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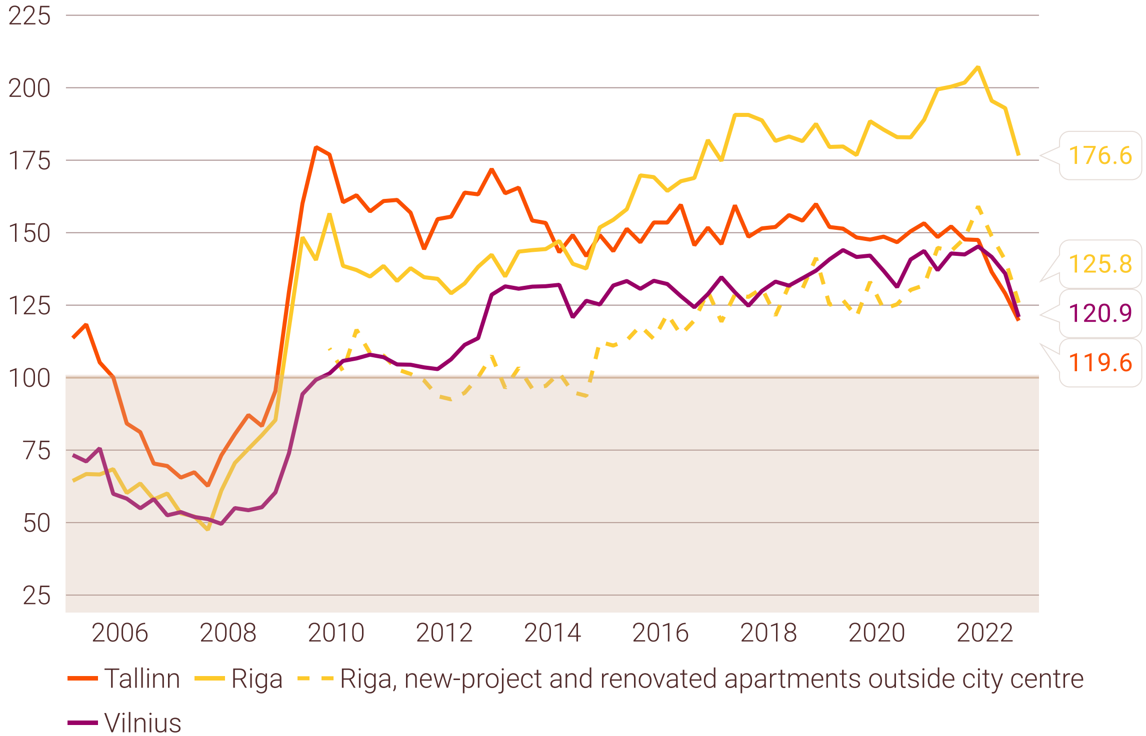
Baltic HAI – higher prices and interest rates dent housing affordability

Buyers are pulling back from the real estate market

Baltic Housing Affordability Index



Sources: Swedbank Research & Macrobond

In the third quarter, housing affordability dropped sharply in all three capitals. Despite quite-fast wage growth, increasing apartment prices and surging interest rates dragged housing affordability down. As the primary market transactions are not fully reflected in the statistics yet, the actual HAI is lower, in some cases indicating that at least in primary market apartments are often unaffordable already.

Record-high inflation and higher interest rates are increasing the financial burden on households. As debt service has become more expensive and fears of recession have dented consumer confidence, the demand for housing has started to diminish. Buyers are more cautious and have paused purchasing – sales in the secondary market are falling, while the primary market has started to cool as new reservations have slumped.

On the supply side, real estate developers are displaying more caution and waiting for stronger demand. By contrast, secondary market prices have started to come down on a monthly basis. The first half of the year experienced a surge of housing demand from Ukrainian refugees; some of it is reversing now and reducing the tightness in the secondary market.

Overall, market activity will likely be subdued over the next 12 months. Low demand and higher rates should lead to a moderate price correction of 5-10% next year.

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First signs of upcoming price correction

Lower affordability leads to reduced housing demand

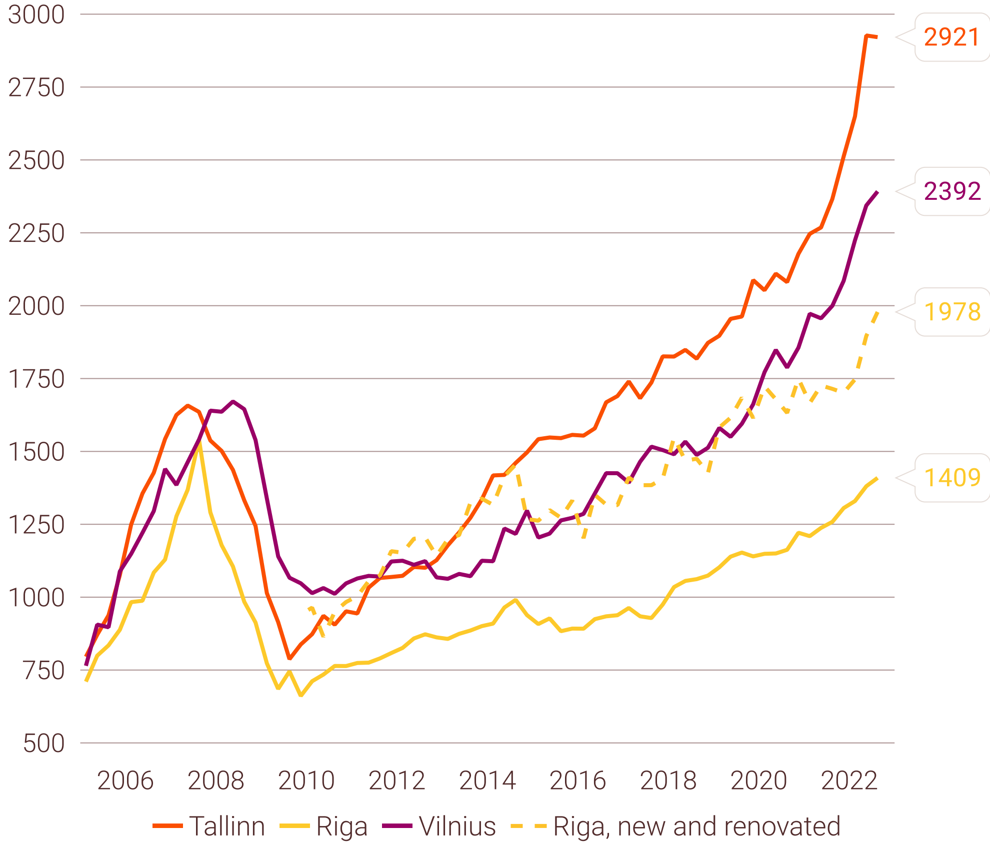
In Tallinn, annual apartment price growth slowed to 23%. Skyrocketing prices have led to a sharp fall in housing affordability, while the rising euro interbank offered rate (Euribor) has started to kick in. Meanwhile, soaring inflation has been eroding household real incomes for the past year. The previously euphoric activity on the housing market has been replaced by caution. Transaction numbers in the secondary market have fallen, while flat reservations in the newly built segment have almost stalled, like at the start of the pandemic. The supply has considerably increased, mainly in the secondary market, while developers are more cautiously introducing new projects. In October and November, prices of older flats were down on a monthly basis.

In Riga, the average apartment price increased by 12% over the year. Activity in the housing market weakened and transactions fell by 6%, compared to a year ago, likely due to cost-of-living shock, higher interest rates, and weaker confidence. The activity fell in both the primary and the secondary market. Moreover, it seems that the buyers have become less interested in the pre-sales of apartments still under construction. The price growth in the coming months will likely be backed by earlier pre-sales of new apartments as construction works are completed and the sales are finalized. Older Soviet-era apartments became less attractive due to their low energy efficiency. With the prospect of rising energy bills, more owners were interested in selling them quickly - prices were decreasing month over month.

In Vilnius, official data recorded nearly a 20% increase in the average apartment price, as more expensive primary market deals were finalised. However, market activity is falling, and the demand shock from refugees is waning. The inflow of Ukrainians has stopped, and we even see some reversal in migration trends, resulting in a drop of demand for housing in the capital. Data from online postings suggest a rapid fall of rent prices, while apartment prices remain stable for now. Higher rates and prices make housing unaffordable to some households, dampening demand and stifling market activity. Current rent yields suggest that apartments are overpriced by at least 10% in Vilnius; we expect prices to correct over the next 12 months.

Average apartment price

EUR/m2



Sources: Swedbank Research & Macrobond

Wage growth remains rapid

Real wages are falling due to high inflation

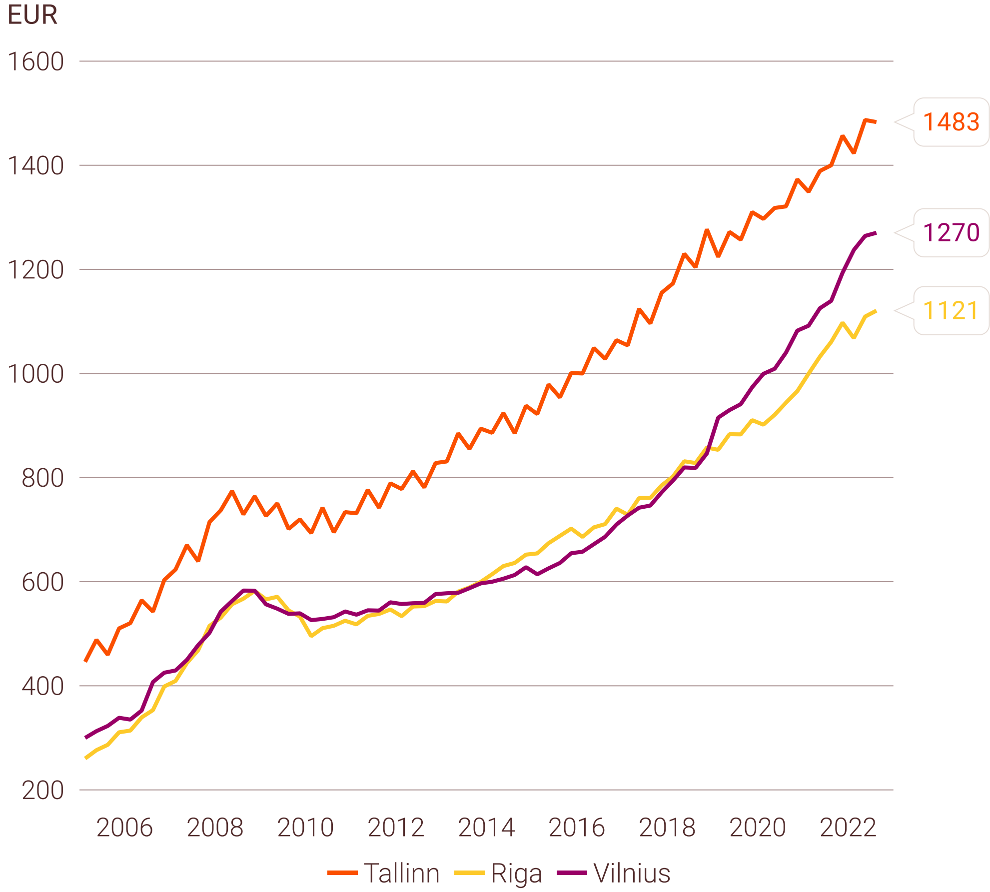
Net wages increased by 5.9% in Tallinn and 5.7% in Riga compared with a year ago. In Vilnius, wages kept growing at double digits – by 11.5% on average.

Wage growth was still mainly driven by labour shortages, which are fading but remain a problem--at least in some sectors. Real wages fell this year, and employees might try negotiating higher wage increases, although their success is not certain. The slowing economic activity should weaken the negotiating power of workers. However, governments in all three Baltic countries decided on generous minimum wage increases, which will keep nominal wage growth elevated despite slower economic growth. Next year, we expect gross monthly wage growth to be around 8-9% in all three Baltic countries.

Wage growth lagged house price appreciation this year and led to falling housing affordability. This dynamic will reverse next year – housing prices are likely to fall, while net wages are set to grow quite quickly. However, affordability will be dragged down by the rising interest rates. The housing affordability index (HAI) is likely to move sideways as interest rates will continue increasing, but wage and housing price ratio should improve.

In the Baltics, flexible interest rate contracts dominate, and rising interest rates affect household disposable income almost instantaneously. Despite this, the household leverage ratios are low: household debt as a share of GDP is around 15-30% in the Baltics, compared to 50% in the euro area. A significant share of transactions is completed without loans. Due to these factors, housing markets in the Baltics are less sensitive to increases in interest rates, but the negative sentiment is likely to weigh on activity going forward.

Average monthly net wage



Sources: Swedbank Research & Macrobond

Market activity has normalised

Sales are likely to fall further

The activity on housing market weakened. Falling affordability and very low consumer confidence led to a decrease in housing demand. The past several quarters saw unusually high market activity due to the post-pandemic boom and influx of refugees. In the third quarter, sales fell to pre-pandemic levels; they are likely to deteriorate further.

While official registry data on primary market transactions are very lagging, there is a clear fall in primary market activity. Developers have been reporting very low numbers of new reservations for a few months now.

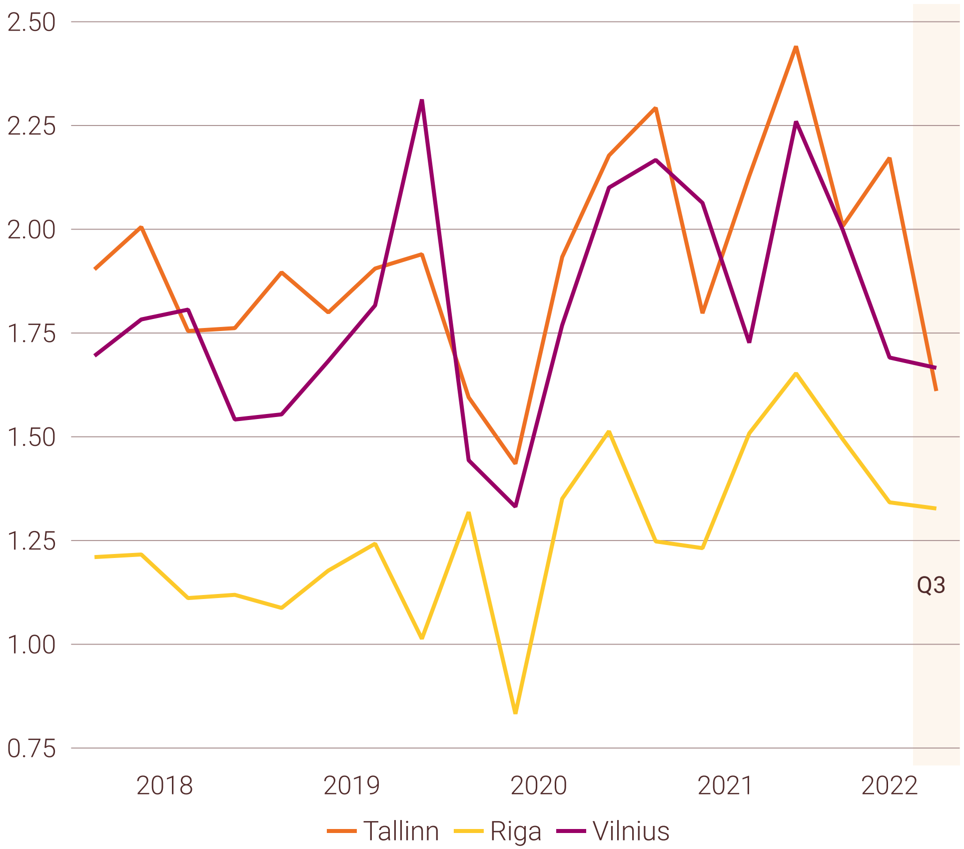
On the other hand, prices in the primary market might prove quite sticky. The supply of finished inventories is still very low, especially in Vilnius and Tallinn. Real estate developers are in a decent financial position to hold onto unsold apartments without cutting the prices. Nonetheless, smaller developers might start offering discounts quite quickly to meet their financial obligations. It seems that developers expect the slump to persist.

The secondary market is more responsive right now. We see not only a lower demand due to lower housing affordability but also an uptick of supply. Higher rates lead to a decrease in speculative demand. Some apartments that were held for renting might end up being sold as the costs rack up. Used apartment prices started falling on a monthly basis in the Baltic capitals.

We might also see a change in consumer tastes across market segments. The pandemic recovery period favoured larger apartments that can accommodate comfortable working from home. Now, with high energy prices, smaller apartments with greater energy efficiency are likely to be in high demand.

Transaction activity in Baltics

Transactions per 1000 residents



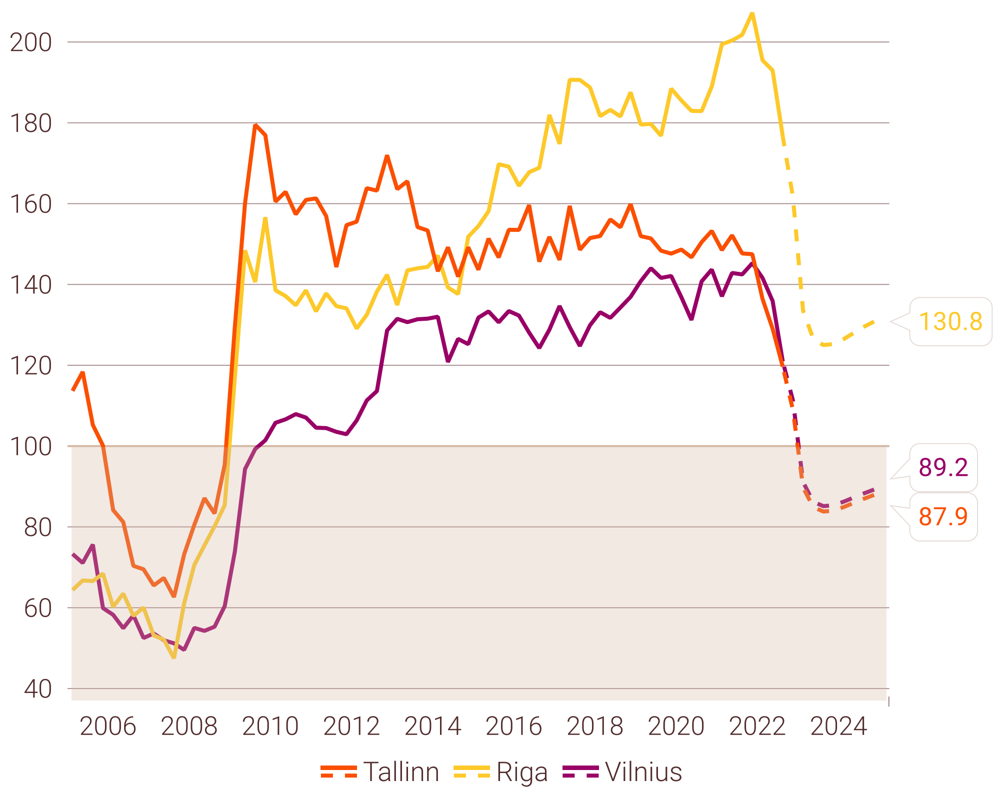
Sources: Swedbank Research & Macrobond

Rising interest rates can make housing unaffordable for more households

Rising mortgage-servicing costs will reduce new lending

Baltic Housing Affordability Index

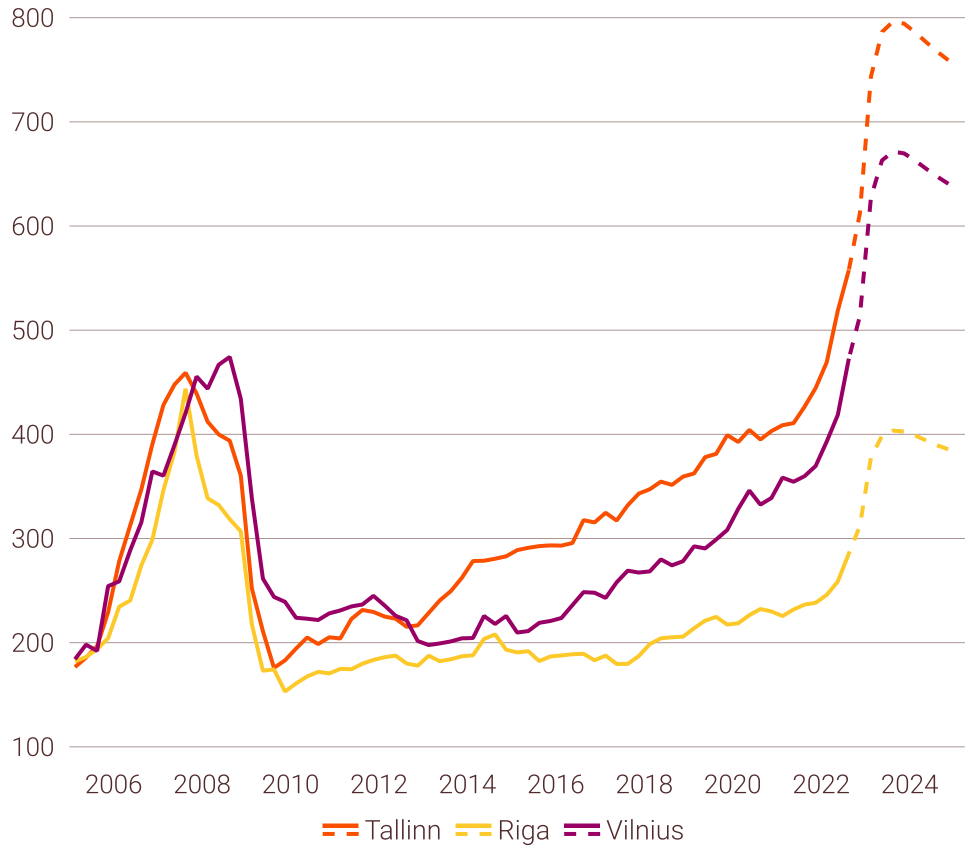
Market expectations scenario: 3M euribor futures



Sources: Swedbank Research & Macrobond
Note: Actions taken by the European Central Bank will raise the euro interbank offered rate (Euribor). The scenario assumes all variables constant, except the interest rate.

Monthly mortgage payment

New loans only, market scenario: 3M euribor



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.

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

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., 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., 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.

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