Housing Affordability Index: Q2 2023

Affordability nearing the bottom, improvement on the horizon

- Housing affordability fell even further; now housing is unaffordable in Vilnius and Tallinn
- Interest rates are bogging down recovery

With interest rates continuing to soar, housing affordability fell further. In the second quarter, Tallinn joins Vilnius in the sub-100 index bracket, signalling that housing in two of the three Baltic capital cities is now out of reach for the average household in terms of affordability. While apartments in Riga remain relatively affordable, those targeting newer properties might be in for a disappointment: this segment has slipped into the unaffordable range for the first time since 2014.

In Vilnius and Tallinn, apartment prices increased annually, while Riga was already experiencing a slight decline. A closer look indicates that in both Tallinn and Riga there was a dip in older apartment prices; meanwhile, prices of newer apartments were more resilient. Vilnius price growth is slowing as well, and we therefore might see a minor correction in the Lithuanian capital as well. Market activity in Tallin and Vilnius has declined, while Riga's transaction counts remain unchanged from the same period last year. The mood is still downbeat, and uncertainty is rife.

Interest rates now are assumed to have reached their peak and will remain at current levels until the second quarter of 2024, when we expect rates to start to decline. Moreover, we expect that net wage growth will continue to outpace price growth in Tallinn and Riga, while Vilnius is about to catch up. This will provide some support for housing affordability. Therefore, we will likely reach the bottom in housing affordability this autumn.

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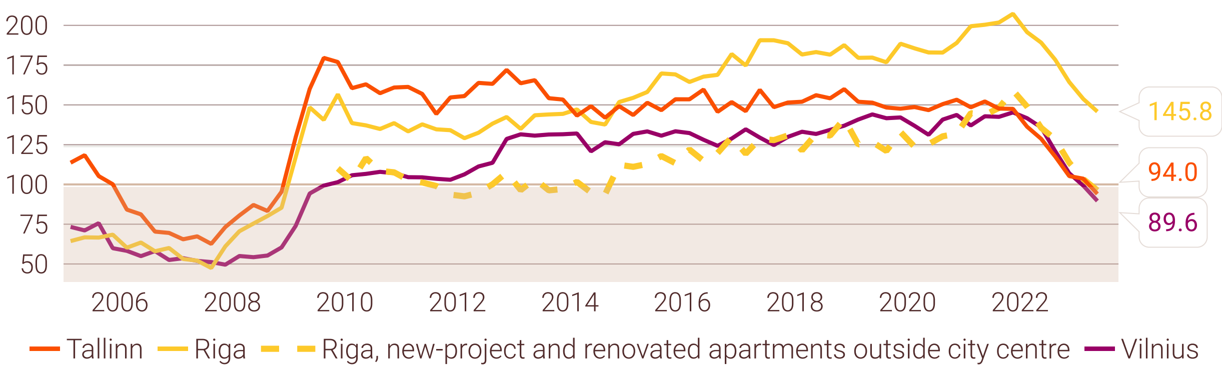
Baltic Housing Affordability Index



Sources: Swedbank Research & Macrobond

Example: A housing affordability index value of 94 means that the average net wage of a household is 6% lower than minimally required to afford an apartment of 55 m^2.

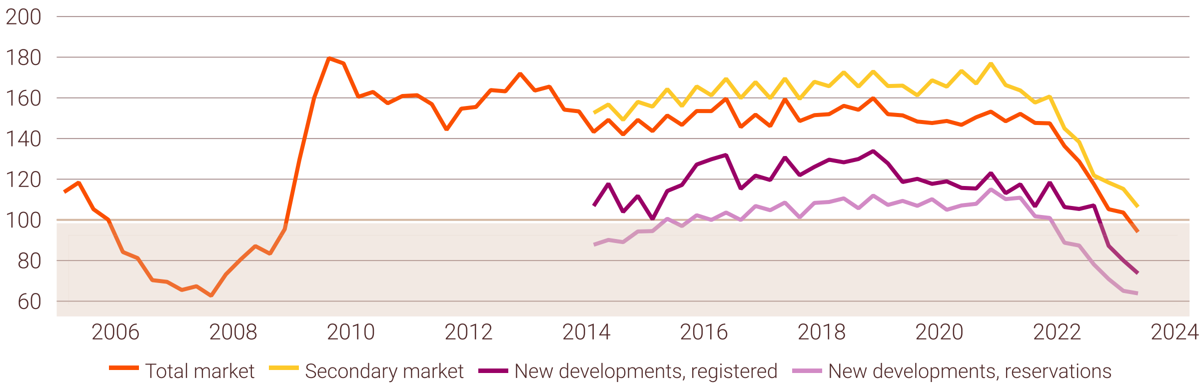
Tallinn – higher rates have let the air out of the housing market

Housing affordability is mainly affected by the increase of interest rates. Demand continues to be constrained by tighter lending conditions, the high cost of living, the economic downturn, and generally low household confidence. While high borrowing costs keep investments in real estate less attractive in general, buying an apartment in a new development is not affordable for most families.

The fall of the housing affordability index to an unaffordable level was anticipated, as interest rates have been rising rapidly. Meanwhile, the apartment price-to-wage ratio has come down from its peak but is still above the levels seen before the booming real estate market of the previous two years. Wage growth is strong, while price developments on the primary and secondary markets are mixed. Even though prices in the secondary market have started to fall quite broadly since April, this is barely visible in the average price statistics due to composition effects. According to preliminary data, the average price in the secondary market was marginally lower in July and August compared with last year. The average price of new apartment reservations asked by developers in the second quarter was higher than at the same time last year, but growth has slowed substantially.

The secondary market is so far affordable on average, although, affordability has fallen sharply and could drop close to 100 in the third quarter. As interest rates are at their peak and price corrections in the secondary market have taken place a further worsening of secondary market affordability is unlikely. Meanwhile, new developments have been unaffordable for over a year now. As reservations of new apartments were primarily made in the construction phase, we are finally seeing the registration of primary market transactions with substantially higher prices. However, the completion of buildings is uneven, and thus, the share of new developments in total transactions varies significantly. These two factors are likely to distort the picture of average price developments in the coming quarters.

Housing affordability Tallinn



Sources: Swedbank Research & Macrobond

The housing market supply-demand balance has improved, as overall supply is higher and demand lower compared with previous years. The stock of new developments offered is finally close to normal levels – offers continued to increase in the second quarter and were 60% higher than a year ago, when the stock was especially low. Reservations have increased from their trough but were still more than two times lower than the pre-pandemic average.

Purchase decisions are being considered carefully as interest rates have increased to their highest level since 2008. In addition to tightened lending conditions, the unaffordable primary market is also limiting demand. Substantial price corrections have so far been avoided, as unemployment is low and wages are growing rapidly; meanwhile, developers' financial conditions are allowing them to put up with the slower pace of sales. However, further price corrections are still not ruled out, especially if unemployment starts increasing and confidence remains weak. The trough of housing affordability will be reached during the autumn, as the ECB has ended its hiking cycle.

Riga – housing still affordable

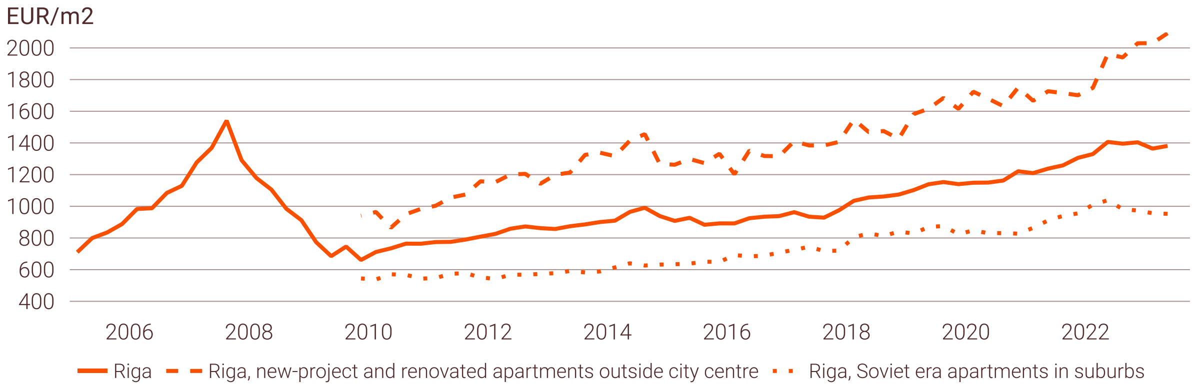
With interest rates soaring to levels not seen since 2009, it comes as no shock that housing affordability declined for the sixth consecutive quarter, plummeting to its lowest levels in about nine years. Nevertheless, apartments in Riga are still affordable for the average household. Inflation and the euro interbank offered rate (EURIBOR) – terms that were of somewhat limited interest when they were relatively low or sub-zero, respectively – have now infiltrated the vocabulary of the average household.

Market activity declined following the start of the war in Ukraine but has overall been rather resilient, with the second quarter seeing the level of transactions unchanged from a year ago. Moreover, the average number of transactions for the first half of 2023 exceeded the pre-COVID average, i.e., the average of the first halves of 2017 to 2019. June stood out for new projects and properties renovated after the 2000s in the suburbs: the transaction count in this segment grew during the second quarter by 50% from the previous quarter. The increase was due to the selling of a few large projects that had been finished earlier.

For the first time in five years, annual price growth for apartments in Riga descended below zero, supporting housing affordability. Prices declined by 1.8% annually while registering an increase of 1.3% over the previous quarter. At the same time, the average wage boomed, increasing by 10.6% year on year. With such a robust increase in income, saving for the initial down payment now requires only about 21 months, the shortest duration since 2005 (and about a year less than in Tallinn or Vilnius). But there's a catch – due to the rising EURIBOR, the expected monthly payment for an average apartment has skyrocketed over the past year, increasing by approximately 43% (or EUR 115). Rising rates impose a significant strain on households that have recently acquired a mortgage and deters those eyeing a new property. However, prospects should brighten next year due to the anticipated interest rate reductions. Soviet-era apartments still dominate the market, and around 60% of transactions involve apartments built or renovated before the 2000s in suburbs. Focussing on properties built or renovated post-2000, the outlook darkens, aligning more closely with the situation in other Baltic capitals. For the first time since 2014, newer properties in Riga are not affordable for the average household.

In summary, as interest rates seem to be plateauing, housing affordability is about to bottom out in the next quarter and start improving thereafter, which should help market activity to pick up next year. There is a risk, however, that prolonged economic weakness could have a larger negative impact on the labour market, depressing consumer sentiment and lowering demand for housing.

Average apartment transaction price



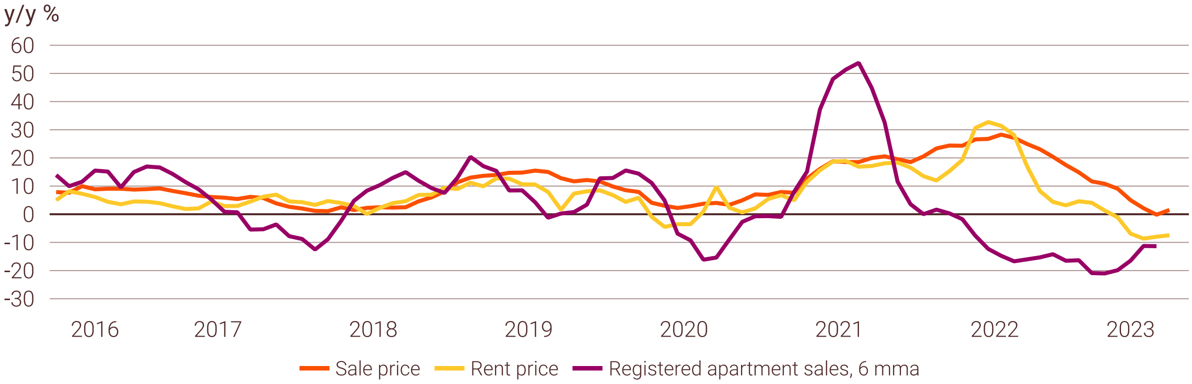
Sources: Swedbank Research & Macrobond

Vilnius – high rates, weak sales, stable prices

The housing market in Vilnius continues to struggle through a protracted slump. The fall of housing affordability to a 13-year low reduced market activity significantly. Lower apartment sales have yet to translate into lower apartment prices, although there are some signs that prices might come down slightly in the second half of the year. The slump in the housing market will continue in the near future due to high interest rates and the adverse economic environment, which could dampen the labour market and consumer confidence.

Even though wages and housing prices are rising at an almost identical annual pace, housing affordability has taken a dive in the past several quarters. Due to the sharp rise in ECB policy rates and the popularity of flexible interest rate mortgages, the average interest rate on a housing loan increased from 2.2% to 5.6% in a year's time. Such a significant move in interest rates pulled the housing affordability index down to 89 – a level at which the average household can no longer afford a decently sized apartment. Tighter financing conditions directly translate into lower market activity. Sales have been subdued for almost a year now, although they have stabilised at a lower level and are not in a freefall. Supply is adjusting to the new level of demand. The reduction in both the issuance of permits and the actual volumes of residential construction show that developers are wary about introducing too much new supply into the market.

Online listings signal weaker prices ahead



Sources: Aruodas, Swedbank Research & Macrobond

Even though sales are weak, housing prices have been surprisingly resilient so far. The official registry shows the average selling price to still be about 10% higher than a year ago. However, the price picture is quite complex. Online listings show that prices in August were unchanged from last year, while the more sensitive rent market has already experienced some price correction. The resilience in prices can be partially explained by composition effects - developers report that sales were the weakest in the cheaper apartment segment. Small, cheaper apartments have been an attractive investment in recent years, and second-home buyers a significant source of housing demand. With interest rates so high, a buy-to-let business model is no longer attractive, leading to a reduction of sales and a shift to a more expensive market composition.

Housing affordability is likely to bottom out in the third quarter of this year, as the ECB's interest rate hikes will be fully reflected by then. We expect that wages will grow faster than housing prices during the second half of the year, but housing will be hard to afford for the rest of 2023. Due to the healthy fundamental housing demand and restricted development of new housing a major price correction is unlikely, although prices could adjust downward in some segments of the market. The housing market will remain subdued for several upcoming quarters and is set to recover more significantly only when the ECB eases policy rates next year.

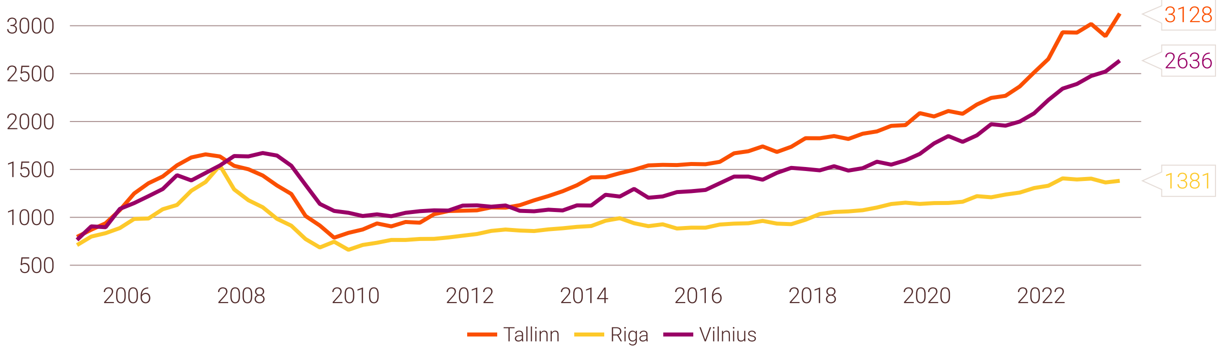
Appendix

	Tallinn, Estonia	Riga, Latvia	Riga, new-project and renovated apartments, Latvia	Vilnius, Lithuania
Average apartment transaction price, EUR/m2, y/y %	6.7	-1.8	6.7	12.5
Annual change in the average mortgage interest rate, basis points	315	317		334
Average monthly net wage, EUR, y/y %	14.7	10.6		11.2
Months to save for a down payment, months	33.6	20.7	31.3	34.4

Sources: Swedbank Research and Macrobond

Average apartment price

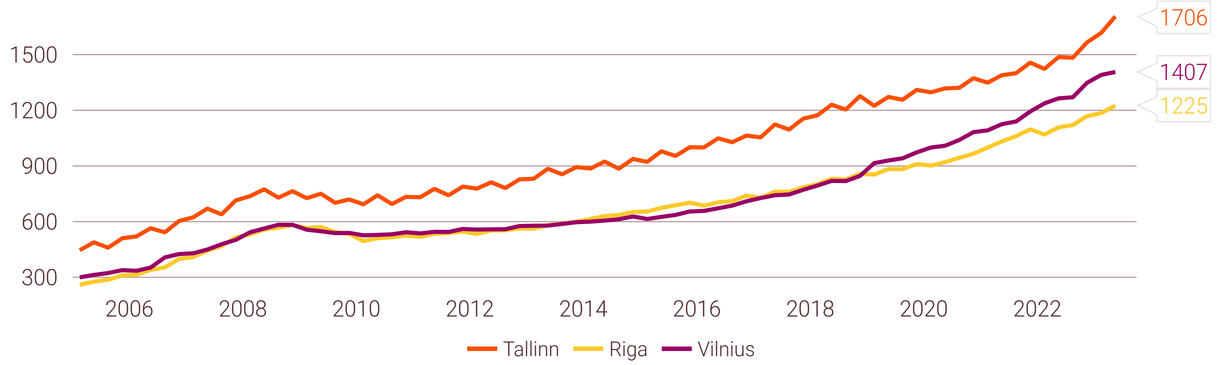
EUR/m2



Sources: Swedbank Research & Macrobond

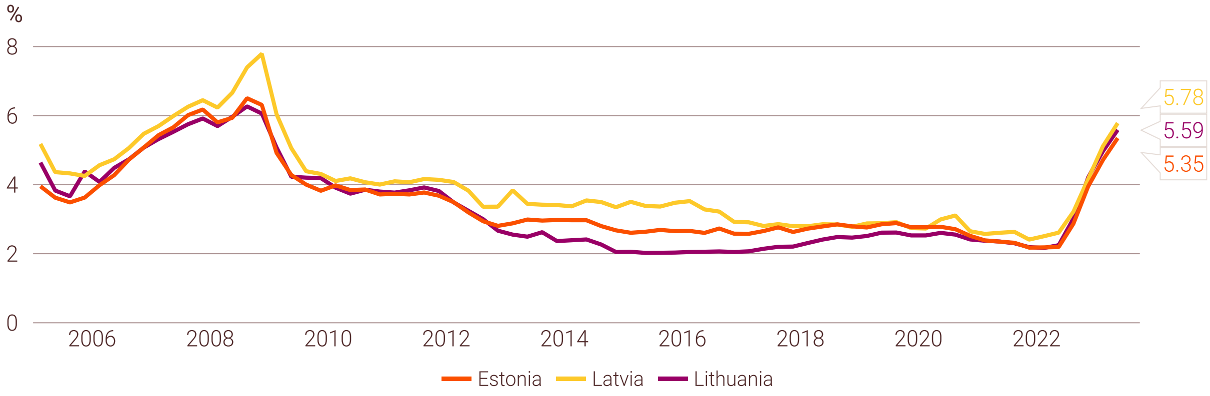
Average monthly net wage

EUR



Sources: Swedbank Research & Macrobond

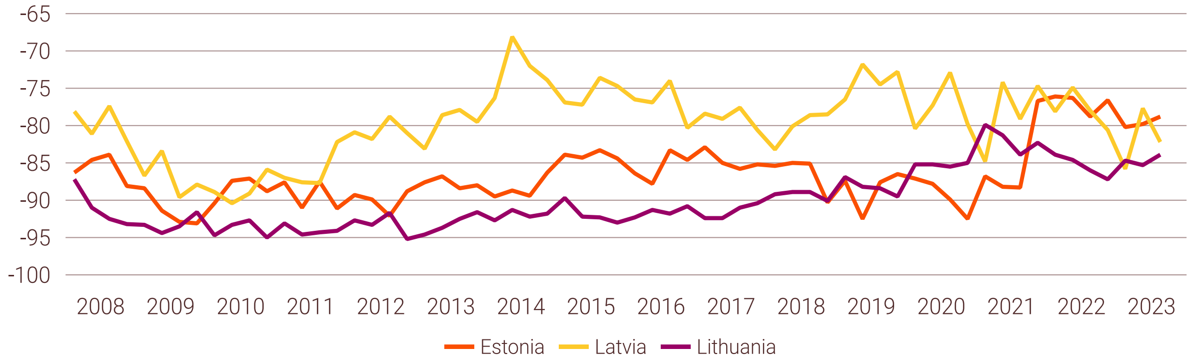
Annual percentage rate of charge for new mortgages to households



Sources: Swedbank Research & Macrobond

Consumer confidence to purchase or build a house

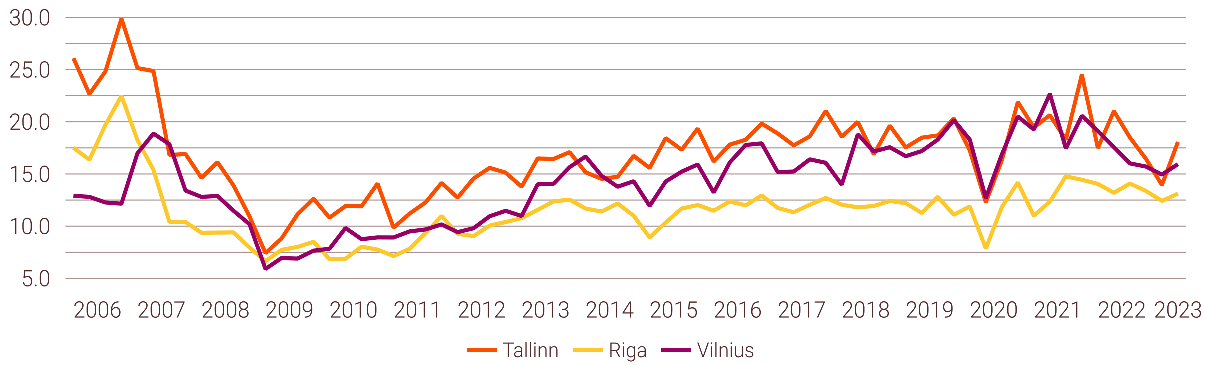
Baltics, over the next 12 months



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.

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

where AverageINC – household income,
NINC – household income that satisfies the norm,
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.

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