Box 1

HOUSE PRICE DEVELOPMENTS IN CENTRAL AND EASTERN EUROPEAN COUNTRIES

In recent years many of the non-euro area EU countries in central and eastern Europe (EU9) have experienced rapid growth in residential property prices. The available data indicate that between 2004 and 2006 the average annual growth rate was over 30% in the Baltic countries, Bulgaria and Romania, and between 6% and 8% in Poland and Slovakia (see Chart A). Although the average figures mask some volatility in the growth rates over the years, and the available residential property price statistics are of mixed quality and are not fully comparable across countries,[1] these strong growth rates prompt questions as to their drivers, sustainability and macroeconomic implications.

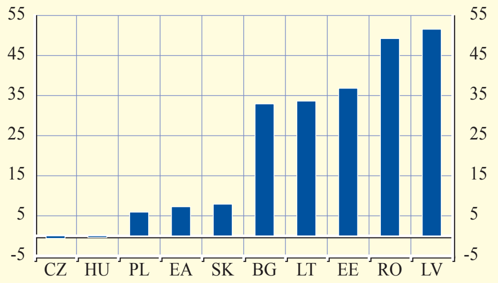
Given the usual rigidity of housing supply, demand factors play a key role in determining house prices in the short to medium term. Among these factors, housing financing seems to be of particular importance for the EU9 economies. In most of these countries mortgage instruments have in recent years become more widely available at lower cost and longer maturities, and on more flexible terms (such as lower amortisation requirements and higher loan-to-value ratios). This is attributable to the deepening of and increasing competition in the mortgage loan markets, reflecting both the low initial level of financial development and integration into the EU (see Chart B). Moreover, in many countries low nominal and real interest rates have prevailed, owing to improved macroeconomic stability and lower risk premia.

Other important factors are strong output growth, rising employment and higher income expectations. In addition, in several EU9 countries fiscal incentives, such as subsidies to

1 The residential property price indicators presented for the EU9 countries are based on non-harmonised national sources and differ in statistical quality. Consequently, they are not directly comparable across countries and may not cover the entire housing market in a given country. In particular, the figures for Bulgaria, Estonia, Hungary and Romania refer only to prices collected in capital or major cities. The available price data for Bulgaria, Hungary, Latvia, Romania and Slovakia relate only to existing dwellings. Furthermore, most series reflect average prices of pre-defined dwelling categories, and do not properly account for quality changes of the dwellings over time. This may be of particular relevance in the case of markets with large quality differences between old and new dwellings, and dwellings in different locations or regions. The changes in dwelling prices presented should therefore be analysed with caution.

Chart A Annual average growth of residential property prices in 2004-06

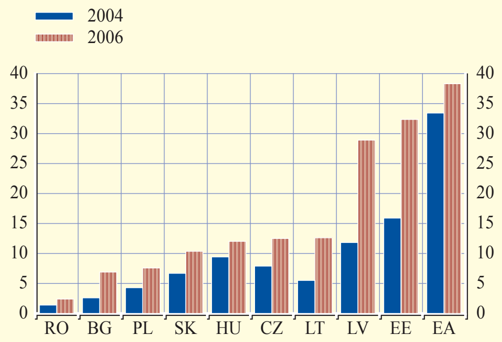
(annual percentage changes)



Source: ECB calculations based on non-harmonised national data.
Note: Data for the Czech Republic cover the period 2004-05. Figures for Romania are estimates provided by Banca Naţională a României. The euro area (EA) aggregate excludes Slovenia.

Chart B Outstanding loans for house purchase

(as a percentage of GDP)



Sources: ECB, Banca Naţională a României and Българска народна банка (Bulgarian National Bank).

saving, lower interest rates on mortgages, tax deductibility of interest payments and/or reduced property taxation, have also played a role. However, some of these measures have recently been curtailed.

In addition to the typical house price drivers referred to above, the EU9 countries have been exposed to several transition-specific factors.[2] In the past house prices in many of these countries were distorted owing to large-scale public/municipal ownership and rent regulations, which effectively contained prices below their market value. Thus, the recent price increases might to some extent be viewed as a correction of these distortions. Furthermore, strong demand for new houses may reflect the poor quality of the initial housing stock and the rapidly changing geographic concentration of economic activities. In some countries, in connection with EU entry, foreign demand for housing has increased, primarily in capital cities and holiday resorts. Moreover, there was a temporary boost to demand around the time of EU accession in some countries amid anticipation of higher house prices on account of hikes in the VAT rates on construction materials in the process of VAT harmonisation within the EU.

In the medium to longer run house prices are also determined by supply factors, especially by regulations in the housing markets. In several EU9 countries complicated spatial planning and construction procedures appear to have depressed supply.

One of the main channels through which housing market developments can affect the economy as a whole is the link with household consumption. Higher property prices may increase households' wealth and boost consumption, contributing to consumer price pressures. The impact on aggregate consumption is, however, not straightforward, since not all households are affected in the same way.[3] This depends, among other things, on whether a household owns a property and, if it wishes to sell, whether it intends to trade up or down (for instance, a household climbing the "housing ladder" may actually reduce consumption). Moreover, given data

2 See Égert and Mihaljek (2007), "Determinants of house price dynamics in central and eastern Europe," *Focus on European Economic Integration,* 1/2007, pp. 52-76.
3 See for instance ECB (2003), "Structural factors in the EU housing markets".

limitations for the EU9 countries, it is difficult to obtain reliable empirical evidence on this link. Property prices may also affect consumption via the credit channel, since residential property can be used as collateral for borrowing. A rise in the value of property may increase the collateral available to its owners. Although growing in importance, mortgage equity withdrawal instruments are relatively rare in the EU9 countries, with few exceptions.

Housing market developments can also affect the economy as a whole via financial markets. Given the strong growth of loans for house purchase, an increasing part of financial intermediaries' assets in many EU9 countries has become linked to residential real estate values. It is difficult to assess to what extent this reflects a catching-up development and to what extent this may be excessive lending. Although average household debt levels are still relatively low in several countries (see Chart B), rising interest rates may be negatively affecting the balance sheets of households. The interest rate channel may be particularly important in Hungary, Poland and the Baltic countries, where the vast majority of mortgage loans are at a variable rate. An additional risk stems from the fact that in some EU9 countries a significant proportion of household loans are denominated in foreign currency, exposing borrowers to exchange rate shocks and challenging the effectiveness of monetary policy in controlling credit growth. Moreover, there may be a risk of deteriorating credit standards. In some countries loan-to-value and loan-to-income ratios have increased, making banks and households more vulnerable to falls in property prices and adverse shocks to income and interest rates.

Given the potentially important spillovers from the housing market to the rest of an economy it is important for central banks to monitor house prices and mortgage developments, analyse their main drivers and identify any misalignments. To this end, reliable statistics are of key importance, an area in which further efforts are urgently required. The link between the housing market and financial stability necessitates close monitoring of the mortgage loan markets and, where necessary, the adoption of appropriate prudential measures on the part of regulatory authorities. In addition, it is important that households in the EU9 countries become more aware of the risks when engaging in certain forms of mortgage borrowing, especially at variable interest rates and in foreign currency. These risks seem to be often underestimated by households. Finally, other relevant policy areas (such as fiscal incentives and housing market regulations) should be overhauled so as to alleviate housing price pressures.