Advanced economy housing markets in a scenario of tighter monetary policy (part I)

The housing market is one of the main channels through which monetary policy is transmitted to the real economy. A tightening of financial conditions hits mortgage interest rates, cooling housing demand. In addition, rising inflation undermines households' purchasing power, thus acting as a second factor weakening housing demand. Given the sharp tightening of monetary policy in recent quarters, in this article we set out the shifting trend that is already beginning to occur in some international housing markets and we analyse the magnitude of the adjustment that could lie ahead.

Diagnosis: which housing markets accumulated the greatest imbalances?

In many developed economies, the price of housing has been rising rapidly for many years, and this trend accelerated during the pandemic (due to a change in preferences, expansive fiscal and monetary policy, limited supply, etc.). Global housing prices went from growing by 2.8% in 2019 to 4.5% in 2020 and accelerated to 11.8% in 2021, in nominal terms (1.4%, 3.5% and 8.6%, respectively, in real terms).[1] This rally slowed in 2022, especially in real terms (growth of 4.1% year-on-year in Q3 2022) (see first chart). The rise in housing prices exceeded the growth of household income and led to significant overvaluation in some markets. According to the Dallas Fed's Exuberance Indicator, 12 of the 25 countries analysed showed signs of overvaluation in Q3 2021.[2]

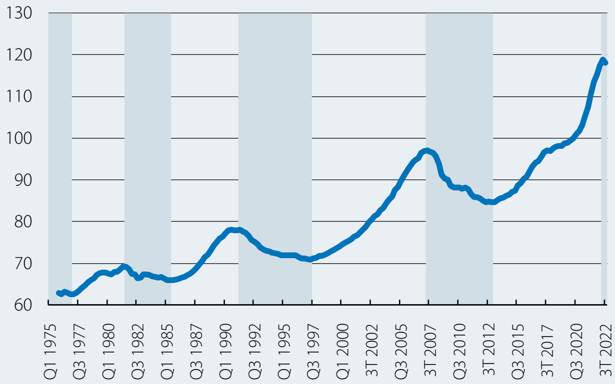
The countries of most concern are those in which the price rally was accompanied by an increase in household debt (which was already high in some cases). In this group, New Zealand, Canada, Australia and the US stand out. In Europe, the notable cases are the Netherlands, Luxembourg, Sweden, Denmark and Norway. In addition, variable-rate mortgages dominate in these countries, meaning that households who have recently taken out mortgages are more vulnerable to the rise in interest rates. A second group includes Portugal, Germany and the United Kingdom, which also recorded a sharp increase in housing prices during the pandemic together with an increase in levels of household debt.

Current situation: a change of trend in housing markets

Housing markets in several advanced economies began to experience a correction in mid-2022, amid higher interest rates and an erosion of household real disposable income. The markets with the biggest declines in housing prices since their peak (with data up to December 2022 or February 2023, depending on the country) are Australia (–9.7%), Sweden (–9.6%), Canada (–10.4%), the US (–5.9%), Germany (–5.7%), New Zealand (–5.0%) and Norway (–2.8%). Despite these falls, the price of housing in all these countries is still above the pre-pandemic level. Moreover, sales have fallen at double-digit rates year-on-year in several of these countries: Australia (–47%), Norway (–38%), Sweden (–35%), the US (–33%) and New Zealand (–31%).[3]

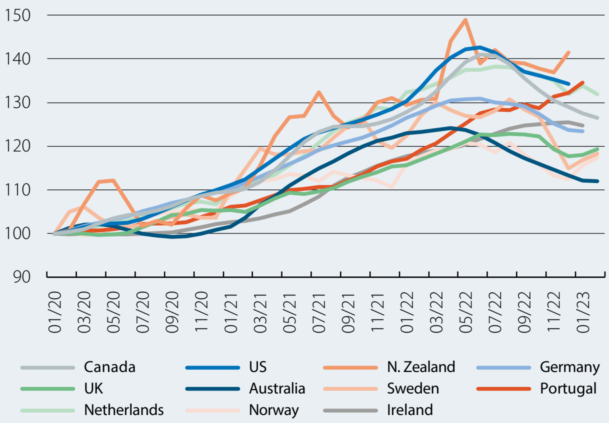
The signs of cooling are somewhat more modest in the United Kingdom and the Netherlands, with prices falling

Global housing prices
Index (100 = Q4 2019)



Note: *Aggregate price in real terms of 25 countries with dynamic relative weighting.*
Source: *CaixaBank Research, based on the International Housing Observatory database, described in Mack and Martínez-García (2011).*

Nominal housing prices
Index (100 = January 2020)



Source: *CaixaBank Research, based on data from Refinitiv.*

1. Global housing price indicator built using data from 25 advanced economies. See: https://int.housing-observatory.com/.
2. The price correction experienced since last summer in many economies has already cooled some of these markets, so by Q3 2022 only five countries were showing signs of overvaluation.

3. Average year-on-year change for the last three months based on available data. The most recent figures correspond to December, January or February 2023, depending on the country.

Housing market indicators in different developed economies
(%)

	Housing prices			Household debt		Variable rate	Overvalued housing?
	Change: Dec.-2019 vs. peak	Change vs. peak	Annual change (latest figure)	% GDI (latest figure)	Change vs. Q4 2019 (pps)	% new mortgages (2019-2022)	Dallas Fed Exuberance Indicator
N. Zealand	49.1	–5.0	8.0	122	4.2	–	Yes
US	42.6	–5.9	4.4	101	2.6	5	Yes
Canada	41.2	–10.4	–2.5	179	1.7	–	Yes
Netherlands	40.4	–4.5	–0.8	198	–13.4	15	Yes
Luxembourg	37.5	–	11.1	193	8.0	38	Yes
Sweden	36.2	–9.6	–7.0	193	9.2	64	Yes
Portugal	32.7	–	13.1	113	2.9	69	–
Germany	32.3	–5.7	–2.4	91	3.4	11	Yes
Ireland	25.7	–0.6	6.1	96	–30.0	21	NO
Australia	25.2	–9.7	–9.1	196	–1.1	–	Yes
Norway	24.8	–2.8	–0.3	241	–2.8	–	MODERATELY
UK	23.0	–2.9	2.1	139	2.6	4	NO
France	18.9	–	6.5	118	5.5	3	Yes
Denmark	18.2	–3.8	–2.4	204	–32.0	26	Yes
Japan	15.2	–	7.5	115	–1.3	–	MODERATELY
Italy	9.7	–1.0	3.0	81	–0.1	26	NO
Spain	6.1	–	7.6	94	–3.0	30	NO

Notes: *The data on debt for New Zealand, Luxembourg, Norway and Japan correspond to 2021 and reflect a % of net income. Housing is considered to be overvalued if the exuberance indicator of the real price of housing exceeded the critical value in at least one quarter in the period 2021-2022 (models with 1 and 4 lags). «MODERATELY» indicates that prices are overvalued according to only one of the two models considered.*
Source: *CaixaBank Research, based on data from Eurostat, the ECB, Refinitiv, the Federal Reserve Bank of Dallas and the OECD.*

by less than 5%, although the decline in activity in the sector is beginning to become apparent (year-on-year sales are down 18.2% in the UK and 15.5% down in the Netherlands, as of February 2023).

Future outlook

The downward trend in housing prices can be expected to continue over the coming quarters, as the scenario of tighter monetary policy filters through to the real economy.[4] The speed and intensity of the adjustment in the various housing markets will largely depend on the imbalances that have accumulated during the expansive phase of the housing cycle. As a result, we can expect the corrections to be more pronounced in those markets where: (i) housing prices experienced sharper growth, in excess of household income (overvalued markets), (ii) levels of household debt are high and have been rising in recent years, and (iii) the cost of financing to buy a home has increased more as a result of the actions taken by the central banks in recent quarters.

In order to assess the potential adjustment in housing prices that could occur in these markets, in the Focus «Advanced economy housing markets in the face in a scenario of tighter monetary policy (part II)» of this report, we take an in-depth look at the pressure exerted by the tightening of affordability and the increase in interest rates. The exercises we conducted point to potential corrections (for the average of the countries analysed) of around 15%. Beyond this figure, there are two important nuances. Firstly, the anticipated correction is not sudden, but rather is expected to occur over a two-year period. Secondly, there are significant disparities from country to country, with a more pronounced adjustment potential in Anglo-Saxon economies (specifically, the US, Australia and Canada) and a range of different impacts within Europe. In this regard, it should be noted that the Spanish housing market is in a good position, both in relative and in absolute terms. It should also be noted that, while these exercises offer a measure of the potential fall we could see in housing prices in the countries where the imbalances are more pronounced, they are nevertheless illustrative exercises and do not take into account all the relevant factors. Thus, they should be interpreted as offering a measure of the risk, rather than providing a forecast. Indeed, there are several factors which offer support to the housing market. These notably include the strong performance of the labour market across all the economies analysed, which supports household income and thus helps to mitigate affordability issues and limits forced sales. In addition, households have healthier balance sheets and banks have large capital buffers to absorb potential losses without triggering feedback mechanisms which could lead to a downward spiral in prices. That said, the correction in the housing markets where the biggest imbalances have accumulated remains a risk when monetary policy makes a sudden change of course.

4. Generally speaking, housing prices tend to show a certain degree of rigidity towards downward adjustments during changes in the cycle. The sharp falls in the number of sale transactions suggest that the adjustment in prices will continue over the coming quarters.