CENTRE FOR EUROPEAN POLICY STUDIES
Thinking ahead for Europe since 1983

IS EUROPE'S HOUSING MARKET NEXT?

CEPS COMMENTARY/12 FEBRUARY 2008

DANIEL GROS *

A bubble in the American housing market – fuelled in part by so-called 'sub-prime' mortgages – was the catalyst for today's financial market turbulence. But the bubble was not confined to the United States. In Europe, house prices have also increased sharply over the last decade – more dramatically than in the US in many cases. The same is true of other OECD countries and emerging markets, where rapidly increasing incomes have put pressure on asset prices.

Indeed, with a few exceptions (essentially Germany and Japan), housing prices have risen almost everywhere to levels never seen before. How could such a global pattern emerge when real estate is the most local of all assets?

Recent research suggests that the global housing boom was closely linked to the unprecedented increase in the supply of liquidity by major central banks. To be sure, financial innovation, like lending to buyers who would not normally have qualified for mortgage loans (sub-prime borrowers) also played a role. But sub-prime mortgages would probably not have been supplied on the same scale if central banks had not created an environment of ample liquidity and persistently low interest rates.

The sub-prime crisis has so far affected mainly financial markets in the US and Europe. This is not surprising if one considers that on both sides of the Atlantic, prices have reached historical peaks and, until recently, had accelerated.

This is no mere coincidence. There has always been a correlation between American and European house prices. Over the last three decades, prices in the US and Europe have tended to follow three slow-moving, related boom-bust cycles. All previous peaks were followed by several years of declining prices (in real terms). There is no reason to assume that this cycle will be any different.

Since last year, prices have declined in the US. Because data for the euro area will become available only much later, it is not yet possible to determine whether prices have already turned on the Continent as well. But if the past pattern holds, house prices should start to fall very soon in (continental) Europe as well.

In both the US and Europe it seems that prices went 20-30% above their longer-term average values. Such a large overshooting is likely to be followed by some undershooting. This would imply that prices will probably have to fall at least by 20-30%, but possibly considerably more before they find a bottom.

---

* Daniel Gros is Director of the Centre for European Policy Studies. This commentary was first published in the New York Sun. CEPS Commentaries offer concise, policy-oriented insights into topical issues in European affairs. The views expressed are attributable only to the author in a personal capacity and not to any institution with which he is associated.

European policy makers thus have cause for concern. While there is little evidence in the euro area of large-scale sub-prime lending, there is considerable evidence to suggest that house prices have an important impact on domestic demand, albeit with wide variations among individual countries.

Almost everywhere, higher house prices have been associated with strong consumption. Lower house prices throughout Europe are thus likely to be accompanied by weaker consumption demand, as in the US. In Germany, for example, house prices have remained relatively low and consumption weak,

The impact of house prices on construction activity has been more varied. In Spain and Ireland, construction investment has increased to a level (18-20% of GDP) far above that of the US and not seen in any other OECD country except Japan before its bubble burst in 1989. In these two countries, lower housing prices are likely to be associated with a sharp and prolonged drop in domestic demand, which should be stronger even than what can be expected in the US.

By contrast, in France and Italy, where house prices have increased almost as much as in the US, there is no evidence of a housing overhang. The negative impact of a downturn in housing prices in these two countries should thus be limited to a drop in consumption. Germany should be affected the least, because both house prices and construction activity have been below trend for some time.

In short, the downturn in house prices will not be limited to the US. And, on both sides of the Atlantic, that decline is likely to undermine consumer spending.