Housing Affordability Index: Q4 2022

Rising interest rates put pressure on the housing market

- Apartment price growth and rising interest rates dealt a blow to housing affordability
- More homebuyers are priced out of the primary market

Housing affordability fell sharply in the Baltic capitals as climbing interest rates increased the cost of mortgages. On top of that, apartment price growth exceeded wage growth. In the fourth quarter, housing affordability index (HAI) values slipped to 110.5 and 107.0 for Tallinn and Vilnius respectively. Housing was still affordable (HAI above 100), but affordability was the lowest in more than a decade. Riga boasts the most affordable housing among the Baltic capitals, but its HAI also plunged from a record-high 207.2 in late 2021 to 164.3 in the fourth quarter of 2022.

The impact of lower affordability is clearly visible in lower apartment sales. Sales in the Baltic capitals were weak in the second half of 2022. Moreover, households are less keen to reserve apartments that are still under construction, which suggests that market activity will remain muted. It will likely remain subdued for at least as long as interest rates are on an upward trend. We forecast that housing prices in the Baltics will remain stable or slightly decline. The price correction will come from the secondary market. The prices in the primary market likely will not budge much, given the elevated construction costs and relatively sound financial position of real estate developers.

We forecast that the ECB will hike rates two more times in May and June and the ECB deposit rate will reach 3.5% and stay there until the end of the year. This will further lift mortgage rates and weigh on housing affordability, despite some apartment price correction and stable average wage growth. We expect that housing affordability will continue to deteriorate across the Baltics in the first half of the year. In fact, an average household is already no longer able to afford an apartment in the primary market in Tallinn or Vilnius. If prices and interest rates stay where they are, wage growth alone will be sufficient to lift affordability by the end of this year. Building tensions in financial markets are capping further interest rate increases; thus, we are likely close to the nadir of affordability.

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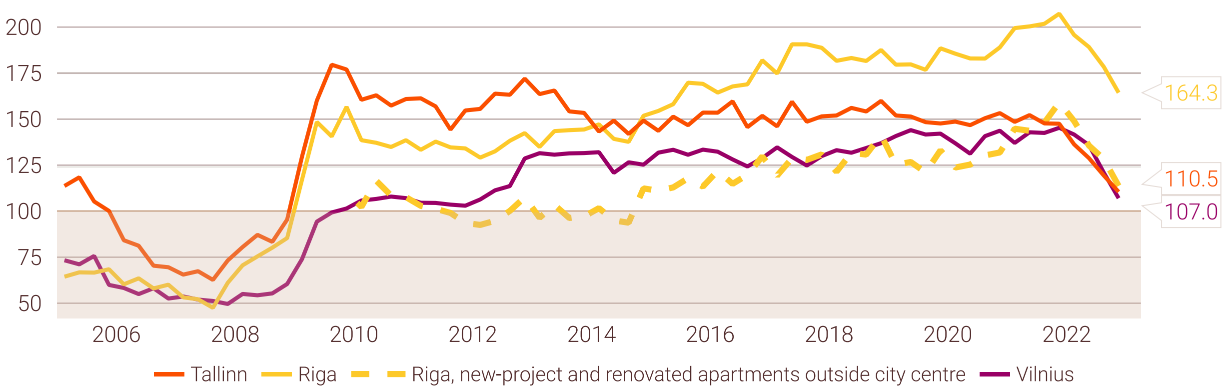
Baltic Housing Affordability Index



Sources: Swedbank Research & Macrobond

Example: A housing affordability index value of 107.0 means that the average net wage of a household is 7% higher than minimally required to afford a 55 m2-large apartment.

Tallinn – housing market is looking for a new equilibrium

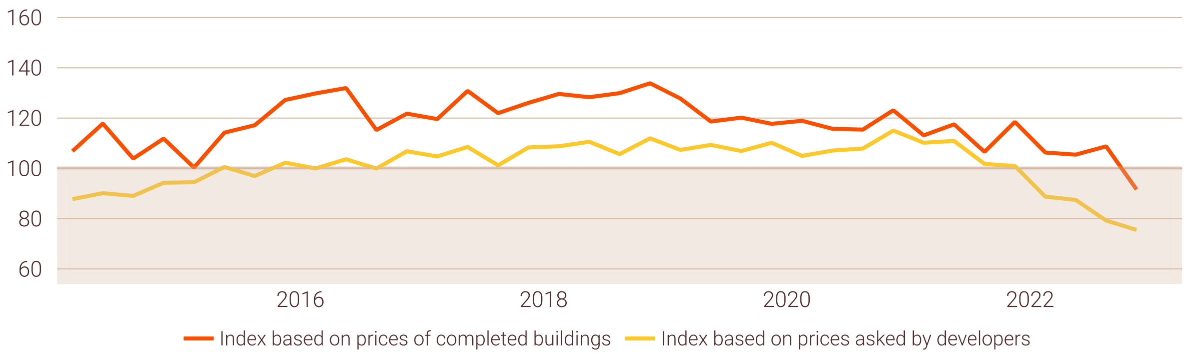
A sharp fall in housing affordability, led by rising interest rates and overvaluation of housing prices, and a decreased purchasing power due to abnormal inflation have cooled activity in the Tallinn housing market. Although the housing market has previously been hot, this has not resulted in excessive leverage, and there is no pressure for quick sales, at least for now. However, rebalancing in the market will bring a moderate price correction this year.

Transaction numbers fell by one-third in the last quarter of the year. At the same time, the secondary market saw an over 40% decrease in transactions from the elevated activity level of a year earlier. Compared with the same time frame of the pre-pandemic 2019 year, activity with secondary market apartments was around one-fifth lower. While new developments reserved about a year ago were finally completed and handed over to buyers, reservations on the primary market continued to be subdued. Compared with the 2019 year on average, reservation numbers were still almost five times lower at the end of last year. This situation has also somewhat increased the stock of new developments offered, while new projects are being introduced cautiously.

Despite the sharp decline in housing demand, the annual price increase was 20% in the fourth quarter, as the official registry data are lagging. Meanwhile, prices in the secondary market were 5% down on a quarterly basis. In the fourth quarter, prices of new apartments asked by developers remained at the level of the third quarter. However, offers included some extras, e.g., a free kitchen or compensation of utility bills, which do not reflect directly in price statistics. The pressure to make substantial discounts remains low, as the financial position of developers is strong; however, some discounts to attract potential buyers are not being ruled out.

Tallinn Housing Affordability Index

New developments



Sources: Swedbank Research & Macrobond

Housing affordability will remain downbeat this year, since the rising euro interbank offered rate (Euribor) is increasing borrowing costs. As the excess demand has been wiped off and policy tightening makes households think twice before making a purchase decision, housing is on the road to price correction.

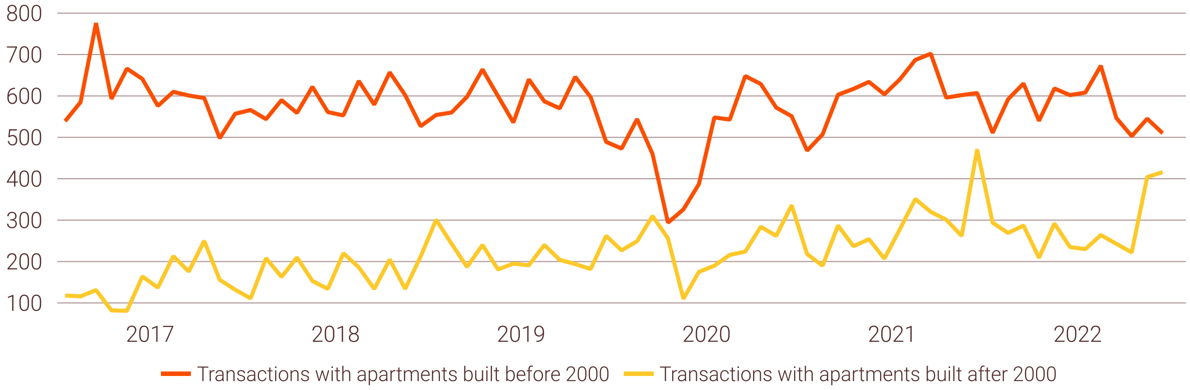
On the bright side, wage growth is keeping strong, while inflation is easing. In the second half of the year, we expect real wages to gradually start growing. Based on market expectations, the Euribor should reach its highest point in the second half of this year. Affordability should start recovering, and activity might start rebounding already in the second half of the year, on the back of an improved apartment price-to-wage ratio and a gradual decline of the Euribor rate.

Riga – housing is still affordable, but buyers are more careful

In 2022, high living costs, elevated real estate prices in some segments, and climbing interest rates depressed consumer confidence and households' willingness to purchase or build new apartments/houses. As a result, housing market activity continued to decline in the final quarter of 2022.

In the fourth quarter, the total number of transactions fell by 8.7% over the year; however, this was still higher than before the pandemic. At the same time, transactions with new or renovated apartments significantly increased. However, this was a short-term effect, as the surge in activity simply reflects transactions with previously made reservations. These reservations of newly built apartments were made well in advance, but construction was not completed until the end of the year. However, in 2022 overall, fewer transactions with new or renovated apartments were registered than a year before. Moreover, the number of new reservations has notably decreased over the past year.

Transactions in Riga



Sources: Swedbank Research & Macrobond

In the fourth quarter, average apartment price growth moderated to 7.5% year on year. Price growth was primarily driven by new-project or renovated apartments, those built or renovated after 2000, while the price growth of older apartments almost came to a halt. Prices of Soviet-era apartments trended down throughout the second half of 2022. The average price of these apartments in the fourth quarter was up by a meagre 0.4% from a year ago. These apartments have been losing their attractiveness already for several years, with the recent rise in energy prices and, hence, greater heating costs, accelerating this trend. Price correction in this segment is possible, as demand remains sluggish in 2023. However, Soviet-era apartments remain considerably cheaper than alternatives, so they still accounted for about 57% of total transactions in 2022. At the same time, the prices of apartments built or renovated after 2000 and located outside the city centre increased by a whopping 19.3%. Rapid price growth, along with higher mortgage rates, has made the new-project and renovated apartments notably less affordable.

In the fourth quarter of 2022, housing affordability declined. Average net wage growth stood at 6.4% in Riga, failing to keep up with apartment price increases. Furthermore, higher interest rates made mortgages more expensive. As activity continues to be subdued, prices are likely to decline, at least in the secondary market. Prices in the primary market will remain elevated, as construction costs are still high, and developers have implemented construction approaches to improve the sustainability of buildings. The average price-to-income ratio will start to improve as wage growth overtakes apartment price growth. Moreover, as inflation retreats, the purchasing power of households will start to edge up in the second half of the year. Nevertheless, housing affordability will be depressed by higher interest rates and continue declining, at least through the first half of the year.

Vilnius – lower affordability suppresses market activity

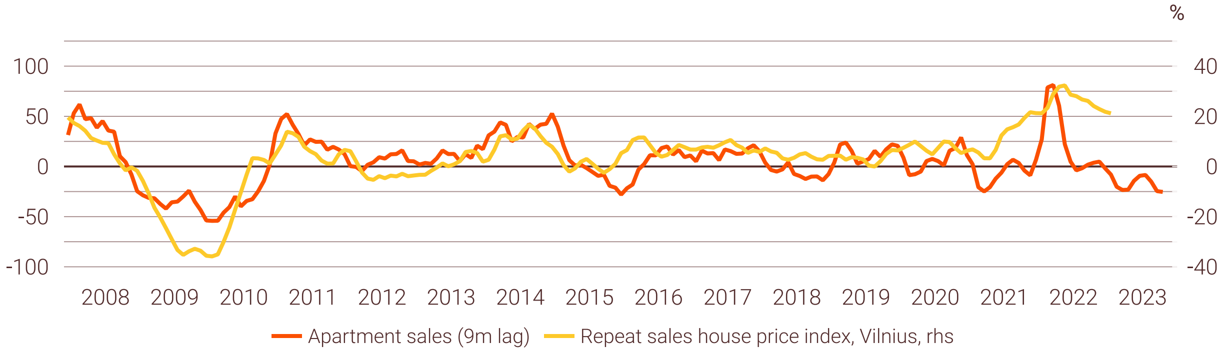
The housing market has entered a period of uneasy calm. Rapid apartment price growth and the steep increase in interest rates have dampened demand, and, as a result, market activity has fallen below the pre-pandemic level. Currently, prices are stable, as market participants have a strong-enough financial position to wait the market slump out. Nonetheless, a moderate price correction is in the cards.

An array of factors suppressed market activity at the end of 2022. First, the pent-up demand that characterised the market in 2021 was gone. Another boost to the housing market was the inflow of refugees; the spike in rental demand spilled over into the housing market briefly, but the effect waned by the fourth quarter. Finally, the past price increases and current sharp moves in rates made apartments less affordable, and some households were priced out of the market. Secondary market activity is currently 20% below pre-pandemic levels, and real estate developers reported very slow reservations in the autumn; however, it seems that interest in housing has rebounded a bit recently.

Despite falling market activity, annual price growth in Vilnius is still elevated, at nearly 19%. Most of the price increase happened during the first half of 2022, and official registry data have been quite lagging. More timely price indicators show that apartment prices have been moving sideways since September. Monthly price data are volatile, but secondary market prices fell in both December and January. It is unclear, though, if this signals the beginning of a broader trend.

Drop in sales often foreshadows falling prices

y/y %



Sources: Swedbank Research & Macrobond

Monetary policy tightening is quickly passed through in Lithuania due to the prevalence of variable interest rate mortgage contracts, and rising rates are the primary reason for falling housing affordability. In the last quarter, average mortgage rates on new business stood at 4.2% and are rising higher as the ECB continues increasing policy rates. Housing affordability has been dented by higher interest rates, but so far it seems that it is mostly deterring investors, not first-time buyers.

Usually, a fall in market activity is followed by a price correction with a lag of six to nine months. Currently, the market is quite resilient. While developers report returning customer interest, and mortgage applications are maintaining a decent level, some price correction is still likely. Nonetheless, nominal wages are expected to grow quite rapidly-- rates are expected to peak during the summer. These conditions, coupled with even a minor fall in prices, could spark some market recovery towards the end of 2023.

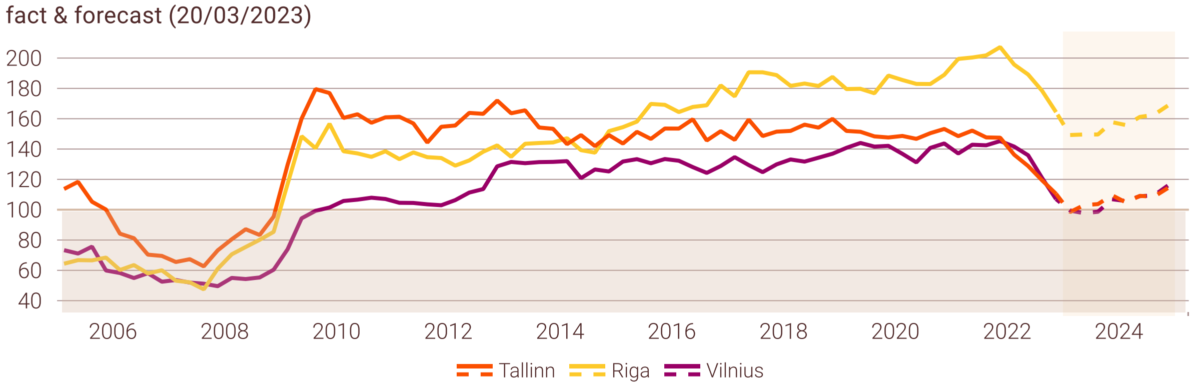
Baltic HAI: Additional analysis

Fight with inflation will further dent affordability

We forecast that housing affordability will worsen, with the HAI value likely dropping below 100 in Tallinn and Vilnius in the first quarter of 2023. Actions taken by the ECB will raise the Euribor higher and increase mortgage servicing costs in the Baltics. Mortgage rate forecasts are calculated taking into account the three-months Euribor futures extracted on 20 March 2023. We expect that wage growth will remain rather rapid at 7-9.5% in the Baltics, while apartment prices will likely see a mild and temporary contraction. As apartment prices level off, the ECB interest rate hiking cycle comes to a halt, the rising wages will lift the housing affordability towards the end of 2023 and in 2024.

Baltic Housing Affordability Index

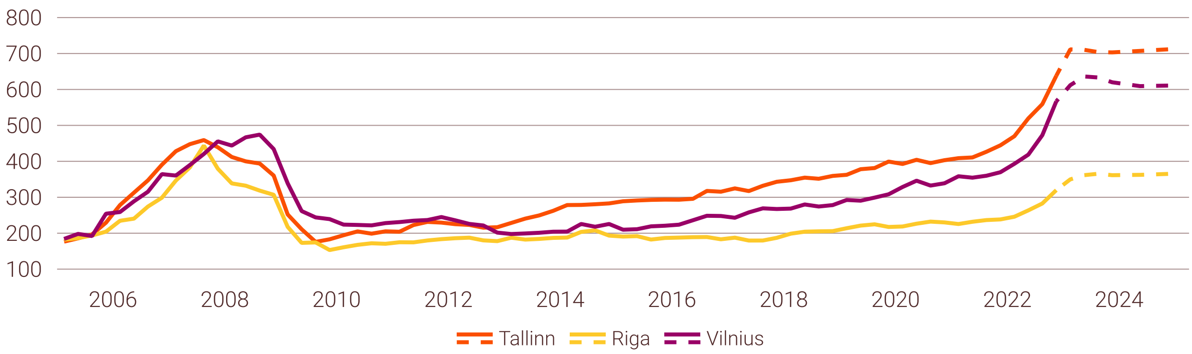
fact & forecast (20/03/2023)



Sources: Swedbank Research & Macrobond

Monthly mortgage payment

fact & forecast (20/03/2023)



Sources: Swedbank Research & Macrobond

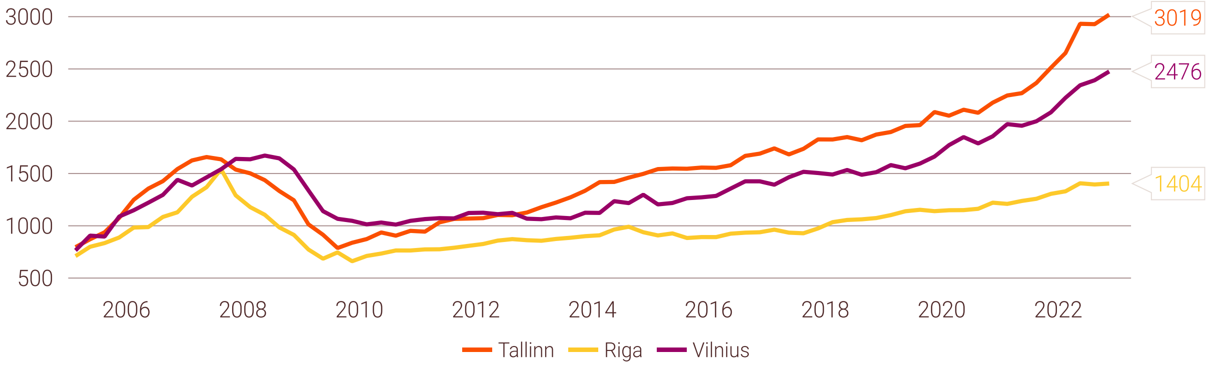
Appendix

	Tallinn, Estonia	Riga, Latvia	Riga, new-project and renovated apartments, Latvia	Vilnius, Lithuania
Average apartment transaction price, EUR/m2, y/y %	20.2	7.5	19.3	18.7
Annual percentage rate of charge for new mortgages to households, basis points	138	176		202
Average monthly net wage, EUR, y/y %	7.5	6.4		13.0
Months to save for a down payment, months	35.3	22	31.9	33.7

Sources: Swedbank Research and Macrobond

Average apartment price

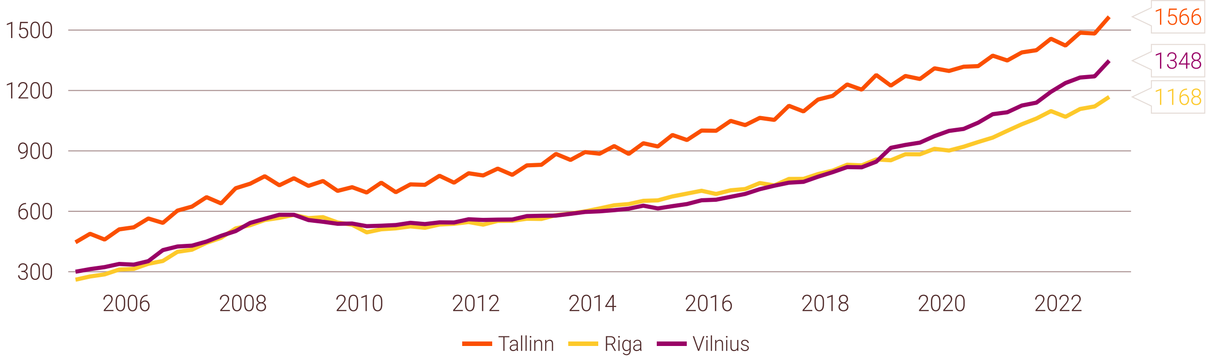
EUR/m2



Sources: Swedbank Research & Macrobond

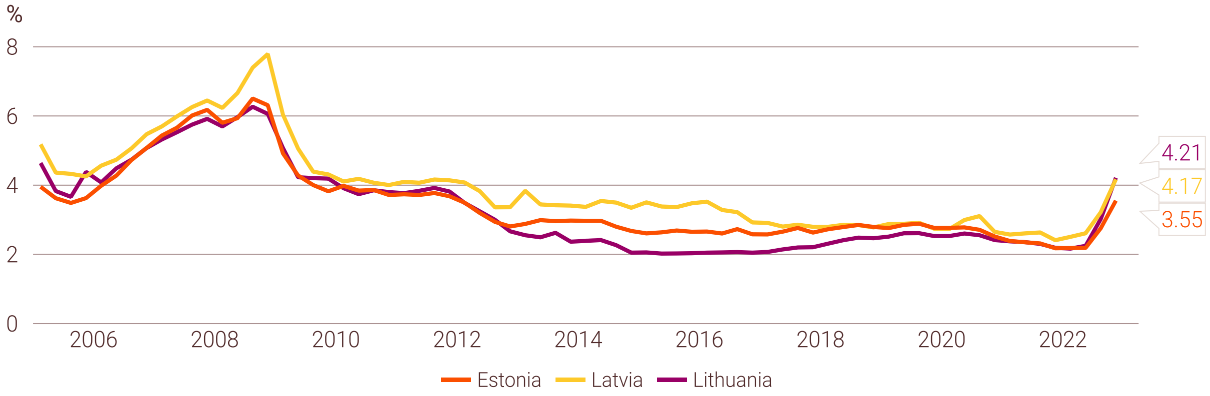
Average monthly net wage

EUR



Sources: Swedbank Research & Macrobond

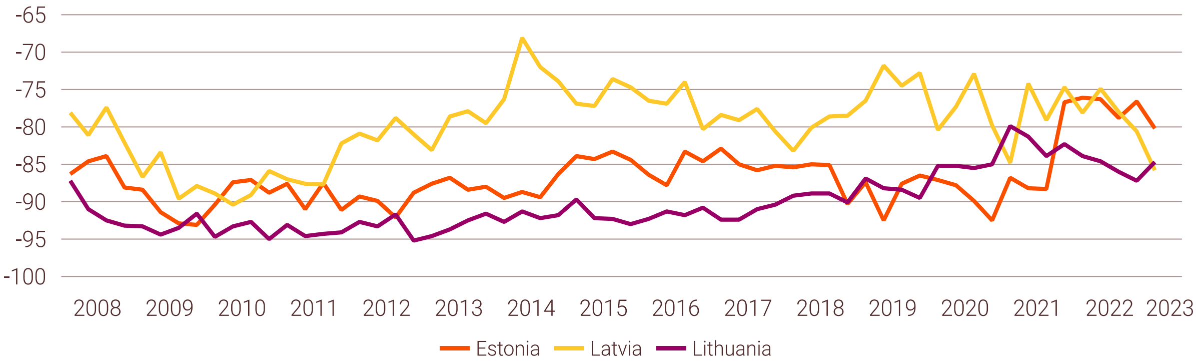
Annual percentage rate of charge for new mortgages to households



Sources: Swedbank Research & Macrobond

Consumer confidence to purchase or build a house

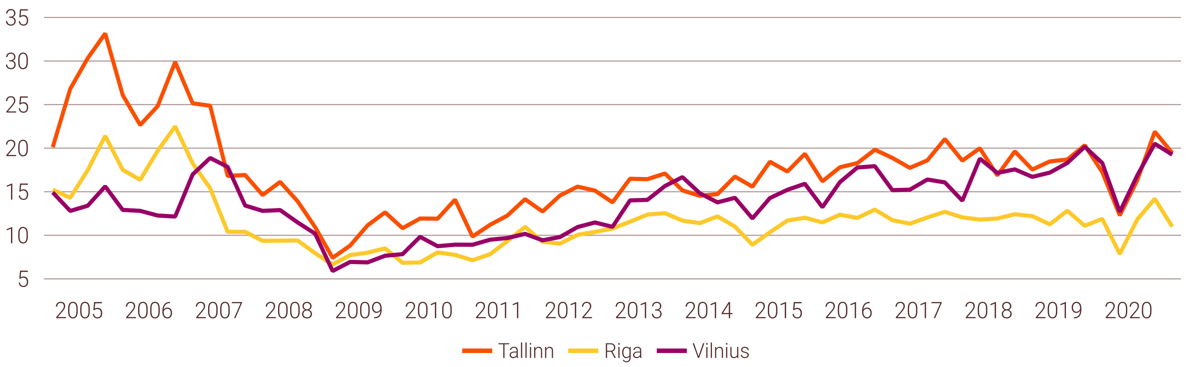
Baltics, over the next 12 months



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.

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

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.