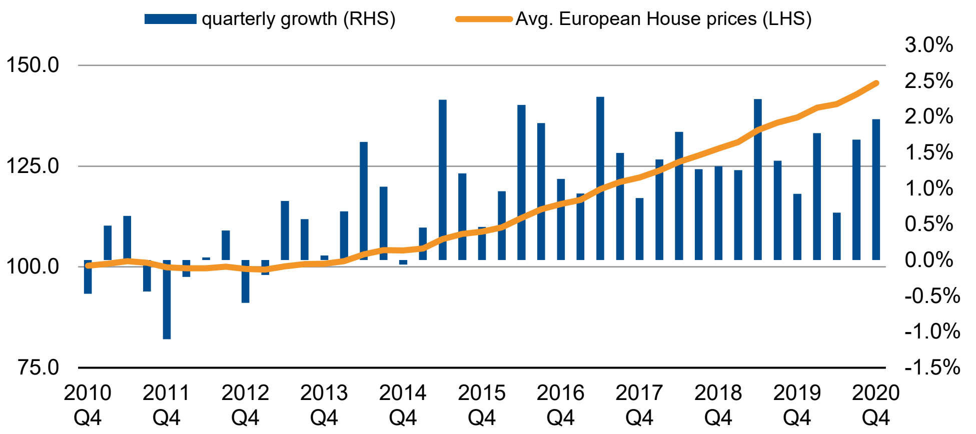
# European house prices: time for regulators to hit the brakes?

**Growth in house prices across Europe was stronger in 2020 than it has been at any time in the last decade, even though European economies spent much of the year in lockdown and unemployment increased. The economic outlook and pressure on housing affordability and profitability point to a moderation in growth. That said, with ultra-low interest rates, housing shortages in metropolitan areas and high-income mid agers (so far) being spared income losses, growth could even accelerate. This may be the right time for regulators to become proactive and introduce stricter macroprudential measures, else banks and borrowers might be caught on the wrong foot when the tide turns.**

**Figure 1: Quarterly growth in European house prices**

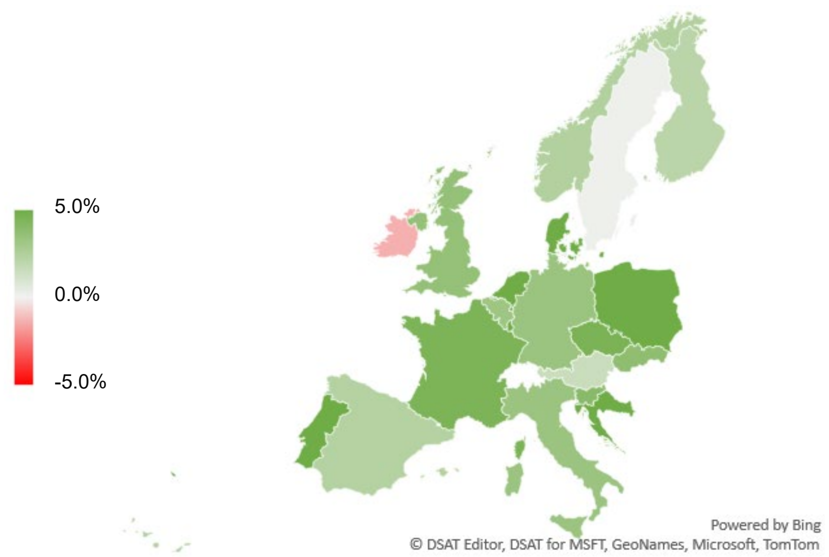



Source: Eurostat, Scope Ratings

In Q4 2020, average European house prices increased by 2.0% quarter-on-quarter compared to 1.75% in Q3. Average annual 2020 growth of 6.2% was twice the annual rate of the last decade and even higher than the growth in the economically very favourable last five years.

Over a longer term, house price indices (HPIs) have started to decouple from previous trends in most countries. Only in Ireland has a stagnation in prices marked the premature end of the recovery observed in the last decade.

**Figure 2: European house price heat map: annual growth: 2020 vs avg. 2010-19**

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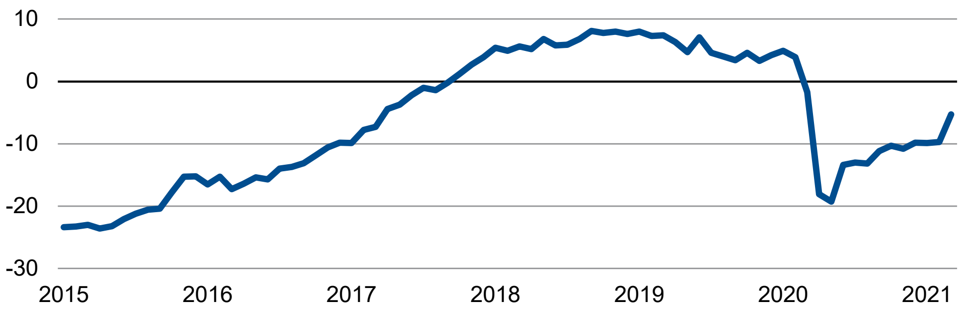
Economic fundamentals only partly justify these price increases and thus put the sustainability of growth rates in question. With household income and rents only increasing very moderately during the last year, we see increased pressure on housing affordability and profitability. Although these factors point to a moderation of growth rates, we also see factors which could drive a persistence or even acceleration of growth rates.

### Housing supply will likely remain tight…

The pandemic has put a temporary halt on many construction sites. According to EUROCONSTRUCT (see here), residential construction output in Europe contracted by 8.6% in 2020 and we will likely see the aftermath of this shock in the next few months. This will further delay the already tight supply of new housing, especially in metropolitan areas, and could be a driver for further house price increases.

In second quarter of 2020, the number of new building permits in Europe dropped by 18.1% year-on-year. This has partly recovered, but as of end-2020 the number of permits is still 7.4% lower than in the previous year. We see the same pattern in the 'Construction Confidence Indicator', a survey-based measure conducted by the European Commission. Lower business confidence reflects financial constraints as well as shortages in both material and labour force.

**Figure 3: EU Construction Confidence Indicator**




Source: European Commission, Scope Ratings

Despite the slump in business confidence and output, our Outlook on the sector remains stable. We expect construction companies to be at the forefront of the expected recovery as companies are likely to be among the main beneficiaries of government efforts – for example through the European Commission's 'Green Deal'.

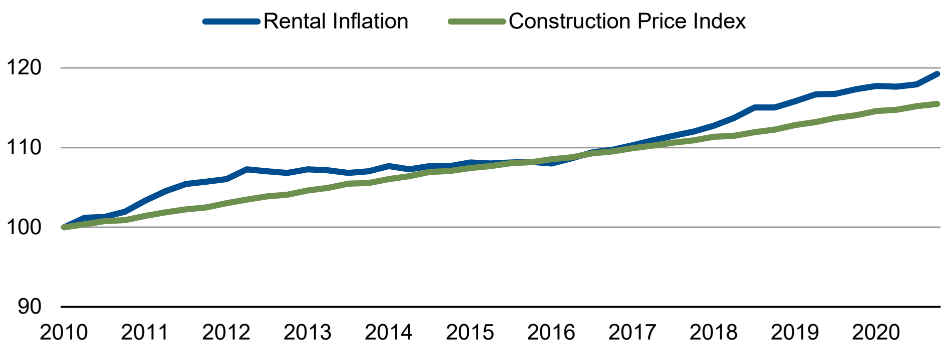
### … this may be even amplified by EU's 'Green Deal / Renovation wave'

As part of the Green Deal, the Commission recently published a strategy paper called the 'Renovation Wave for Europe' (see here). The target is to incentivise the renovation of 35 million European buildings out to 2030 to increase their energy efficiency. This makes sense, both environmentally and socially, as buildings account for 40% of Europe's energy consumption and around 34 million Europeans are unable to afford keeping their homes adequately heated.

However, the increase in renovations could at the same lead to a crowding-out of new building activity as the capacity of construction firms is limited. This could further hamper the supply of new housing. The Commission is targeting the creation of 160,000 green construction jobs over the next 10 years, but training those people is a lengthier process than providing cheap funding.

Together with the potentially lower supply of new residential housing, the increased demand for construction firms could ultimately also lead to higher construction prices; so far only a minor factor in the current house price rally. Since 2010, construction prices have increased only moderately with an average annual growth of 1.3%, slightly lower than overall rental inflation.

**Figure 4: Inflation in construction prices and rents**




Source: Eurostat, Scope Ratings

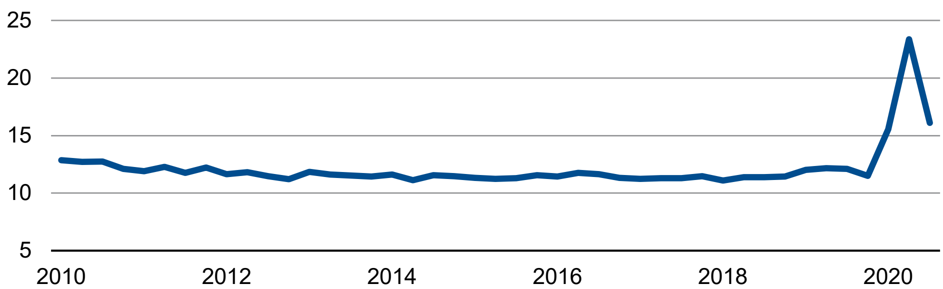
### Record high savings during the pandemic…

On the housing demand side, ultra-low interest rates remain the primary driver. However, the pandemic may have even strengthened demand. Not only because people feel a stronger benefit in owning property during the working from home phase; but housing may also in some cases have become even more affordable as savings are hitting the roof.

After reaching its all-time high of 23.3% in second quarter 2020, the savings rate has decreased to 16.1% again, reflecting the more relaxed Covid-19 restrictions in the early parts of the third quarter 2020. With constantly high infection numbers in Q4 2020 and Q1 2021, further acerbated by region or countrywide lockdowns and travel restrictions, we expect savings will have increased again.

Strong savings are expected to continue throughout 2021 until increasing vaccination rates and herd immunity allow for a new normal. As such, savings from foregone consumption may further boost house price growth.

**Figure 5: EU saving rate**




Source: Eurostat, Scope Ratings

### … as high-income adults still benefit from financial leeway

Income losses have not been distributed evenly across populations. Typical house buyers, middle-aged high and medium wage earners, are, so far, less affected by unemployment. Their losses mainly stem from absence from work, which was largely offset by the safety net put in place through wage compensation schemes. For these people, it is most likely that additional savings will be used for asset accumulation. See here our previous commentary with more details.

### Will the market moderate itself or do regulators need to step up?

In most European countries, house prices were already reaching their sustainable limits prior to the pandemic. Lasting support and looser macroprudential measures as well as the persisting low interest-rate environment are helpful for the economy. But they can have unintended consequences for the European housing market as they may fuel growth beyond what is sustainable.

Lower LTVs because of higher HPIs have a less beneficial impact on recovery rates than in the past. We assess the increase in house prices only in part justified by economic fundamentals, which could then lead to stronger price corrections – if and when lockdowns subside, and insolvencies potentially prompt higher unemployment. As such, house prices are now more distant to their sustainable levels and most of the HPI increases are neutralised in our credit analysis through higher declines in market values.

With pandemic house price growth rates often close to 10%, calls for moderating over-exuberance are increasing. Increasing insolvencies and unemployment, especially when starting to impact the relevant housing target group, have the potential to force the market into a moderation of growth rates. But other factors could delay such moderation or even accelerate current growth, at least in the short-term.

Few banks have so far amended their underwriting criteria and, in most countries, previous macroprudential measures have been reduced and/or halted. As such, this may be the right time for regulators to become proactive, else banks and borrowers might be caught on the wrong foot when the tide turns.

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