

The Estonian Economy

Risks at the housing market

- Growth of house prices one of the fastest in Europe
- House prices have grown faster than households' incomes
- Surge in supply should slow future price growth

Growth of house prices one of the fastest in Europe

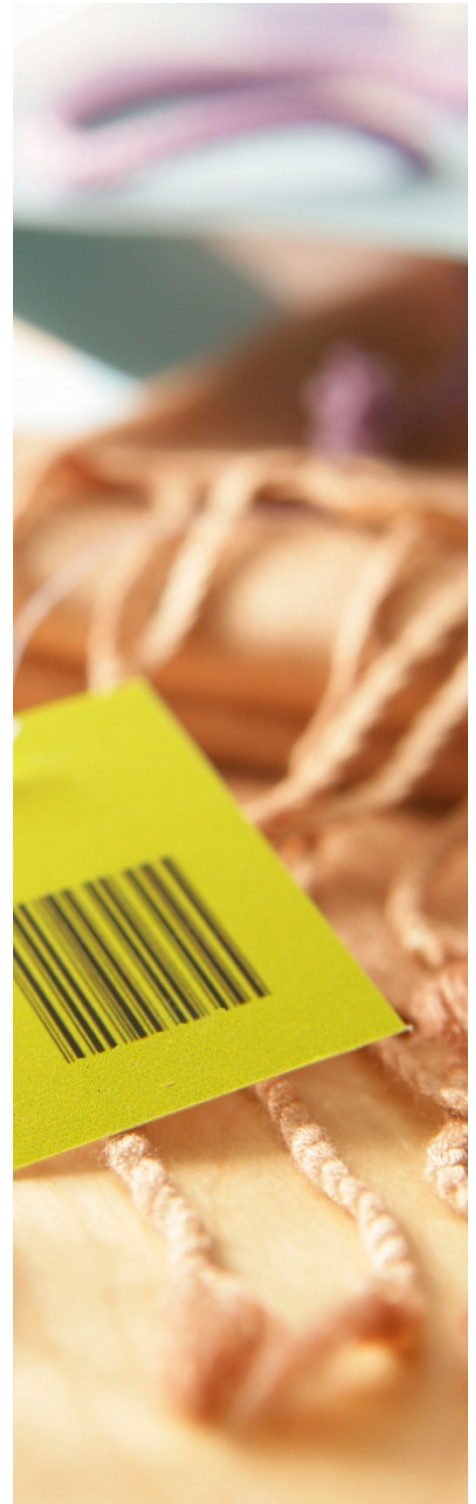
Of the 27 countries Eurostat has data for, Estonia has seen, since 2010, the biggest increase in dwelling prices. The prices of apartments (which amount to around 75% of all purchase-sale transactions in real estate) have increased the most, by around 11% a year since 2011. Higher incomes are enabling households to improve their living standards. Real estate is also an attractive investment option, as nominal interest rates for loans and deposits are very low and housing rents have increased substantially. Construction prices have also risen a bit since 2010, but much less than dwelling prices.

House prices have grown faster than households' incomes

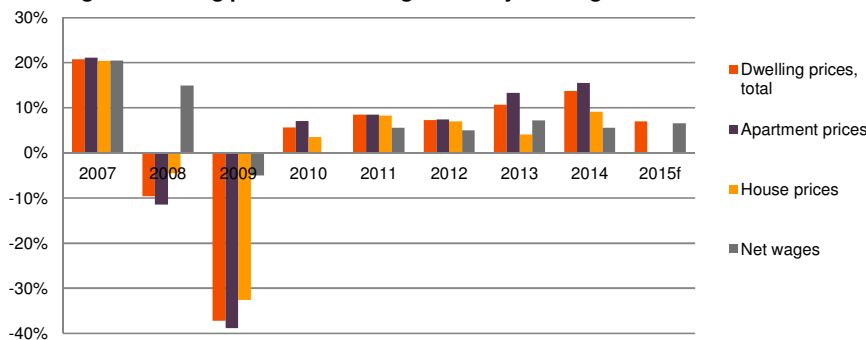
Since 2010, the prices of dwellings in Estonia have risen faster than average net wages. Since mid-2014, a fall in interest rates has improved housing affordability somewhat for those who wish to purchase a dwelling with a mortgage. Despite the fast increase in real estate prices, demand for housing has grown, and the number of purchase-sale transactions has been rising since 2012. Although demand for housing loans has increased in line with the rise in activity on the real estate market, the role played by the loan market has been smaller, and lending more conservative, than during the previous growth cycle.

Surge in supply should slow future price growth

Construction data show that the development of new dwellings has picked up in 2014-2015. A substantial number of new dwellings has reached or will reach the market soon. The larger supply should reduce the growth of real estate prices, especially in the apartments segment.



Change in dwelling prices and average monthly net wages



Source: Statistics Estonia, Swedbank forecasts

Liis Elmik
+372 888 7206, liis.elmik@swedbank.ee

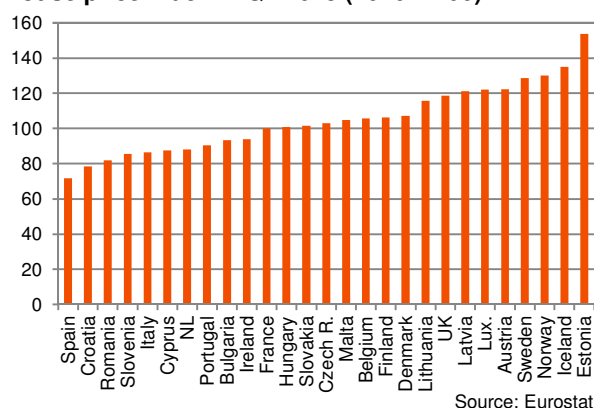
Risks at the housing market

The rapid growth of dwelling prices in Estonia, one of the fastest in Europe since 2010, has not been entirely justified. The role played by the loan market has been smaller than during the previous growth cycle, however. The development of new dwellings has picked up, and the substantially larger supply should reduce the growth of real estate prices.

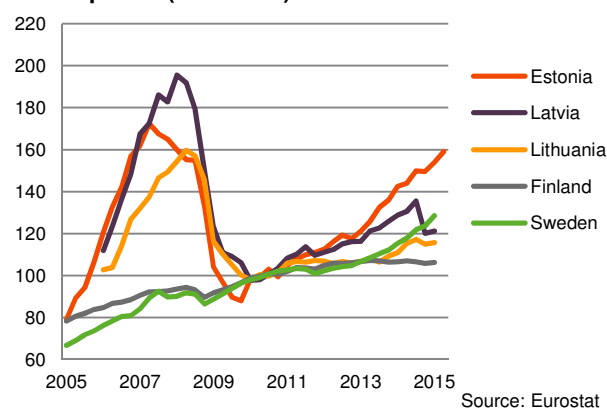
Growth of house prices one of the fastest in Europe

Of the 27 countries Eurostat has data for, Estonia has seen, since 2010, the biggest increase in dwelling prices.¹ In 10 countries in this data set, house prices were still below their 2010 level in the first quarter of 2015, while, in 16 countries, house prices were higher than in 2010. The largest increases in house prices took place in Estonia, Iceland, Norway, and Sweden. From a global perspective, house price growth in Estonia also stands out. Of the 64 countries in the world where data was available, the real growth in house prices² in Estonia over the past year was the fourth highest, after Qatar, Ireland, and the United Arab Emirates.³ House prices have also, since 2010, risen much faster in Estonia than in its neighbouring countries (see graph below).

House price index in Q1 2015 (2010 = 100)



House prices (2010=100)



In Estonia, the prices of apartments have increased faster than the prices of houses, and the prices of new dwellings have risen more than the prices of existing dwellings.⁴ In the second quarter of 2015, both apartments and houses were 10% cheaper than during their previous growth cycle's peaks – in the second and fourth quarters of 2007, respectively. Between 2011 and 2014, the prices of apartments (which amount to around 75% of all purchase-sale transactions in real estate) increased by around 11% a year, and the prices of houses by around 7% a year. In the first half of 2015, the annual price growth of apartments decelerated and the price growth of houses accelerated. In the second quarter of 2015, the prices of apartments grew by 10% and the prices of houses by 12%, compared with the same period one year before. In the apartments segment, in the second quarter of this year, price growth was faster in Tallinn (+11%, year on year) and other more populated areas (+9%, in areas bordering Tallinn, and Tartu and Pärnu cities), and slower elsewhere (+6%, over the year).

The increase in real estate prices has been mostly demand driven – higher incomes and savings are enabling households to improve their living standards or buy real estate as an investment in an environment of very low interest rates. From the supply side, an increase in

¹ The house price index measures price changes of all residential properties purchased by households (flats, detached houses, terraced houses, etc.), both new and existing, independently of their final use and their previous owners. Only market prices are considered; self-built dwellings are therefore excluded. The land component is included.

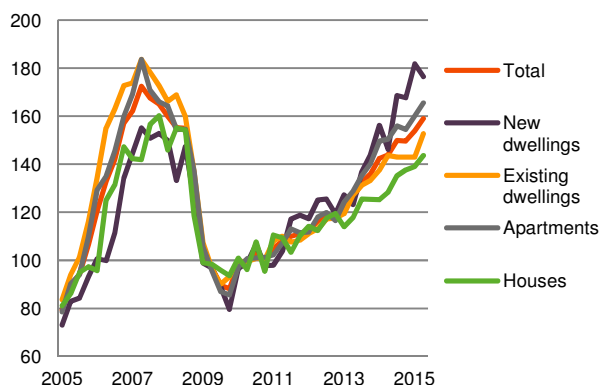
² The real house price index is the ratio of the house price index to the national accounts deflator for private final consumption expenditure. This indicator measures inflation in the house market relative to inflation in the final consumption expenditure of households.

³ Source: <http://www.imf.org/external/research/housing/>

⁴ Statistics Estonia categorises „new“ as new to the households' sector (i.e., purchased by a household from a company). Existing dwellings are dwellings transacted between households.

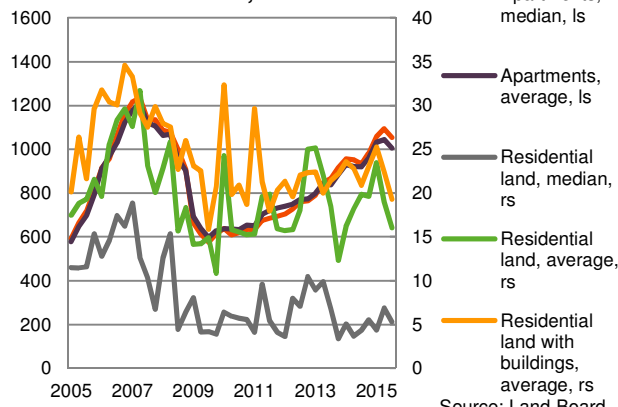
construction prices explains part of the rise in dwelling prices. In the second quarter of 2015, construction was 15% and dwellings 60% more expensive, on average, compared with the second quarter of 2010.

House prices in Estonia (2010=100)



Source: Eurostat

Prices of real estate, EUR/m²



Source: Land Board

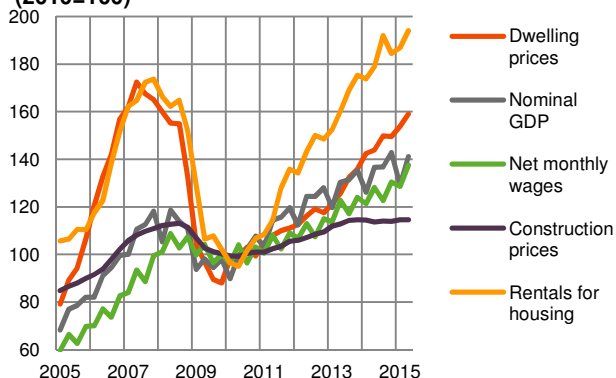
House prices have grown faster than households' incomes

There is no good indicator for assessing the appropriate or sustainable level of real estate prices. One can compare the development of dwelling prices to changes in households' incomes or purchasing power. In 2013 and 2014 (and probably also in 2015), dwelling prices in Estonia have risen faster than Estonia's nominal GDP or net monthly wages (which have, in turn, increased faster than labour productivity⁵). The growth in house prices relative to the growth in disposable income has, since 2010, been one of the fastest in Estonia among the OECD members (the OECD data set for 29 countries, including Latvia).⁶

Since 2010, the prices of dwellings have been rising faster than average net wages in Estonia; therefore, housing affordability for an average wage earner has worsened since then. Since mid-2014, a fall in interest rates has improved housing affordability somewhat for those who wish to purchase a dwelling with a mortgage. Despite the fast increase in real estate prices, the number of purchase-sale transactions has been growing since 2012, especially in the apartments' segment.

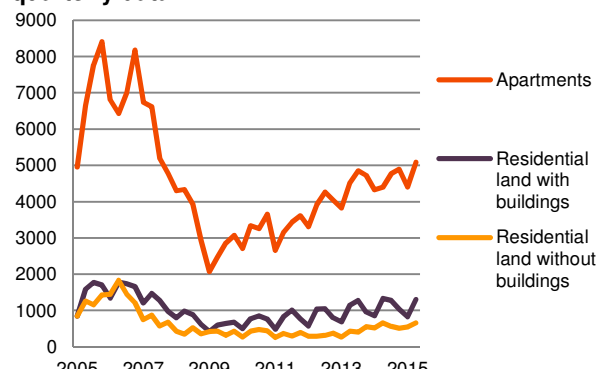
The ratio of house prices to house rents – another indicator used to assess the misalignment of property prices from fundamentals – shows that, since 2010, house rents have grown much faster than house prices in Estonia. The growth of rents is over-estimated here, though, as it is based on the rents of the most sought-after apartments only (rentals of one- and two-room apartments in the two biggest cities, Tallinn and Tartu).

Dwelling prices and other indicators (2010=100)



Source: Statistics Estonia

Number of purchase-sale transactions, quarterly data



Source: Land Board

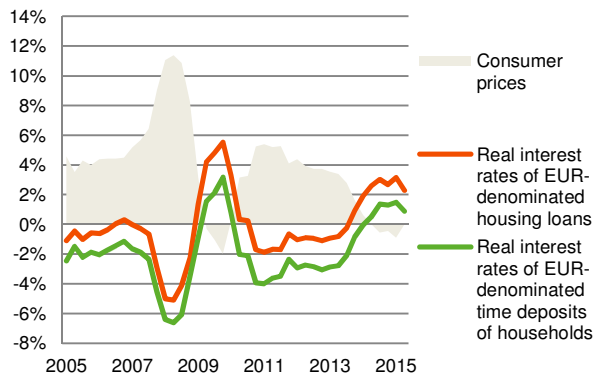
⁵ Swedbank's recent overview on wage growth in Estonia: [The Estonian Economy - August 2015](#)

⁶ <http://www.imf.org/external/research/housing/>

Housing loans' stock is growing very modestly

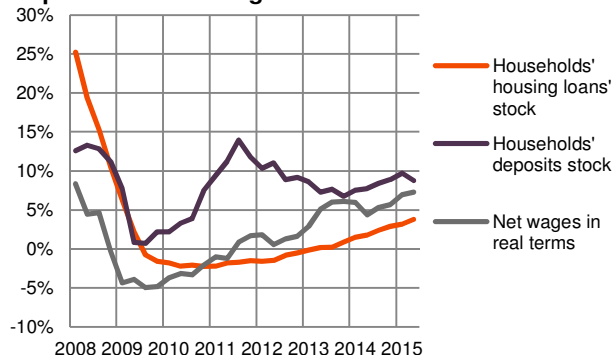
Real estate is an attractive investment option, as nominal interest rates for loans and deposits are low and housing rents have increased substantially. In Estonia, the average interest rate on housing loans was 2.3% in July, the same as in May and June. Because consumer prices decreased in 2014 and in the first half of 2015, compared with the previous year, real interest rates of both housing loans and household deposits turned positive. This – but, perhaps even more, the fast increase in households' incomes – has supported the growth in households' savings stock, which is looking for good investment opportunities.

Real interest rates



Source: Bank of Estonia, Statistics Estonia

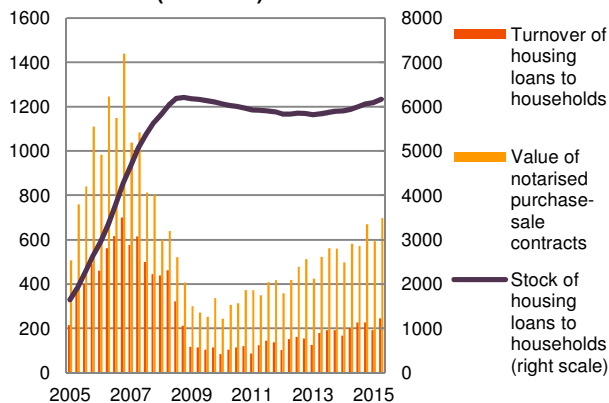
Annual changes in households' wages, deposits and housing loans



Source: Statistics Estonia, Bank of Estonia

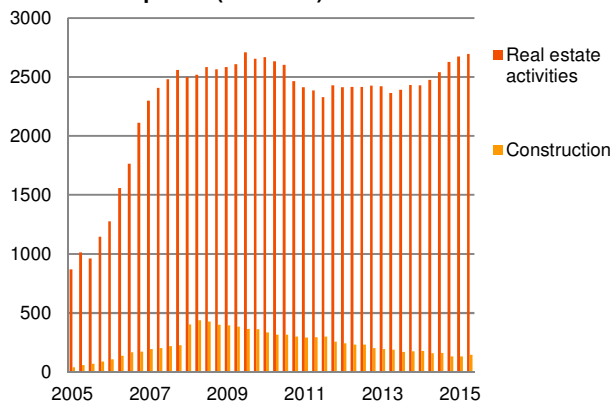
Although demand for loans has increased in line with the rise in activity on the real estate market, the role played by the loan market in housing purchases or in financing construction has been smaller, and lending more conservative, than in the previous growth cycle. Around 60% of the purchase-sale contracts are bought with the help of a housing loan. The housing loans' portfolio for households continues to grow moderately (+3.9%, over the year, in July 2015). From the companies' lending side, the stock of loans in real estate development grew somewhat in 2014 and the first half of 2015. The stock of loans in the construction sector is continuing to decrease.

Housing loans and purchase-sale transactions (EUR mln)



Source: Bank of Estonia, Statistics Estonia

Stock of loans to construction and real estate enterprises (EUR mln)

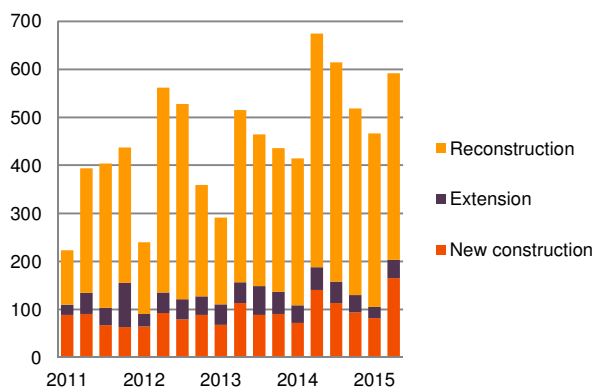


Source: Bank of Estonia

Surge in supply should slow price growth

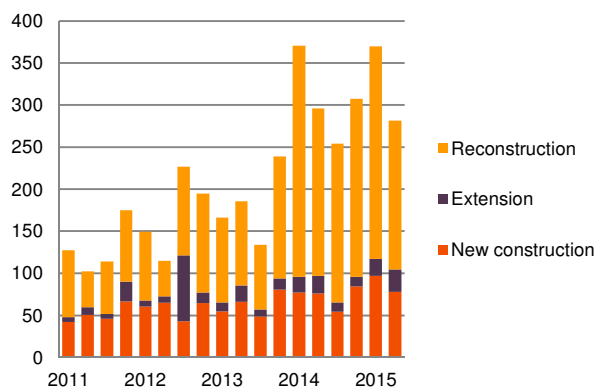
Building permits' and construction data for new dwellings show that the development of new dwellings has picked up in 2014-2015. A substantial number of new dwellings has reached or will reach the market soon. According to the data of the Register of Construction Works, around 1,700 new dwellings were completed in Estonia in the first half of 2015. This is 18% more than during the same period in 2014, or 88% more than in the first half of 2013. About 44% of the 1,700 dwellings were completed in Tallinn. More than half of the completed dwellings were situated in blocks of flats. In the first half of 2015, building permits were granted for the construction of around 2,500 new dwellings (+26%, compared with the first half of 2014, and +75%, compared with the first half of 2013). About 48% of the new dwellings are planned in Tallinn. The larger supply should reduce the growth of real estate prices, especially in the apartments' segment, where price growth has been the fastest in recent years.

Building permits of dwellings (floor area, m²)



Source: Statistics Estonia

Dwellings' completed (floor area, m²)



Source: Statistics Estonia

Liis Elmik

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Address

Swedbank LC&I, Swedbank AB (publ), SE-105 34 Stockholm.
Visiting address: Regeringsgatan 13, Stockholm.