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Trends in the Italian house market, main drivers and prospects

Francesco Zollino

Bank of Italy – Economic outlook and monetary policy studies

The real estate market in the current financial crisis

Bank of Greece, 2 December 2011

✓ A medium term perspective of the house market in Italy

✓ The developments since the financial crisis

✓ Preliminary econometric evidence

  ✓ **Main drivers of house prices**
  ✓ **Misalignement detection of house prices from fundamentals**

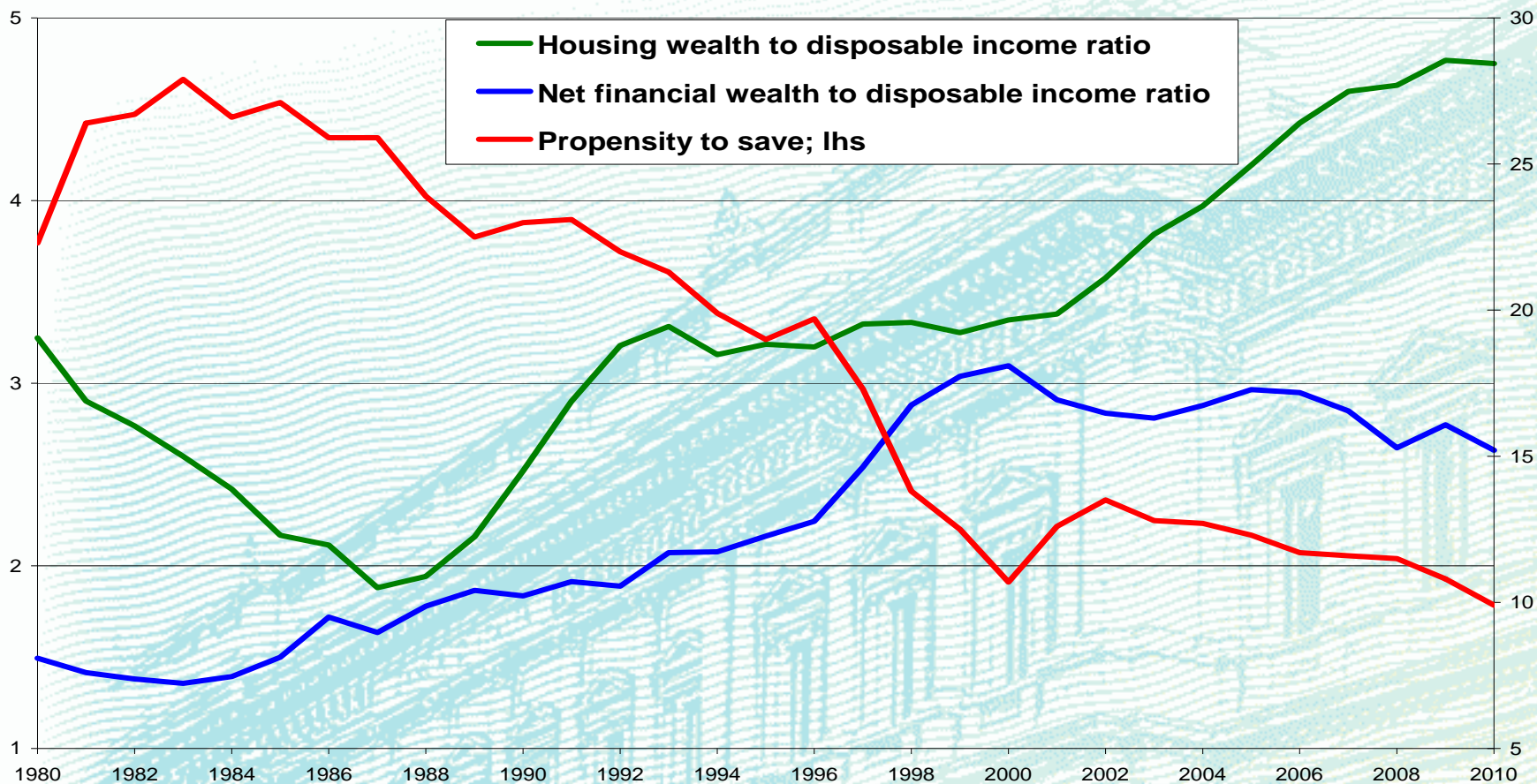✓ Short term outlook and main risks

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HOUSE PRICES (indices 2005=100)
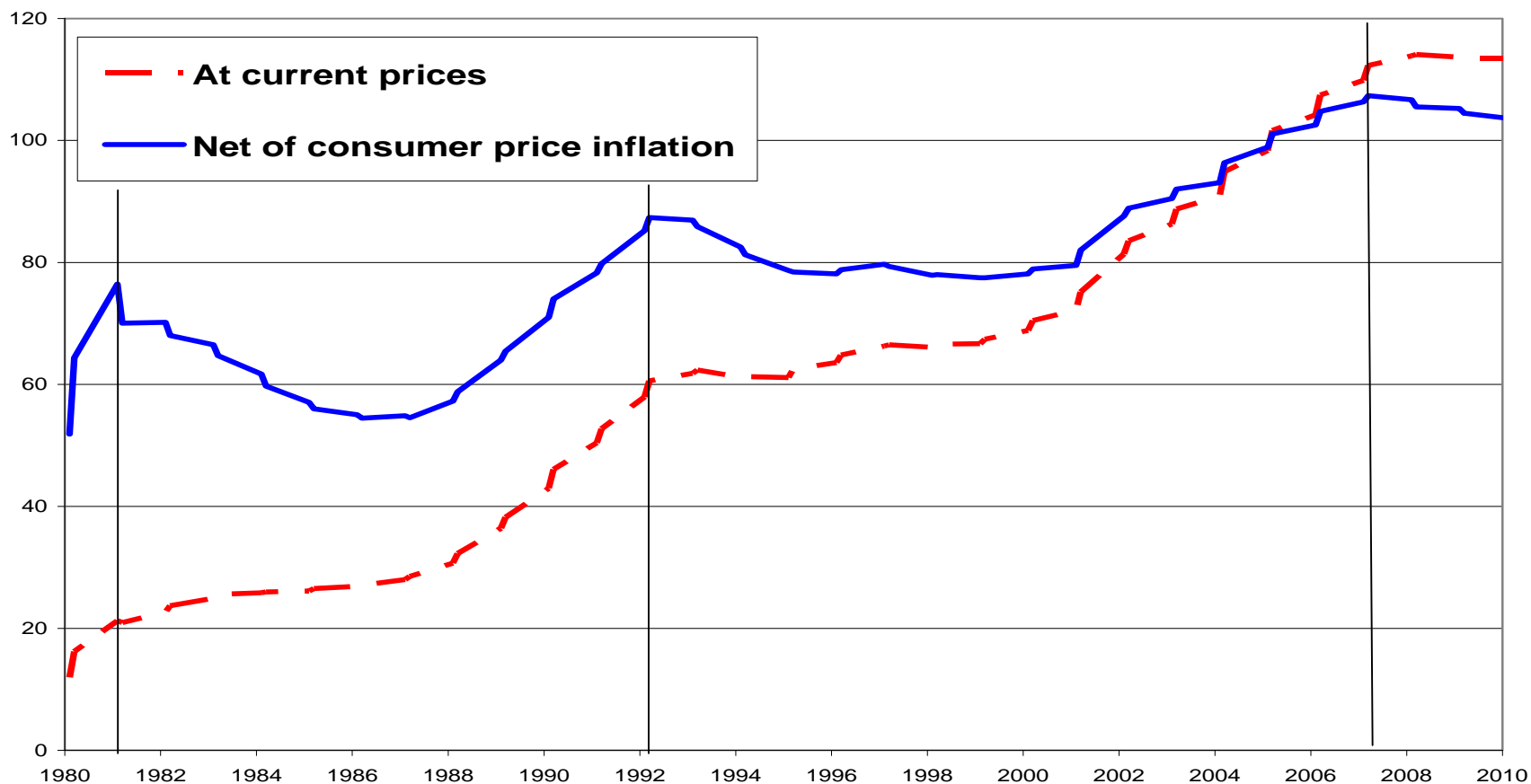
Source: elaborations based on data from Bank of Italy, *Il Consulente Immobiliare*, Istat and *Agenzia del Territorio*

Since the start of the UEM and before the financial crisis house prices marked a more prolonged revaluation than in previous cycles, with an average growth of almost 5% per year in real terms

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Housing wealth to disposable income ratio
Net financial wealth to disposable income ratio
Propensity to save; lhs

Source: elaborations based on data from Bank of Italy, *Il Consulente Immobiliare*, Istat and *Agenzia del Territorio*

The ratio of the value of real property to the households disposable income, broadly stable at around 320% in the nineties, was progressively up in the following years, hitting 470% at the end of the last decade; the propensity to save kept declining
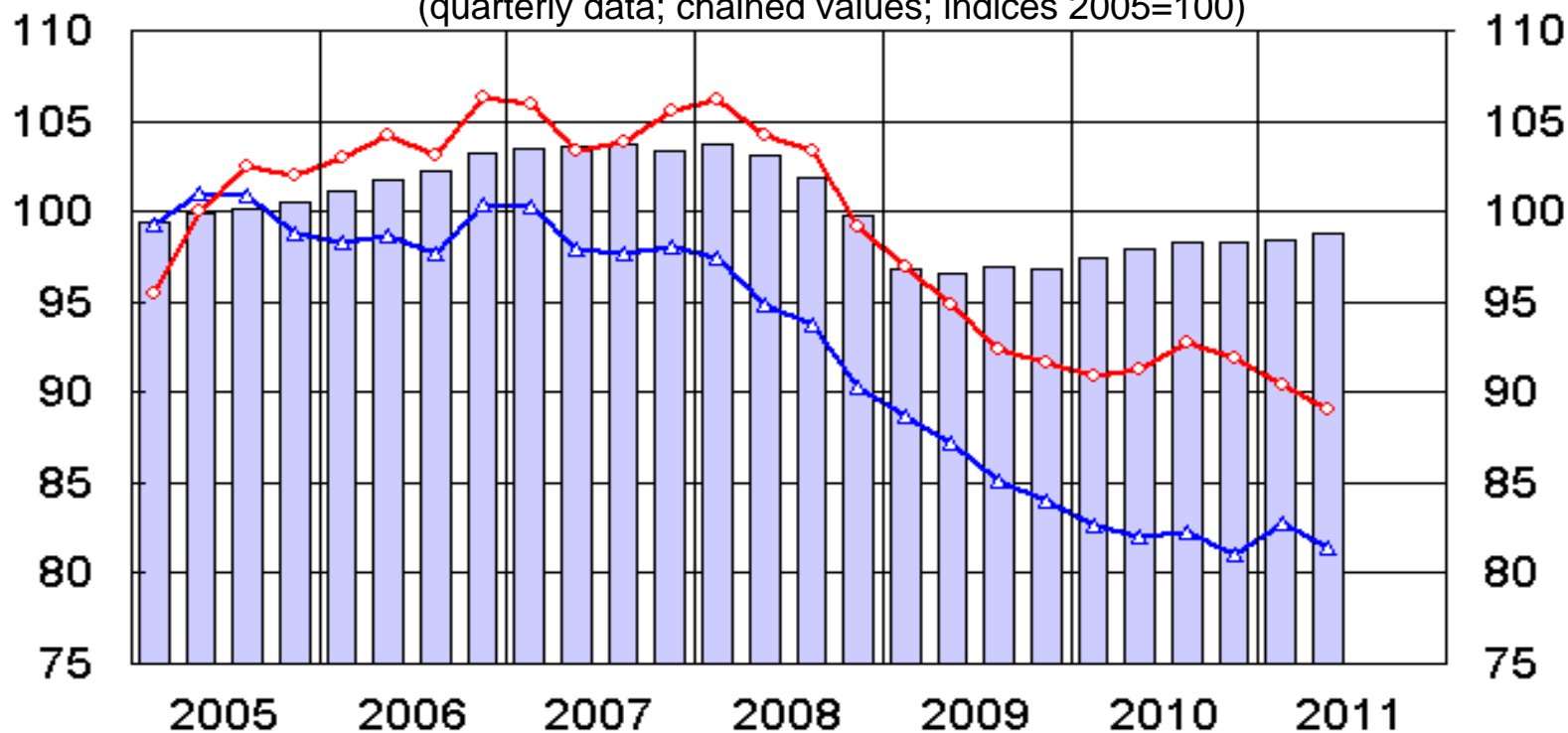
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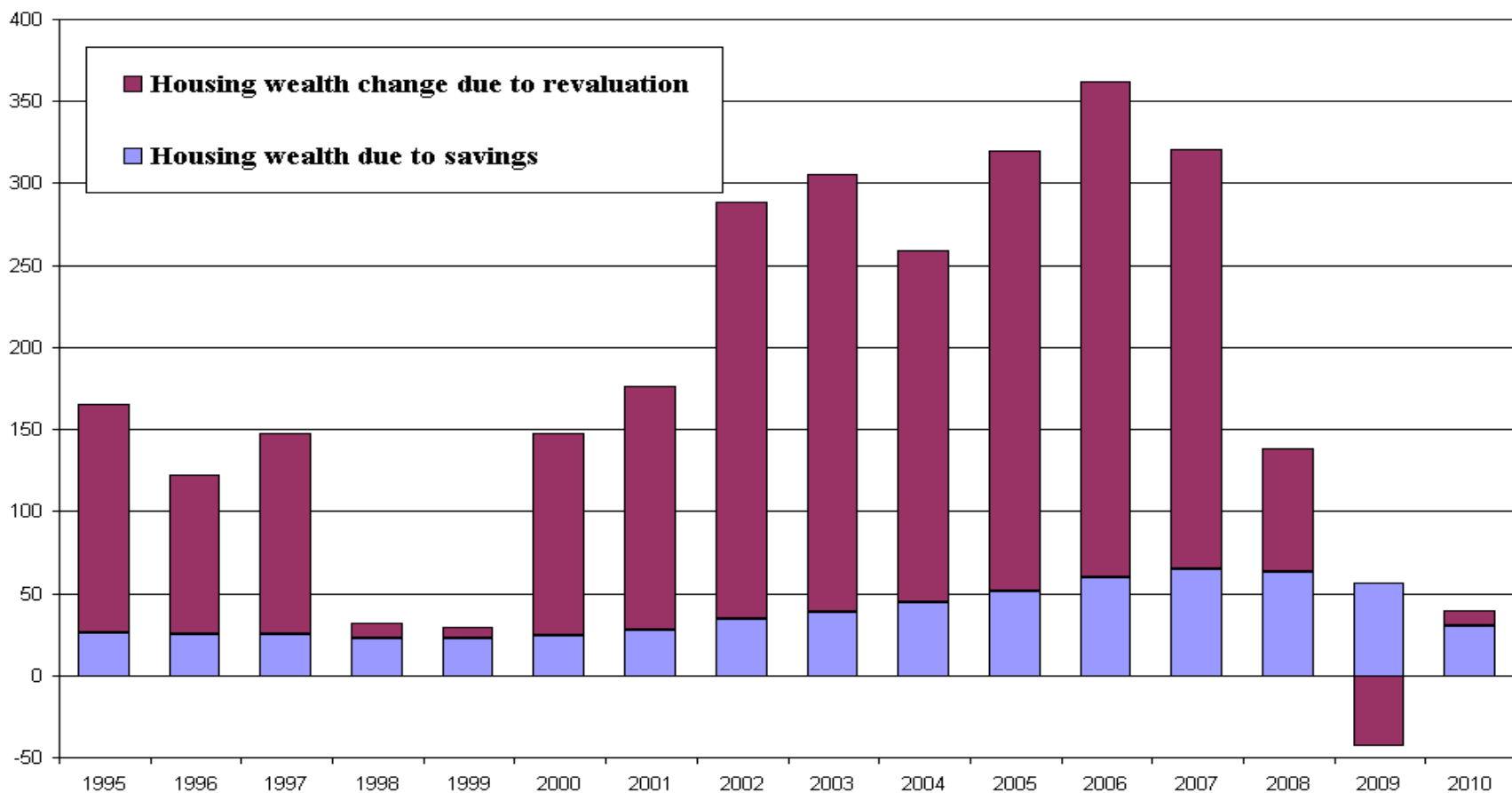
House revaluation was the main driver of the increase in real property until the eve of the financial crisis;

The ensuing positive wealth effects supported consumer spending against a broad stagnation in disposable income

GDP AND INVESTMENT IN CONSTRUCTION
(quarterly data; chained values; indices 2005=100)

Legend: GDP ; GFCF non res. construc. ; GFCF resid. construc.

Impact of the crisis was more severe on construction activity than on GDP (in size and persistence)

Trend in residential investment is still negative (in Q2_2011 expenditure was 16% below the level before the recession)

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HOUSE PRICES AND TRANSACTIONS
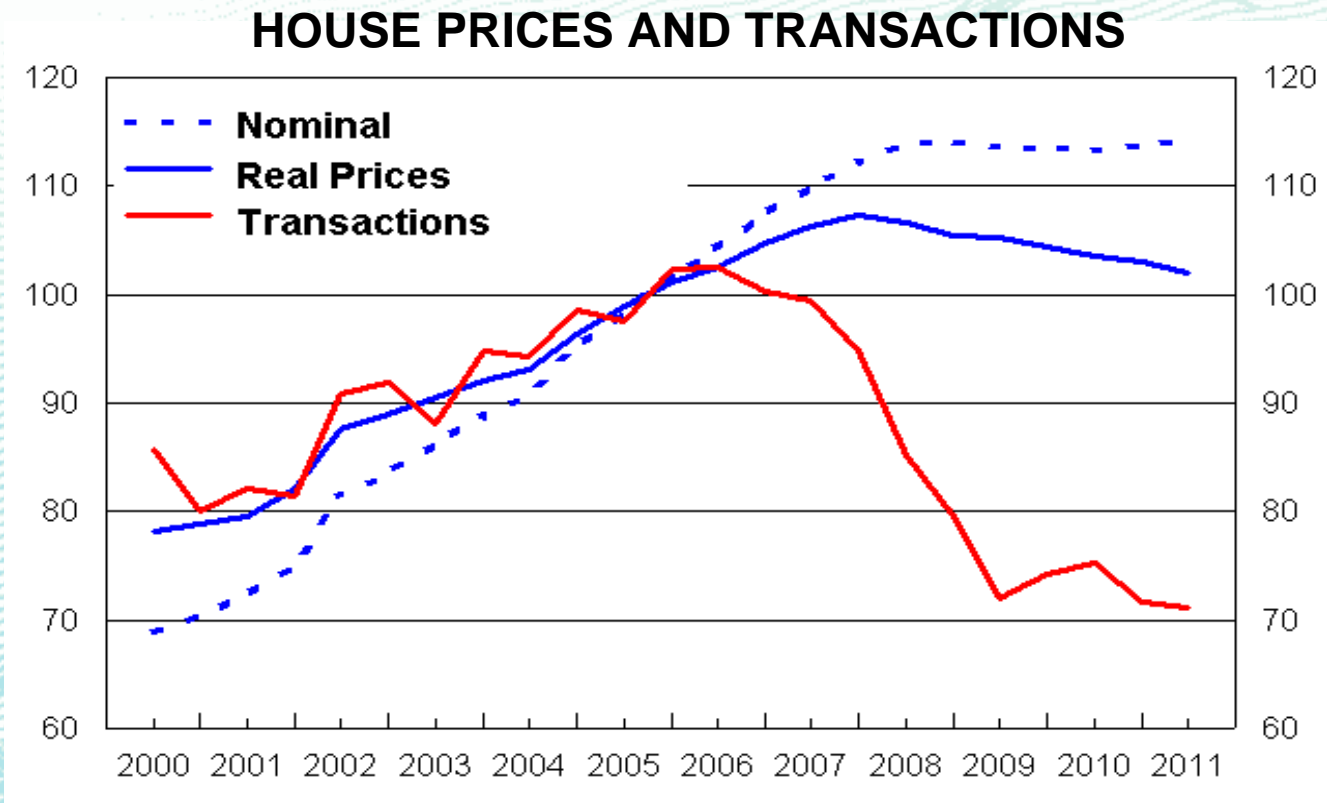
House transactions, turned negative at the middle of 2006; as the crisis deepened, the fall became more pronounced (almost 30% in two years as a whole), with a virtual stagnation in recent quarters

As in previuos cycles, real prices house prices turned down later than transactions, cumulating a 5% contraction since the first semester

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HOUSE PRICES (y-o-y percentage changes)

Date	Province capital cities	Other cities	North	Centre	South-Islands	Italy
2008	2,3	2,8	1,6	1,9	5,0	2,6
2009	- 1,0	- 0,1	- 0,7	- 1,1	0,8	- 0,4
2010	0,2	0,1	- 0,5	0,5	0,7	0,1
2007 - I sem.	6,6	4,5	3,8	6,4	7,1	5,4
2007 - II sem.	5,0	4,1	3,2	3,0	7,6	4,5
2008 - I sem.	3,8	3,5	2,3	3,0	6,3	3,7
2008 - II sem.	0,9	2,1	0,9	0,8	3,7	1,6
2009 - I sem.	- 1,1	0,3	- 0,3	- 1,4	1,3	- 0,2
2009 - II sem.	- 0,9	- 0,5	- 1,1	- 0,7	0,3	- 0,6
2010 - I sem.	- 0,1	- 0,3	- 1,0	0,3	0,6	- 0,2
2010 - II sem.	0,5	0,4	0,0	0,6	0,7	0,4
2011 - I sem.	1,0	0,8	1,2	0,5	0,6	0,9

During the crisis trend in house prices was weaker in capital cities and in the Northern regions; however in the same locations recovery (in nominal values) in recent time is somewhat more established

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A STRUCTURAL SYSTEM FOR HOUSING AND BANKING IN ITALY

i) housing market
$$
\begin{cases}
\text{D: } \textbf{House prices} = f\,[\text{income (+), rent(+), } \textbf{mortgages(+)}, \text{demo(+), house stock (-)}] \\[2ex]
\text{S: } \textbf{Investment} = g\,[\text{build. cost(-), } \textbf{house prices (+), loans (+)}, \text{i(-), surface (-)}]
\end{cases}
$$

ii) mortgage market
$$
\begin{cases}
\text{D: } \textbf{Mortgages} = m\,[\textbf{house prices(+)}, \text{income(+,-), wealth(+,-), } \textbf{mortgage cost(-)}] \\[2ex]
\text{S: } \textbf{Mortgage cost} = n\,[\text{funding cost (+), bank profits (-), bank capital (+,-), } \textbf{house prices (-)} \text{ wealth (-)}]
\end{cases}
$$

iii) loan market
$$
\begin{cases}
\text{D: } \textbf{Loans} = v\,[\text{firms borrowing require.(+), build. cost (+), inv(+), } \textbf{loan cost (-)}] \\[2ex]
\text{S: } \textbf{Loan cost} = z\,[\text{funding cost (+), bank profit(-), bank capital (+,-), firms' profits(-), } \textbf{house prices (-)}]
\end{cases}
$$

Six equations and a large variety of list of exogenous drivers (including candidate determinants of credit supply); quarterly data over the period 1986_Q1-2010_Q4

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HISTORICAL DECOMPOSITION OF HOUSE PRICE GROWTH IN ITALY
(percentage points; yearly averages)
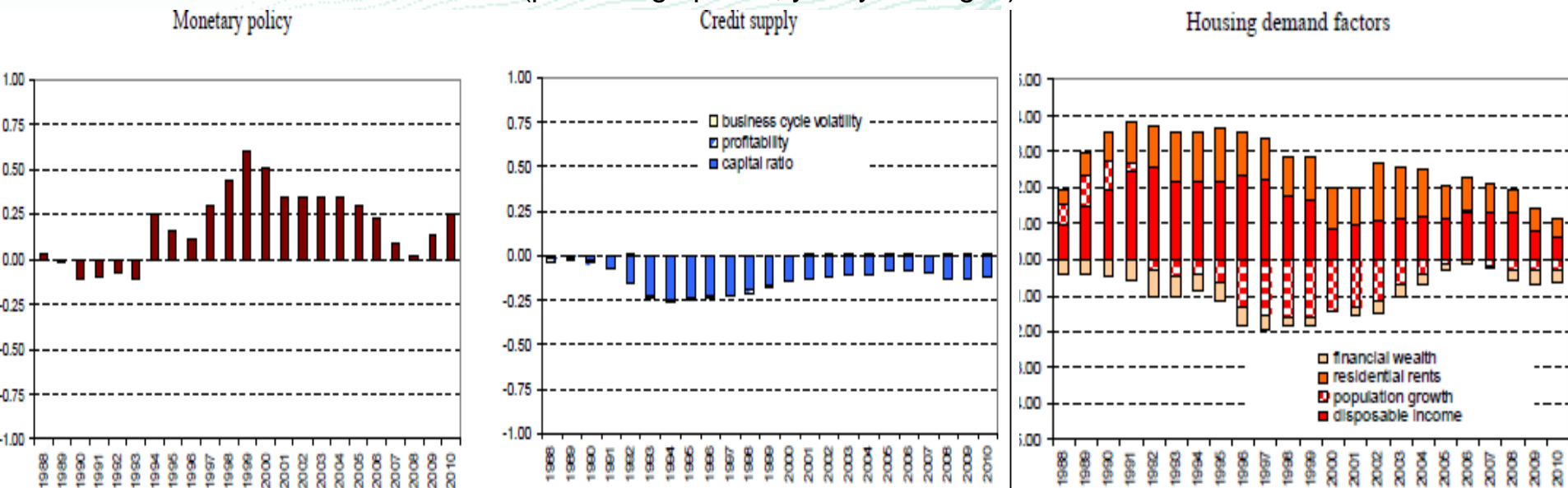
Source: Nobili-Zollino (2011) *A structural model for the housing and credit market in Italy* Bank of Italy, mimeo

House prices mostly react to disposable income, residential rents and demography; lending conditions (policy rate and banks' balance sheets) also exert a significative impact, especially through their effects on mortgages flows, and consequently on house demand.

During the financial crisis a deterioration in credit supply conditions, related to the banks' balance sheet positions, has dampened house price dynamics, partly offsetting the positive stimulus provided by the easing in the monetary stance.

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BANK INTEREST RATE IN ITALY
(percentage values)
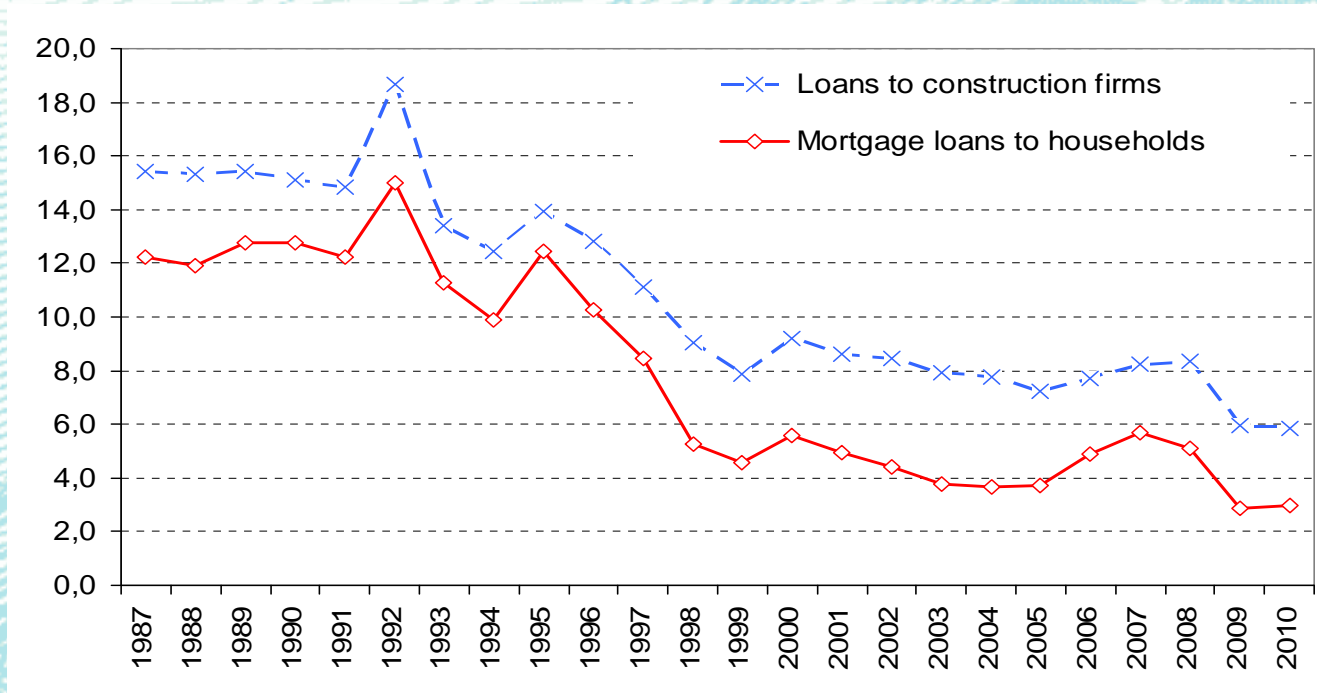
The cost of credit in Italy went largely down in the path to the monetary union; in the final part of the sample of the econometric analysis, it remained almost unchanged although the monetary policy recovered an expansionary stance as the crisis deepened.
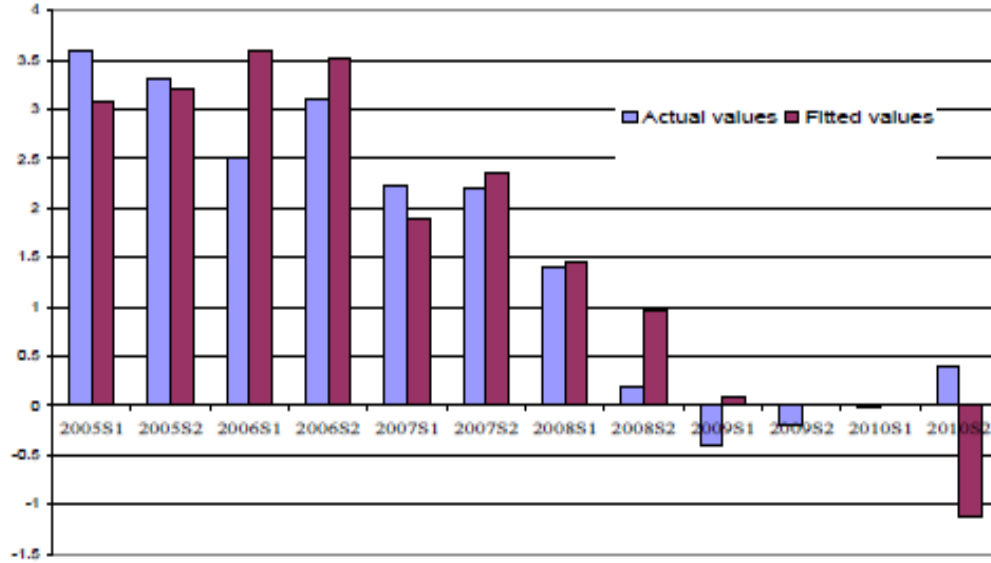
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HOUSE PRICES IN RECENT CYCLES
(current values; annualised average changes in reference periods)
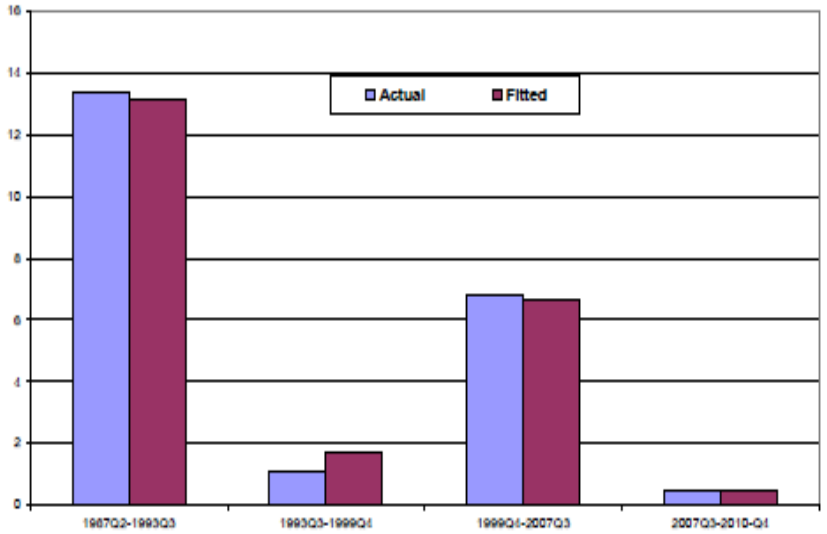
HOUSE PRICES AROUND THE FINANCIAL CRISIS

A. Yearly changes in nominal values

Econometric evidence shows negligible misaligments of house prices over the two cycles before the crisis

During the crisis house price dynamics first lost momentum more severely than implied by fundamentals, and resumed a positive change in the end of 2010 despite main drivers kept deteriorating: the picture as a whole confirms balanced.

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**ESTATE AGENTS' EXPECTATIONS** (*percentage balances of the replies*)
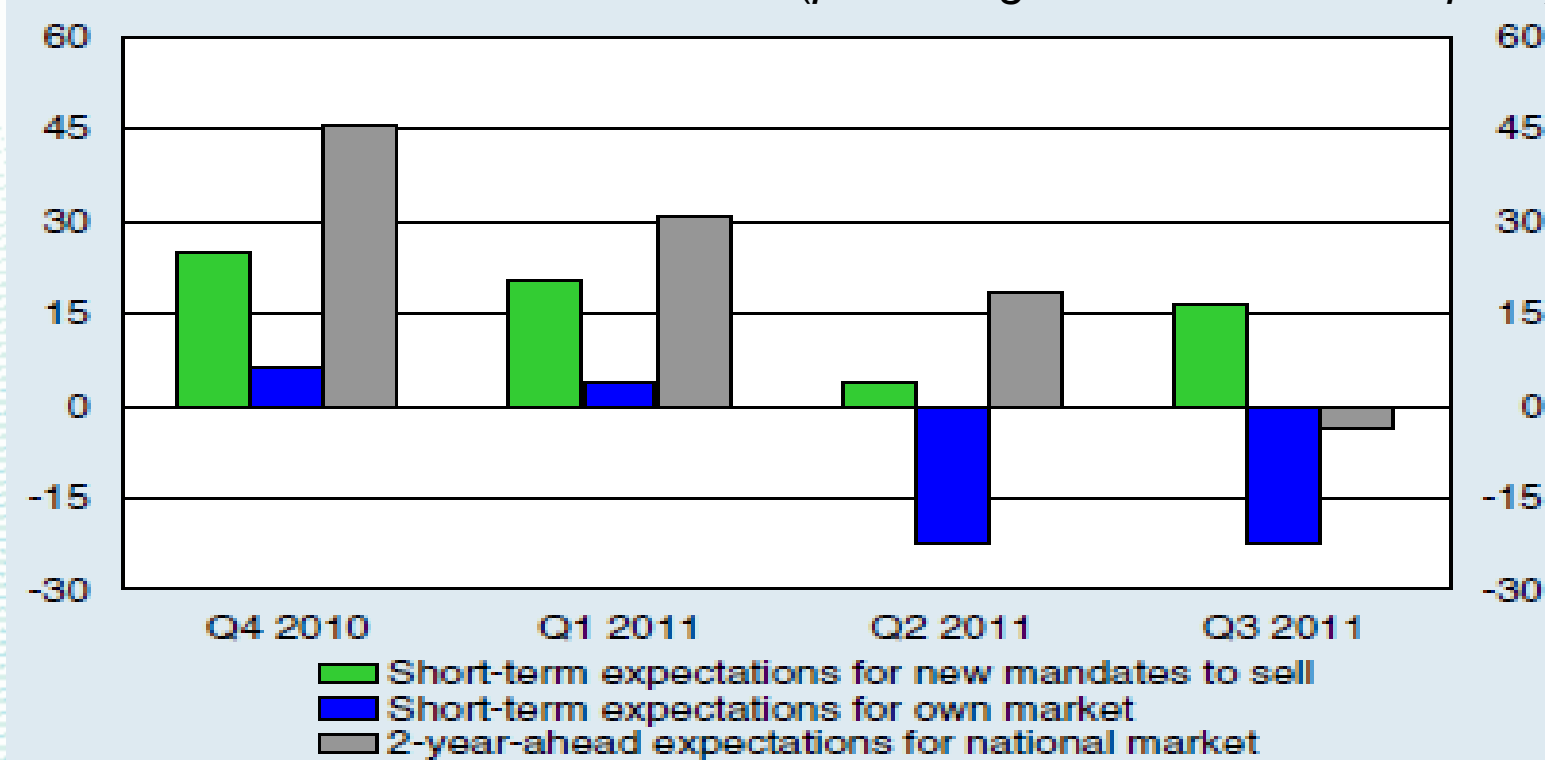
Source: Quarterly surveys conducted by the Bank of Italy, Tecnoborsa and the Agenzia del Territorio

According to the quarterly survey conducted by the Bank of Italy on a sample of 1500 estate agents since Q1-2009, the short term outlook confirms negative (and stable) for the local markets
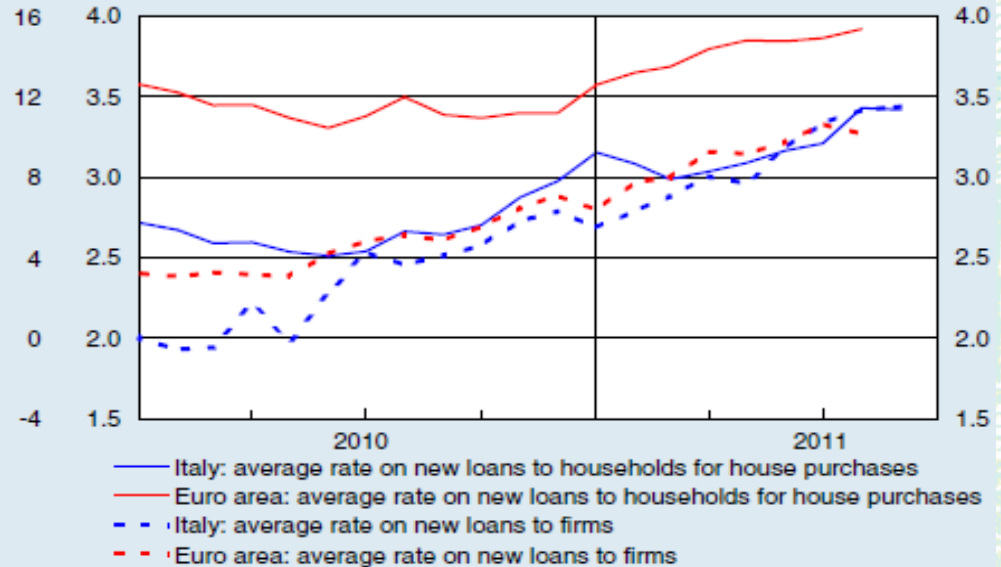
Medium-term perspectives for the national market worsened, amid a growing pessimism over the general economic picture.

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CREDIT CONDITIONS IN ITALY

(a) Lending to the non-financial private sector in Italy
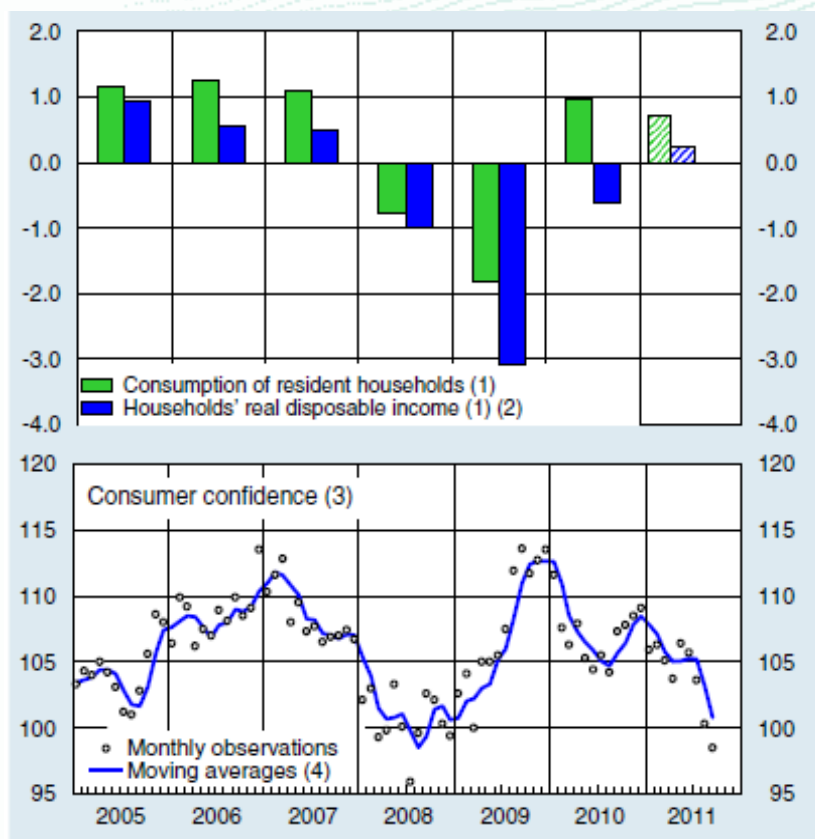(monthly data; annualized three month percentage changes)

Non-financial corporations
Households
Non-financial private sector
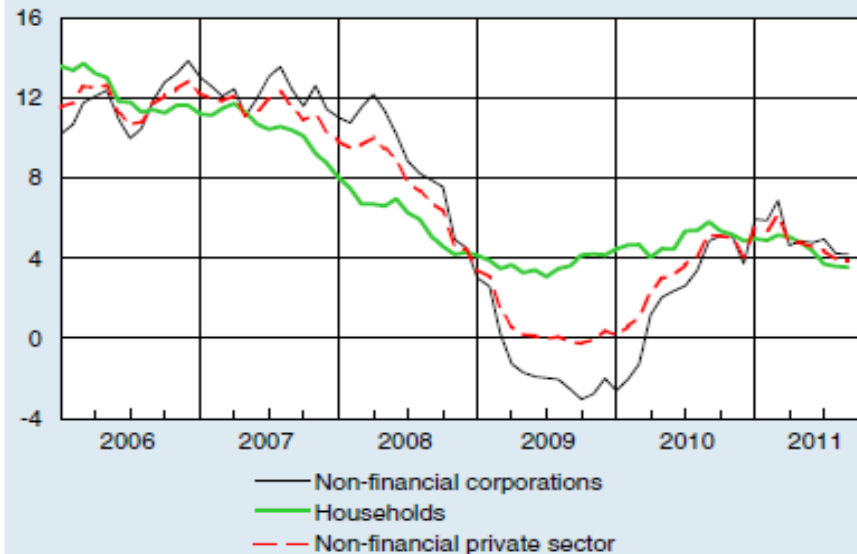
(b) Interest rates on new loans in Italy and the euro area
(monthly data; per cent)

Italy: average rate on new loans to households for house purchases
Euro area: average rate on new loans to households for house purchases
Italy: average rate on new loans to firms
Euro area: average rate on new loans to firms

The terms for lending to households for house purchases is currently showing a limited tightening, due to both the worsening of banks balance-sheet constraints and an increase in the perceived risk of the consumers' creditworthiness. Up to now, adjustment has been more on the costs than on flows of credit

Due to the renewed financial turmoil, credit conditions could further deteriorate, so causing a negative risk on the perspectives of housing market in Italy.

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HOUSEHOLD INCOME, CONFIDENCE AND CONSUMPTION

Legend (top chart):
- ■ Consumption of resident households (1)
- ■ Households' real disposable income (1) (2)

Consumer confidence (3)

- ○ Monthly observations
- — Moving averages (4)

2005 2006 2007 2008 2009 2010 2011

Sources: Calculations and estimates based on Istat data.
(1) Chain-linked volumes; percentage changes in relation to the previous year. Up to 2010, annual data; for 2011, percentage changes in the first half compared with the same period of 2010 – (2) Includes income of consumer households, producer households and non-profit institutions serving households; obtained using the consumption deflator for resident households and non-profit institutions serving households. – (3) Monthly data, seasonally adjusted. Indices, 1980=100. – (4) Monthly data; moving averages for the three months ending in the reference month.

A further negative risk for the housing market comes from the weak households disposable income, that in the past supported house prices

In a short run perspective, household income could be checked by the fiscal consolidation plans and by the difficult recovery of the labour market, as anticipated by a declining consumer confidence.

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HOUSE AFFORDABILITY AND PRICE TO RENT RATIO (*indices 1992-2010=100*)
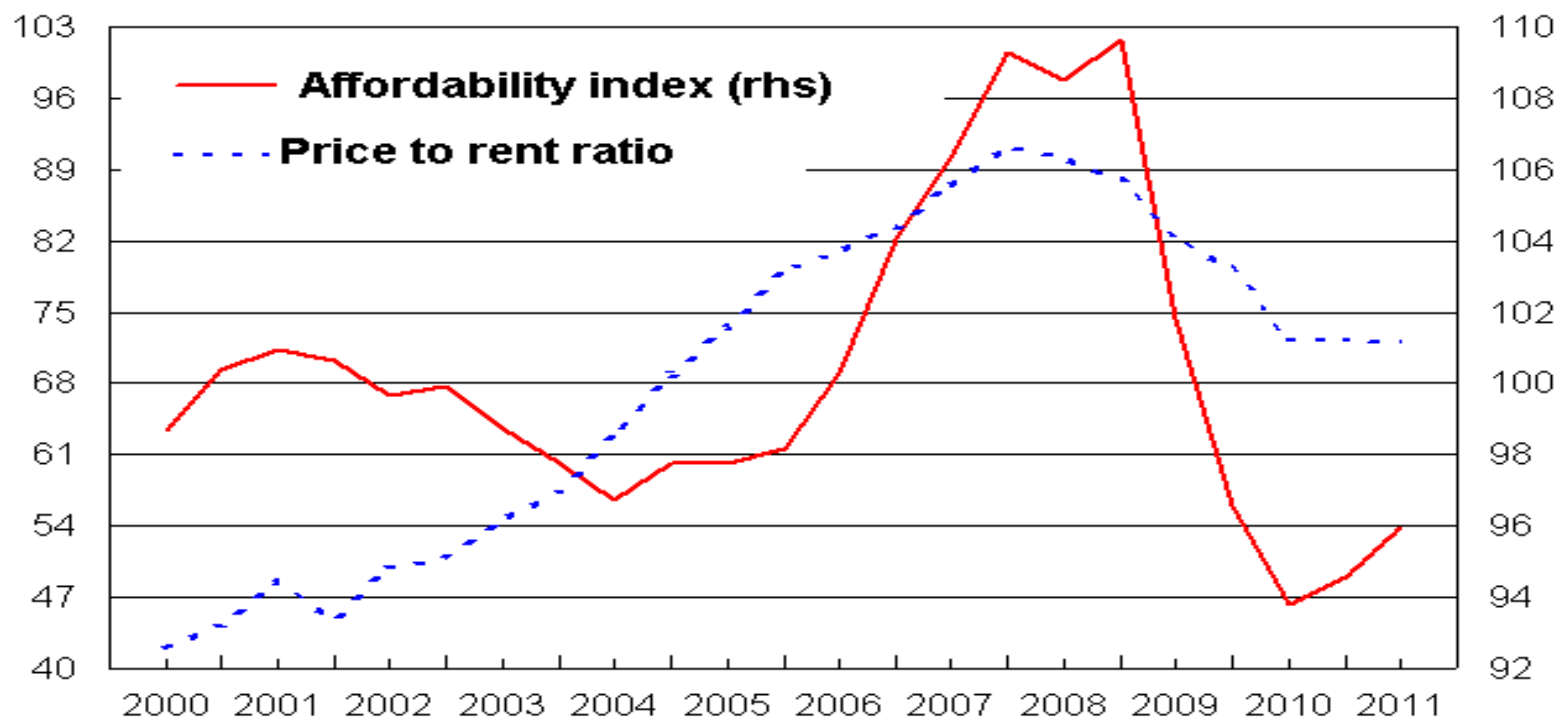
Source: elaborations on data from Bank of Italy, Tecnoborsa and the Agenzia del Territorio. Affordability is measured in inverse scale.

On the positive side, the risk of sharp reduction in house prices over the next few months is limited: the ratio of prices to rents is close to the longrun level and the affordability index is much higher (no signs of overvaluation, in line with econometric evidence). In addition, almost half of the estate agents polled in October expect prices to remain stable.

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