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Focal Point

Rising house prices, mostly a concern for US inflation

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- Record low interest rates and central banks' support to lending are pushing house prices up in most OECD countries. By some metrics, in some countries residential real estate overvaluation is at its highest level in 25 years. The reshuffle in demand following changing working patterns may add further pressure.
- US valuations are high by historical standards, but below the mid-2000 levels. Tighter lending discipline and stronger households balance sheet reduce the risks to financial stability. Yet soaring prices impact the important shelter component of CPI, which may dampen the inflation normalization expected for 2022, increasing pressures on the Fed to tighten.
- In its latest Stability Review the ECB deemed the housing market-related risks as "*elevated*". In its new strategy the ECB will also directly focus on house price developments by augmenting its inflation measure accordingly.
- Taylor-rule based calculations show that if house prices were fully included, the policy rate would currently be 0.3 pp higher.

The extraordinary monetary stimulus implemented after the Covid-19 outbreak brought about a strong support to asset prices via abundant liquidity and tumbling real rates. This has been particularly evident for house prices. The sharp change in working habits, with the rapid diffusion of "Work from Home", has provided and extra boost to the demand for larger homes in suburban areas. Excessive house prices in comparison with fundamentals (disposable income, borrowing costs, etc.) can pose several risks to the economy:

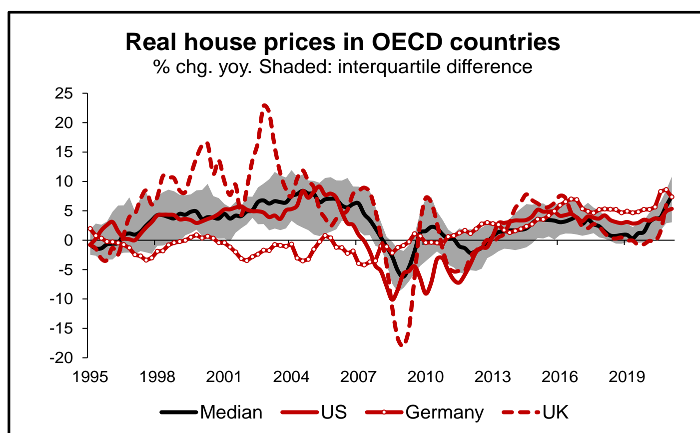
- It can lead to overinvestment and high **leverage**. The correction of a bubble may have (and had in the past) unwelcomed ramifications to the banking system and the whole economy.
- Rising **inequality**: younger and poorer households may be priced out of the market. High house prices may reduce mobility, slowing down the healing of the labour market.
- **Inflation**: landlords translate higher house prices into rents, typically with a 4-5 quarter lag.

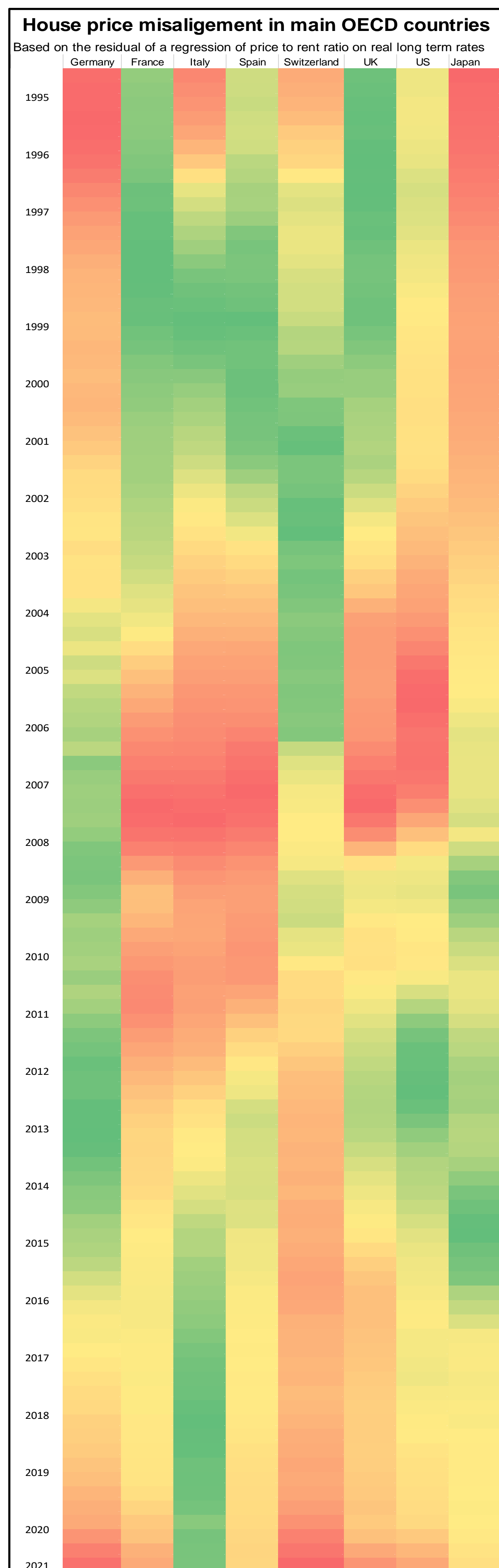
The monetary policy support since the 2008 crises has been a fundamental driver of house prices. This create a fragility in the system in the long term. As monetary normalisation will challenge house valuation, the risk of larget negative spillovers of a price correction on the real economy may limit the room for normalisation itself, capping the upside for bond yields.

Compared with the period preceding the 2008 crisis, prudential measures like higher capital requirements on banks' mortgage activity or limits to the loan to value ratios have been tightened, especially in Europe. But the prospects of low for longer rates is leading to a further reconsideration, with potentially far-reaching implications. For example, in New Zealand the government added the prevention of housing price bubbles as a target to the central bank's mandate. In this Focal point we analyse the recent developments in house prices in the US and the euro area and derive some conclusions on the risks to the macro outlook and implications for monetary policy.

House prices are getting bubbly

In OECD countries, house prices have strongly accelerated, in a rather coordinated fashion, after the monetary policy loosening. In Q1 2021 the median price was up by 7.5% yoy in inflation-adjusted terms, not too far from the peak growth seen in the mid-2000. This is part of a global trend. The IMF shows that in Q1 2021 **house prices grew faster than both income and rents in over half of the countries for which data are available.**

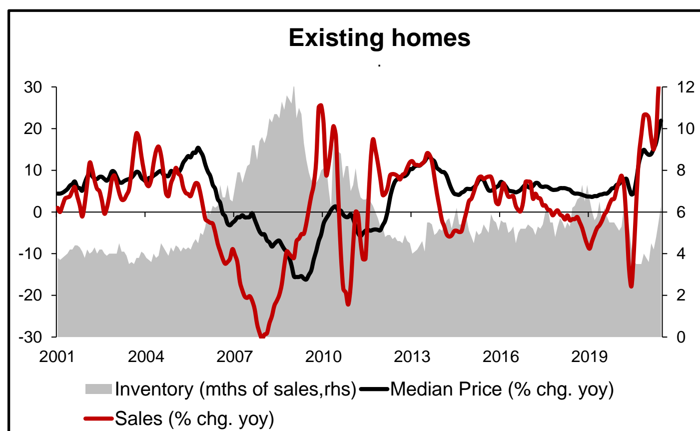




The key issue from a financial stability point of view is whether the price level is consistent with the fundamentals. There are several methodologies to assess this. Here we compare the deviation of the house price to rent ratio (a simple measure of rentability) to its long-term relationship with real interest rates. The resulting heatmap shows that in most of the main OECD countries, price misalignment is widening. The levels seen in Germany and Switzerland confirm worries about the formation of a bubble. In the US prices are high but still below the extremes of the mid-2000.

US: accessibility and inflation top concerns

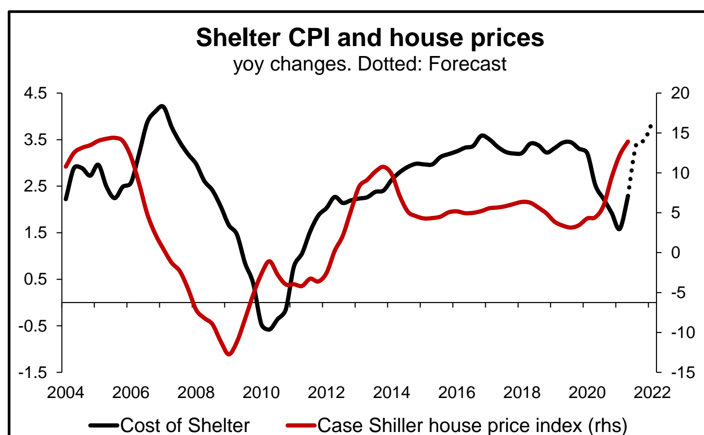
While similar or even bigger in size, the current increase in house prices differs greatly from what occurred 15 years ago. Back then the key driver was rampant speculation by home buyers, made possible by easy credit. Today, prices are pushed up by strong demand amid a shortage of homes available for sale. Moreover, supply struggles to catch up due to persistent shortages of building materials, development areas and skilled workers. Several of these factors will likely abate over the next months. Moreover, higher prices should bring out more sellers. In the US stocks of existing homes covered just 3.5 months of demand in late 2020; it was back up to 6.3 months in June.



Home price inflation is expected to cool off, but prices will remain substantially higher than in the pre- pandemic years. Still, the risks to financial stability appear much lower than in 2007. First, **households are much better equipped** to withstand higher prices: at the end of 2020 household debt amounted to 79% of GDP, some 20pp below the peak reached in 2008. Moreover, mortgage payments account for just above 3% of disposable income, down from 7% in 2008. Secondly, **tighter banking regulation** has forced more lending discipline. In Q1 2021, only 1.4% of new mortgages were classified as subprime, less than one tenth of what was recorded in Q1 2007. Yet, the current low level of risks cannot be taken for granted. Households surveyed by the University of Michigan expect prices to increase by 5% next year, twice the pace expected in 2007. Moreover, lending standards for non-subprime mortgages have been loosened significantly. **Optimism on prices and easier credit could fuel overinvestment.**

A more pressing concern is the impact on consumer prices via shelter costs, which include rents actually paid and what an owner would pay if he had to rent its primary residence. **Higher costs are already preventing younger and less well-off households from buying.** Moreover, a spike in shelter prices here could increase uncertainty on whether the current bout of inflation is temporary. **Shelter costs**

account for 40% of core CPI and 18% of core PCE and have already rebounded from the low levels seen in 2020, for several reasons. First, the return to higher mobility has unfrozen rental applications, increasing demand. Second the increase in house prices has forced many potential buyers to rent instead. Third, liquidity-rich, yield-starved investment funds are becoming an increasingly big player in the rental market. Our projections based on house prices, rented houses' vacancy rates and inflation expectations show that shelter inflation may reach 3.5% by mid-2022.



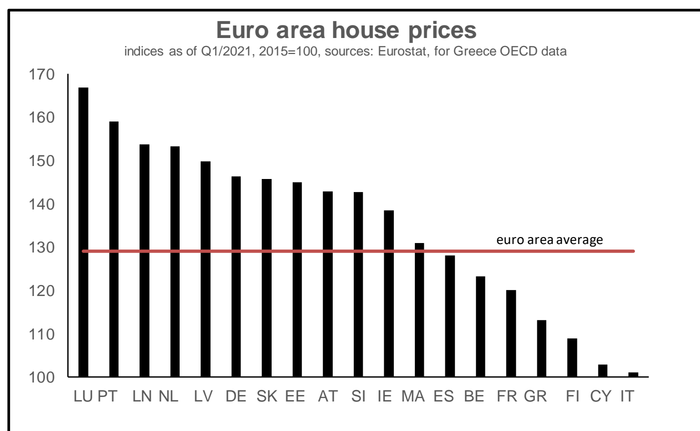
This will offset the expected deflationary effects from moderating demand and diminishing supply constraints (chips, containers, labour etc.). Moreover, **it can have a non-negligible second-round effect via expectations.** Households' expected inflation is heavily influenced by fluctuatipns in the price of frequently purchased goods or services, like petrol. Rents are paid monthly, and a sharp increase will likely affect the perception of overall inflation. Additionally, given the pattern of annual renewals, shocks to shelter inflation tend to be persistent.

The Fed has acknowledged that loose monetary policy is just one of the factors behind rising prices. Some FOMC members floated the idea of tapering purchases of Mortgage Backed Securities faster than Treasuries, to contain demand and prices. Recently, chair Powell pushed back against this view: MBS do contribute to house price increases, but by not much more than Treasuries. Moreover, some FOMC members fear that twisting purchases to tighten financial conditions only in some sectors would set a precedent. Finally, a two-speed tapering would be less predictable and more difficult to communicate.

Euro area: An obstacle to low rates for longer?

House prices have come into the focus of policy makers in the EU. Within the euro area the development has been very heterogenous. Since 2015 house prices have surged by almost 70% in Luxemburg but have practically stagnated in Italy. The Alert Mechanism Report 2021 finds that in 2019 a majority of member states exhibited overvaluations in house prices. Moreover, affordability constraints emerged in about half of the EU countries; more than 10 years of income are needed to purchase a 100 square meter dwelling.

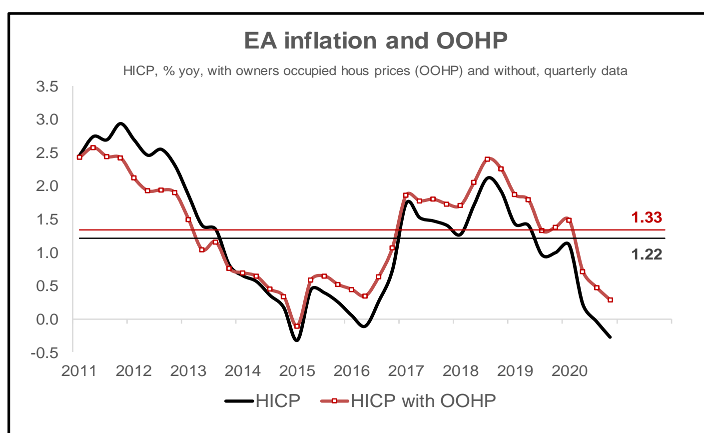
A hotter housing market also poses risks to financial stability. In its May 2021 Stability Review the ECB assessed that risks stemming from real estate markets remained elevated. The concern is based on the Commercial Real Estate (CRE) market where a sharper than expected decline in valuations might set off negative feedback loops. A further decline in CRE prices could feed through to the financial system via increased credit risk, falling collateral values and losses on direct holdings. The Residential Real Estate market might prove vulnerable to a withdrawal of the current policy support measures. The risk is highest in those countries where debt levels are elevated, and policy support measures contribute significantly to household income.



Furthermore, house price developments will increasingly impact monetary policy. In its 2021 strategy the ECB announced it would include owner occupied housing costs into its inflation metric and will include hosing in the assessment of the side effects of monetary policy.

Eurostat's HICP has a 6.5% for actual rentals of housing (against 18% in the US core PCE index). A study for the European Parliament concludes that the inclusion of the cost of owner occupied housing prices (OOHP) would have led to potentially different monetary policy conclusions. Our proprietary analysis finds that since the end of 2014 (when the ECB embarked on QE), **the inclusion of OOHP would have pushed core inflation on average up by 0.4 pp**. However, the dynamics is not impacted and longer term the difference narrows to just 0.1 pp. Including OOHP in a Taylor rule for the ECB, the policy rate should currently be 0.3 pp higher (and on average since 2014 just 0.2 pp higher).

Should house prices increase further, related stability risks would rise. The Bundesbank for instance saw **urban house prices in Germany 15% to 30% above fair value in 2020**. With inflation slowly trending up, house price considerations could indeed be a factor for the ECB to start hiking rates. That said, we doubt that house price increases alone will be sufficient to end the low for longer policy of the ECB.



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