Housing Affordability Index: Q2 2022

The likely end of boom years

- The housing affordability index (HAI) slipped as abnormal price growth gained momentum.
- Falling affordability and purchasing power, as well as bleak expectations, are likely to curb demand and stifle price growth.

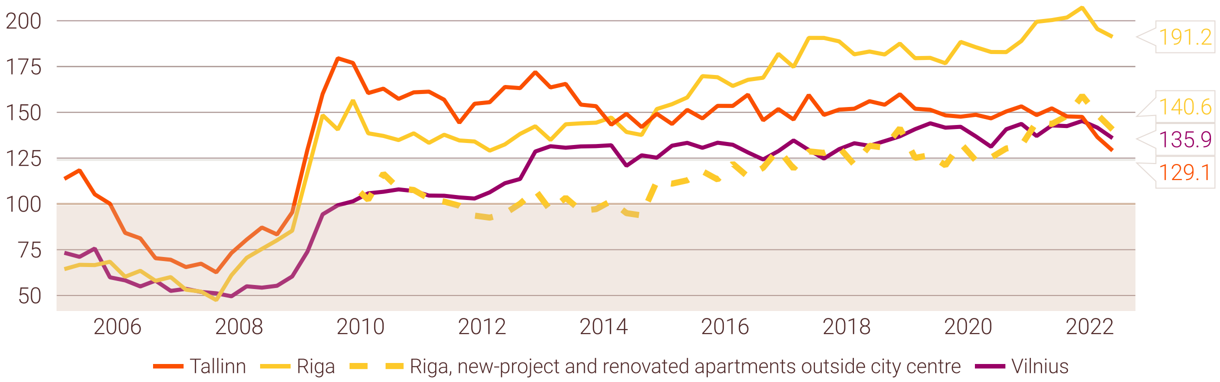
The record-high housing affordability that we have seen over the previous years has dropped in all the Baltic capitals. In Tallinn, the HAI is already at its lowest level since 2008. In Riga and Vilnius, the index is weaker but close to the pre-pandemic levels of 2017-2019.

The reasons for weakening housing affordability are the same in all three Baltic capitals – steep apartment price growth. The still-rapid wage growth cannot keep up with apartment price growth anymore. The prices in the primary housing market have risen on the back of soaring construction costs and the pandemic-induced shortage of new apartments. Meanwhile, very strong demand has overspilled into the secondary market as well and pushed prices of old apartments higher.

However, the outlook is darkening, and recession is around the corner, forcing the housing market to cool down. High apartment prices and the increase of Euribor rates will further outweigh wage growth and deteriorate housing affordability. The affordability of apartments is also being affected by enormous consumer price inflation, leaving households with eroded purchasing power. Given these circumstances and the abnormal price growth, demand for housing is likely to decrease, while supply will hold up or even increase going forward. Hence, we are likely to see some correction in prices, at least in Estonia and Lithuania, as the markets look heated.

Analysts:
Laimdota Komare, laimdota.komare@swedbank.lv, +371 6744 42 13
Marianna Rõbinskaja, marianna.robinskaja@swedbank.ee, +372 888 79 25
Vytenis Šimkus, vytenis.simkus@swedbank.lt, +370 5258 51 63

Baltic Housing Affordability Index



Sources: Swedbank Research & Macrobond

Example: A housing affordability index value of 129.1 means that the average net wages of a household are 29.1% higher than minimally required to afford an apartment.

Tallinn – the housing market temperature is high

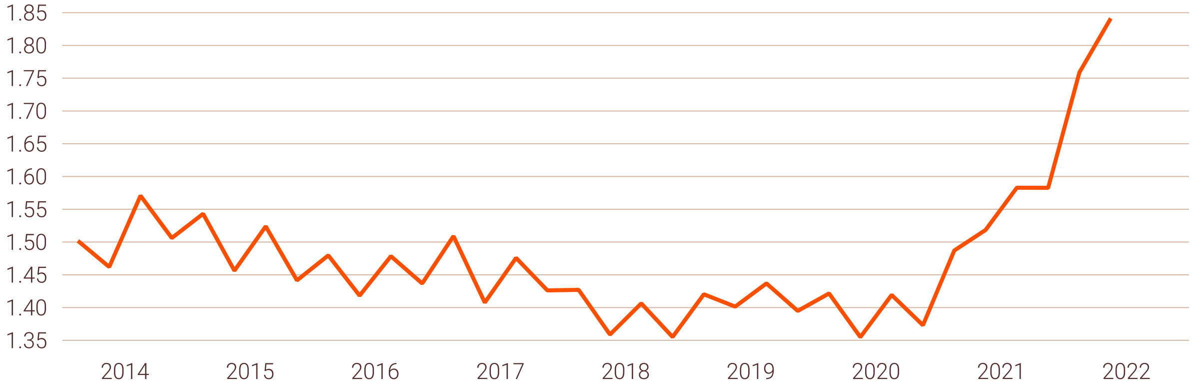
The housing market was active in the second quarter of the year. Households' confidence to buy a home has held up well despite the current challenging environment. Meanwhile, skyrocketing inflation and higher rents – boosted also by the demand of incoming refugees from Ukraine – have encouraged investments in real estate. However, the second half of the year will likely bring a rebalancing of supply and demand on the market.

Housing affordability has dopped to a level last seen in 2009. The price of apartments shot up by 30% in the second quarter compared with a year ago, while average net wage growth in the capital was more than four times slower. However, the observed drop in affordability is likely even more pronounced than we see in the statistics. The statistics have not yet picked up the rapid price growth in the primary market, driven by high construction costs and the shortage of newly built apartments. It will appear in the statistics with a significant time lag. The current reservations of new apartments still in the construction phase are being made at substantially higher prices. Besides this, the statistical share of newly built apartments in total transactions was 23% in the second quarter – still below the pre-pandemic average of around 30%.

The underlying factors that have previously kept up strong demand are starting to fade, and it is difficult to see apartment prices to continue up in this environment. However, due to the already-high price level, we will still see strong annual growth in the second half of the year. Housing affordability has worsened considerably this year as apartment price growth in the capital has significantly outpaced the average net wage growth. Inflation has substantially reduced household purchasing power. The annual growth of households' deposits has slowed considerably this year. However, deposits are still high, but concentrated in the hands of well-off households. Meanwhile, Euribor rates are on the rise, raising the cost of mortgage servicing and thus, increasing the burden on households.

The secondary market has started to show some signs of easing – the annual transaction growth almost stalled in July and August. The tight primary market is also likely to see some relief on supply-demand balance. The housing affordability index for newly built apartments has already reached a level where an apartment is not easily affordable for a household receiving 1.5 the net wage. The stock of new apartments in Tallinn and neighbouring municipalities did not decrease further in the second quarter; however, it remains low, while demand is likely to ease. Housing affordability will continue to worsen in the second half of the year on the back of already-high price levels and rising interest rates. Eventually, lower demand should somewhat alleviate the overvalued housing market.

Secondary market apartment price relative to net wage in Tallinn



Sources: Swedbank Research & Macrobond

Riga – for the housing market, the heat is on

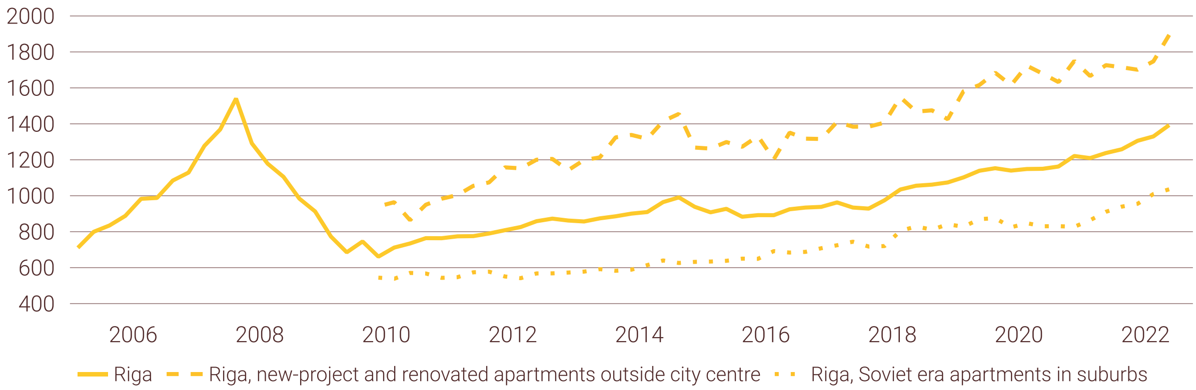
Housing affordability worsened in the second quarter as apartment prices grew faster than wages. Labour market tightness continued to support wage growth at a still-decent 7.5%. At the same time, the rather resilient demand continued to heat up the housing market, with the average apartment price growth in Riga accelerating to more than 12% annually. Although the price growth has reached a double-digit pace, both the price level and the rate of growth are still lagging the other Baltic capitals.

Housing market activity remained relatively strong in the second quarter. However, the number of transactions decreased from the beginning of the year. Construction delays are limiting the number of completed transactions with newly built apartments, while demand for less-energy-efficient Soviet-era apartments seems to be losing steam, amidst rising heating prices.

The price of apartments in new-project or renovated buildings completed after 2000 outside the city centre increased by 9.7%. This segment covers both the primary and the secondary market (about 20% of all transactions). The actual price growth is underestimated, as the primary market prices appear in the data with a significant time lag. The recent primary market transactions reflect the prices for just-completed projects that buyers locked in more than a year earlier. The high prices of new reservations are not yet reflected in the data. Real-time observations indicate that the new reservation prices could be up by as much as 30% over the past 1-1.5 years; in most cases, they have already exceeded EUR 2,000 per square metre, given rising construction and labour costs. The expensive reservation prices suggest housing affordability on the primary market has dropped even more. As a result, we have seen an increased demand on the secondary market for new-project and renovated apartments, which has also driven up their prices.

The rising prices in the other market segments have also spilled over to the market for apartments in older, non-renovated buildings in sleeping districts. Transactions with these apartments, mostly in Soviet-era buildings, accounted for close to 60% of all apartment transactions in the second quarter. Their price increased by about 16.5% over the year and exceeded EUR 1,000 per square metre on average. Although this is still the most affordable housing in Riga, it comes with a caveat – much higher utility bills than in newer or renovated buildings due to low energy efficiency and bigger maintenance costs, as well as the need to invest in renovation. There are signals that the prices of Soviet-era apartments started slipping in late summer, responding to higher supply and dwindling demand.

Average apartment transaction price, EUR/m2



Sources: Swedbank Research & Macrobond

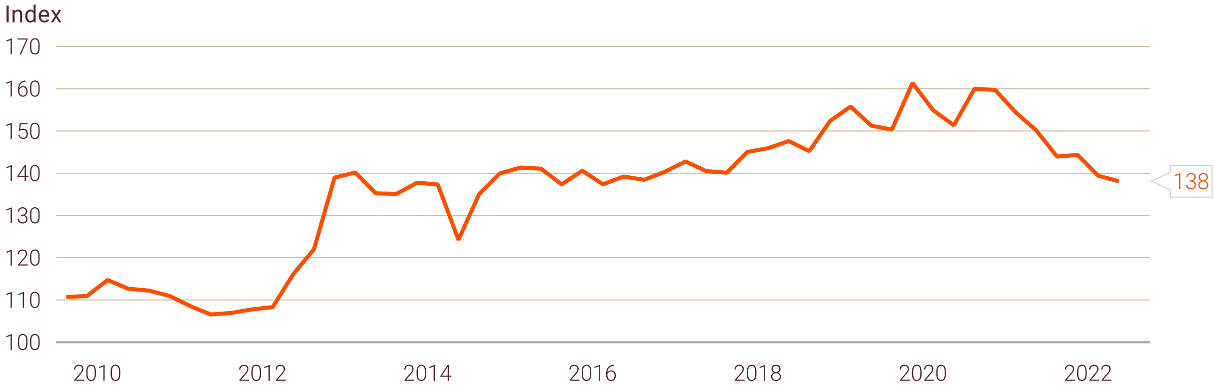
When the elevated number of reservations gradually turns into completed transactions in the next few quarters, the average transaction price will rise further before decelerating. When price growth exceeds wage growth and interest rates increase, housing affordability will drop further, limiting the housing demand. So far, the plans to buy or build homes have remained resilient, though.

Vilnius – affordability continues to deteriorate

The housing market in Vilnius is at a crossroads. Price growth remains uncomfortably high, and shortages of physical inventory are still acute. Nonetheless, there are the first tentative signs of the housing cycle turning over. Slowing economic activity, rising interest rates, and the fading of pent-up demand should put a lid on further price increases.

Average annual price growth stood at 20% in the second quarter, a sudden jump in the new apartment price suggests that more recent sales were finalised, although register data prices are still far below the running market prices. While wages increased over 12% in the period, they fell significantly behind the housing appreciation. Furthermore, rising interbank interest rates pushed average rates on new housing loans to 2.6%, worsening affordability further.

Housing affordability in the secondary market in Vilnius



Sources: Swedbank Research & Macrobond

Market activity has declined markedly over the past quarters, and even in the secondary market it returned to pre-pandemic levels. Admittedly, sales registrations remain high--just not as extreme. On the other hand, developers are sending signs of easing demand, preliminary sales fell to a low level, and reportedly there has been an uptick in cancelled reservations. However, primary market data are not as reliable, and further monitoring is needed to confirm the trends. On the other hand, official secondary market data show only a gradual slowdown in both sales and prices.

There is a chance that we are seeing a beginning of market rebalancing. Both the number of completed dwellings and newly issued permits remain at high levels, and supply is trying to catch up. At the same time, sales have normalised slightly, and the sum of the two factors provides a chance to alleviate the chronic housing shortage in Vilnius.

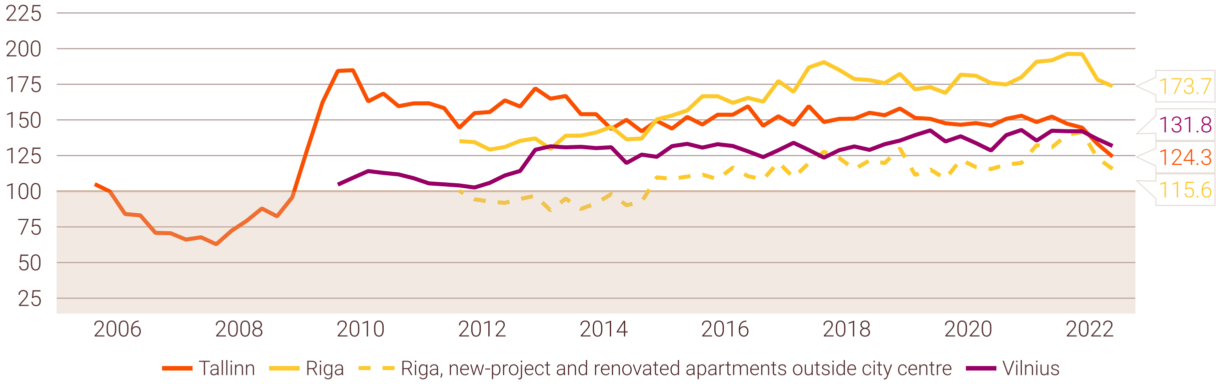
The lag in the official data makes it difficult to judge if the situation in the housing market is normalising. Demand for old apartments seems to have faded slightly, and developers report lower interest for new construction. Overall, the macroeconomic background is unfavourable for the housing market. We expect Lithuania to be in a shallow recession, as well as saddled with steadily rising interest rates and a poor environment for housing affordability. The strong price momentum of the first half of the year will ensure double-digit price growth for 2022, but we expect housing prices to stagnate or even retreat next year. Nonetheless, affordability will continue to deteriorate further over the next six months, pushing marginal buyers away from the housing market.

Baltic HAI: Additional analysis

Soaring construction costs put pressure on prices

Increasing construction costs are putting extra price pressure on housing developers across the Baltics to raise prices. We believe that developers possess enough market power to transfer cost increases to the final buyers of apartments. The primary market transaction prices seen in the statistics represent apartment reservations made a while ago, and they are considerably lower than the current reservation prices, which reflect the past year-and-a-half surge in construction costs. Hence, the actual price increase is estimated to be more rapid. Therefore, we have used construction costs as a proxy and calculated adjusted prices for newly built apartments. These prices were further on used to calculate a weighted average real estate price in all Baltic capitals. In the graph below, we have estimated the housing affordability index in each Baltic capital, while considering the effect of rising construction costs on the newly built apartments. Soaring costs have reduced index values in all Baltic capitals.

Baltic Housing Affordability Index Adjusted for Construction Cost Increase



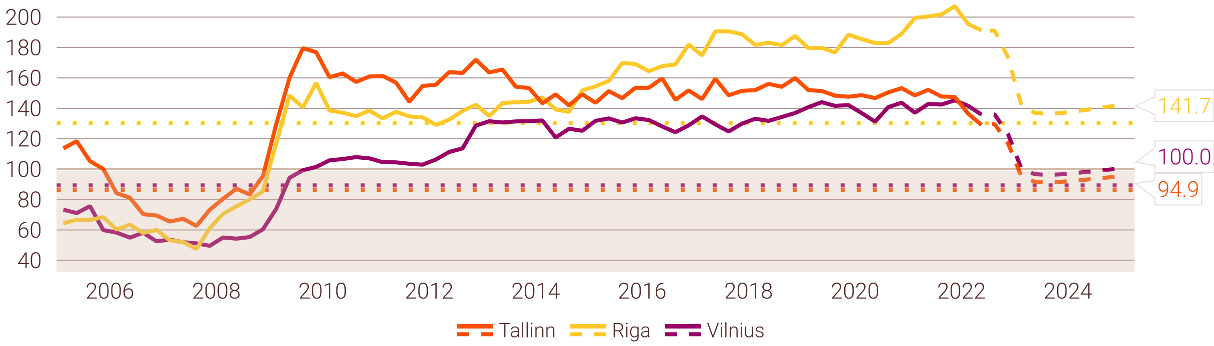
Sources: Swedbank Research & Macrobond

Methodology: The construction cost index is lagged by six months for each country, and new prices for newly built apartments are calculated with the lagged annual increase of the index. Afterwards, a new weighted average price is estimated and used for calculation of the housing affordability index.

Fight with inflation will further dent affordability

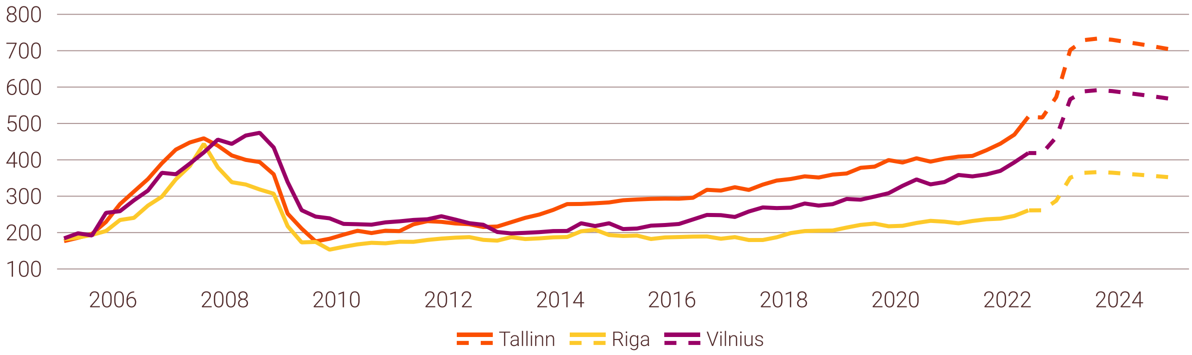
Actions taken by the European Central Bank will raise the euro interbank offered rate (Euribor) higher and increase mortgage servicing costs in the Baltics. Below, you can find an updated analysis on the effects of an increasing Euribor on housing affordability. The scenario assumes all variables constant, except the interest rate. The dotted line represents affordability in the Baltic capitals in an extreme hiking scenario with interest rates reaching 6%.

Baltic Housing Affordability Index
Market expectations scenario: 3M euribor futures



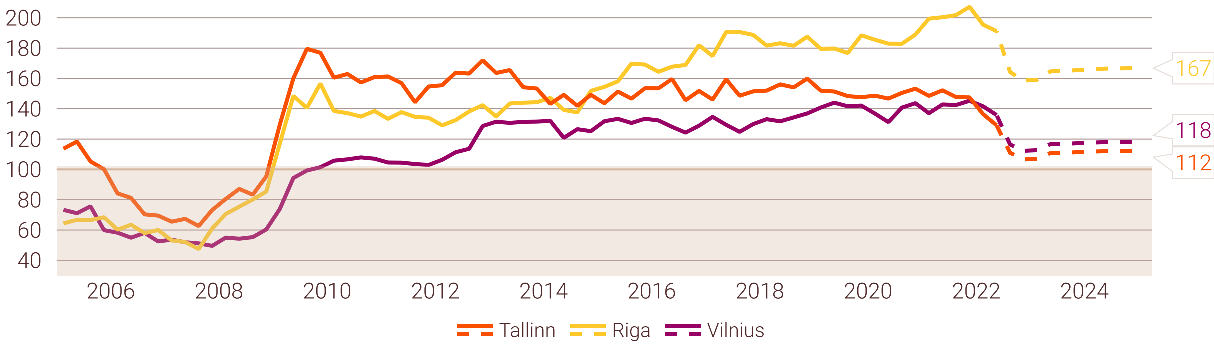
Sources: Swedbank Research & Macrobond

Monthly mortgage payment
New loans only, market scenario: 3M euribor



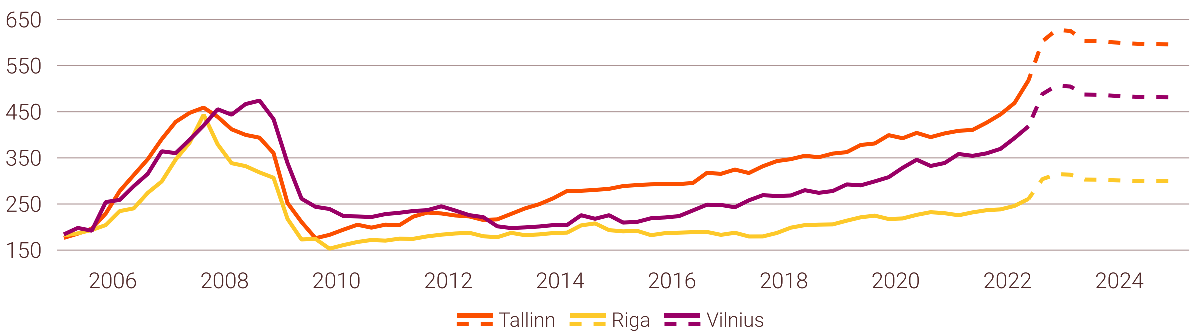
Sources: Swedbank Research & Macrobond

Baltic Housing Affordability Index
Swedbank 6M euribor forecast



Sources: Swedbank Research & Macrobond

Monthly mortgage payment
New loans only, swedbank scenario: 6M euribor



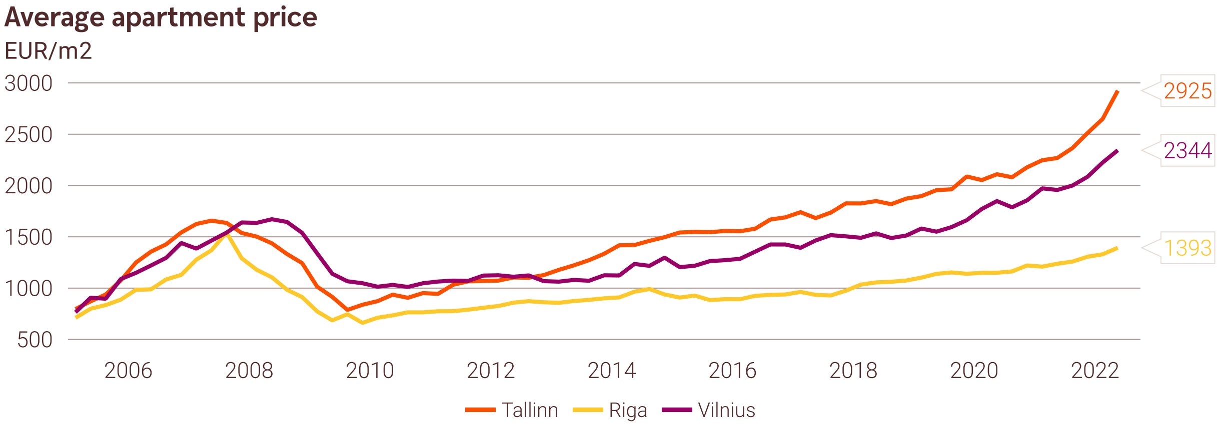
Sources: Swedbank Research & Macrobond

For more background information on interest rate analysis, please refer to housing affordability index Q1 2022.

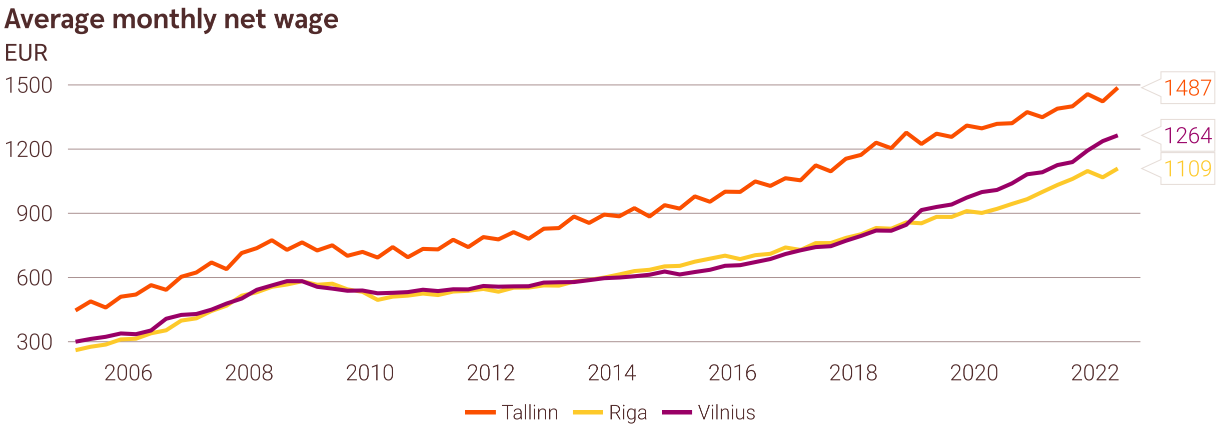
Appendix

	Tallinn, Estonia	Riga, Latvia	Riga, new-project and renovated apartments, Latvia	Vilnius, Lithuania
Average apartment transaction price, EUR/m2, y/y %	29.0	12.6		19.8
Annual percentage rate of charge for new mortgages to households, basis points	-16	0		-11
Average monthly net wage, EUR, y/y %	7.1	7.5		12.4
Months to save for a down payment, months	36.1	23	27.3	34

Sources: Swedbank Research and Macrobond

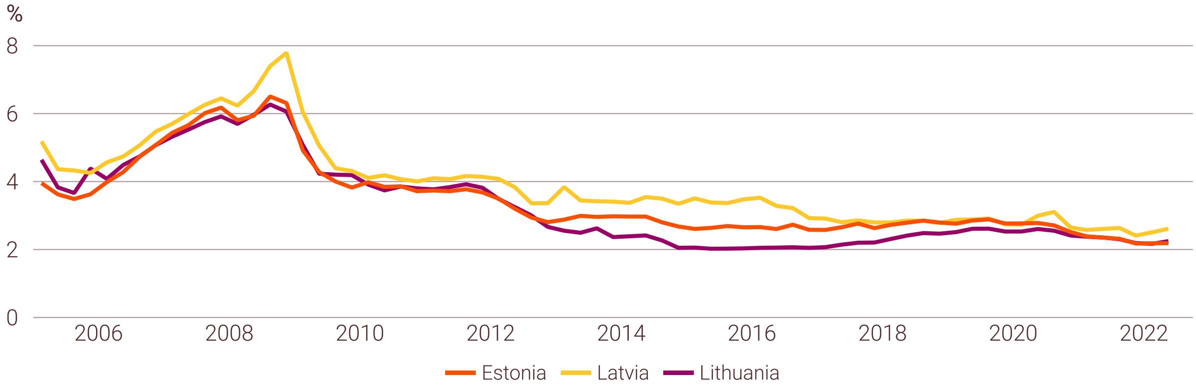


Sources: Swedbank Research & Macrobond



Sources: Swedbank Research & Macrobond

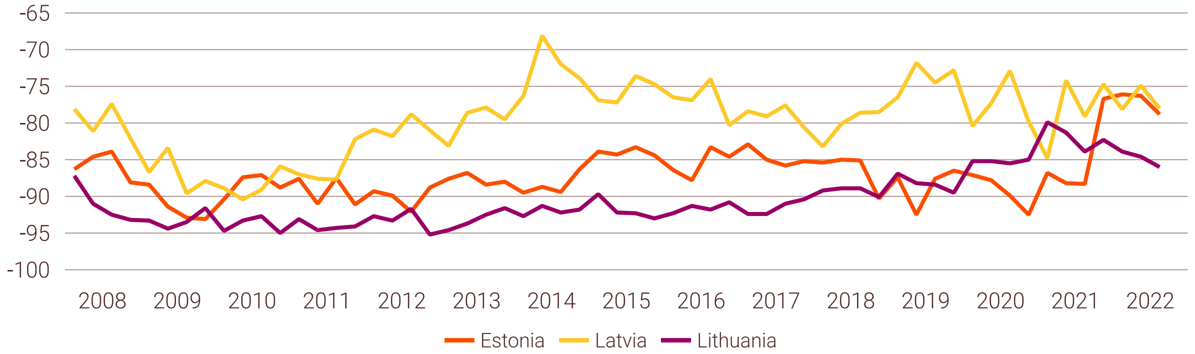
Annual percentage rate of charge for new mortgages to households



Sources: Swedbank Research & Macrobond

Consumer confidence to purchase or build a house

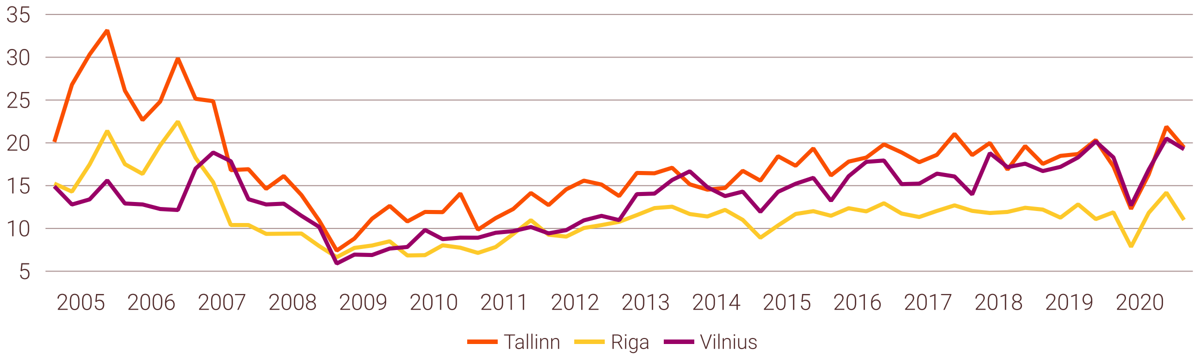
Baltics, over the next 12 months



Sources: Swedbank Research & Macrobond

Transaction activity

Transaction count per 10K residents, residential apartments



Sources: Swedbank Research & Macrobond

Baltic Housing Affordability Index: Methodology

Objective

The Baltic housing affordability index (HAI) measures the degree to which households can afford buying an apartment with a mortgage loan in the Baltic capitals.

Norm (the main assumption)

Household monthly mortgage payments do not exceed 30% of household income.

Variables

- Average apartment price per m^2: three-month average apartment transaction price per m^2 in Baltic capitals.
- Household income: 1.5 of average monthly net wages in Baltic capitals.
- Mortgage interest rate: three-month average annual percentage rate of charge (including interest rate and other related charges) for new housing loans to households, issued in euros, in the Baltics.

Other assumptions

- Average apartment size: 55 m^2.
- Down payment: 15% of total apartment price.
- Term: 30 years.
- Saving rate for down payment: 30% of household income.

Calculation of HAI

The HAI shows actual household income in relation to the income that meets the norm. Thus, if the HAI equals 100, a household uses 30% of its income to service mortgage payments. If the HAI exceeds 100, the household has higher income than required to satisfy the norm. And if the HAI is below 100, the household does not have sufficient income to fulfil the norm.

$$HAI=\frac{AverageINC}{NINC}\times 100\,,\ \text{where } NINC=\frac{PMT}{30\%}$$

where AverageINC – household income;
NINC – household income that satisfies the norm; and
PMT – monthly mortgage payment.

HAI of new-project and renovated apartments

The calculation of HAI of new-project and renovated apartments for Riga is intended to improve the comparability of affordability levels across the three capitals because it considers new-project and renovated apartments – types of apartments more commonly purchased in Tallinn and Vilnius. It takes into account housing affordability in newly built and renovated apartments (i.e., those done after 2000 outside the city centre).

All variables and assumptions, except for the average apartment transaction price, remain the same. That is, for the calculation of HAI for new-project and renovated apartments, the average apartment transaction price of newly built and renovated apartments (i.e., those done after 2000) outside the city centre is used.

The new index and associated apartment price variable are represented by a yellow dashed line in the graphs of the report.

Limitations

The HAI provides an indication of the average household situation, not that of a particular household. Household income and mortgage interest rates faced by a particular household may differ from those presented in the report. The HAI accounts for mortgage costs but excludes taxes and subsidies, including property tax and interest deductions. It also does not consider other household expenses that could affect the household's ability to service mortgage payments, such as rent, lifestyle, or existing liabilities. The HAI does not provide any direct guidance for business decisions, including lending and interest rate decisions.

The average apartment price per m^2 reflects past transactions and does not necessarily indicate the potential affordability or price of apartments in the future. Differences in apartment segment structure and the physical condition of newly built apartments at the time of purchase might affect the comparability of the average apartment price per m^2 across the Baltic capitals.

The HAI is of an informative nature and reflects macroeconomic developments, rather than banks' decisions and lending policies or the potential behaviour of individual households.

Change of data

A data revision was made in the fourth quarter of 2019 for Riga. The history of wages, prices, and transaction counts was changed in 2011.

Frequency

Quarterly.