Saving Rates and House Price Dynamics in Europe: Structural Modeling and Implications for the Future

Report*

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Executive Summary

Population ageing is one of the major challenges of our times. Unless structural reforms are undertaken not only in the welfare systems but also in the labour and financial markets, ageing will negatively affect both growth rates and public budgets, particularly in Europe. Without reforms, the rising needs of an increasingly elderly population will in any case put a stress on growth supporting policies.

The typical policy answer has been to increase labour market participation of both women and the elderly. Retirement ages have been increased and the implicit taxes on the continuation of work after reaching pension eligibility have been reduced or eliminated by resorting to a stronger correlation between contributions, age of retirement and benefits.

Less emphasis has been put on creating the conditions for a more direct participation of the elderly in financing their needs. Yet, a substantial contribution could come from their more substantial asset, i.e. housing wealth. In recent years, house prices have been steadily growing, with some exceptions, such as Germany and Japan (in 2000-6 real house prices in the OECD area increased at an average yearly rate of 6.6 per cent). Although the present financial crisis casts a gloomy uncertainty on future developments, with the possibility that past gains with be more than offset by prospective losses, the question remains as to how much and how far should the elderly be asked to participate directly in the financing of their increasing longevity. Not all the elderly are poor and the

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possibility to concentrate public resources on those more in need will help increasing the effectiveness of the expenditure.

Why concentrate on housing wealth? There are four main reasons:

- the weight of housing wealth in households' total assets;
- for homeowners an increase in house prices is likely to generate capital gains, i.e. additional wealth that might be spent in both housing and non-housing goods;
- the elderly are the main beneficiaries of the increase both because of higher homeownership rates and because their shorter lifetime horizon makes the increase in housing value less likely to be compensated by the PV of increased future rents;
- compared to other assets, house value stands out for its greater illiquidity which, combined with the greater needs of the elderly, could lead to financial innovations directed at increasing liquidity.

The transformation of the (greater) house value into a (higher) consumption flow (for example of LTC services) is however very difficult, unless the house is sold and the proceeds are transformed into an annuity: moving into a different (smaller or cheaper) house usually involves great psychological costs; as for annuities, irrespective of their theoretical dominance relative to other assets, they are rarely bought in any case, even when households have more liquid financial assets. The (increased) house value thus tends to represent a "hidden" wealth, which the owner can hardly dispose of for consumption. It thus ends up being bequeathed, even if not out of a genuine "joy of giving", but rather as a necessity. Still, all this should not be an obstacle to a more active role of housing equity towards the strengthening of the retirement nest-egg.

Financial instruments facilitating to turn housing wealth into consumption have been devised and used in the UK and the US for a long period. One of these instruments, called *reverse mortgage*, is a loan granted to house owners and guaranteed by the value of the house (the name comes from the fact that the contract is the opposite of the mortgage stipulated to purchase a house). Reverse mortgages are flexible products: the loan can be paid out either as a lump sum or as an annuity, and can be repaid by the owner or by his/her heirs. Although similar products have been introduced in different European countries in more recent years, the number of transactions remains very limited, hardly making a market. Through the annuity earned on a reverse mortgage, elderly people could cover at least a share of they old age needs, while at the same time remaining in their own house, which usually contributes to lower living costs; these formulae should therefore be promoted, for example through appropriate tax advantages, and also by reducing their complexity and by making the instruments compatible with a bequest motive (covering only part of the house value).

Despite the complexity of the products, instruments like the reverse mortgage could allow households to better allocate their consumption over time; their effects would not be limited to elderly needs; indeed, by enabling a higher consumption by a growing population group, they could play a role in increasing general consumption. Local authorities could play a significant role by endorsing reverse mortgage schemes and thus helping overcome the elderlies' diffidence towards them.

This is the general setting of the present report. We present, first, an overview of households' saving rates, house and wealth dynamics in Europe, in recent years. We document recent trends and stylized facts concerning saving rates, financial and non-financial wealth stock (with particular emphasis on housing wealth), house prices, the potential role and recent expansion of innovative financial products, such as reverse mortgages, and population ageing. We then use both a macro and a micro perspective to analyze the effects of house price variations on consumption and savings for a set of key European countries: France, Germany, Italy, Spain and the UK. Under the former perspective, we estimate the permanent and transitory components of house price fluctuations and explore the dynamic interactions between consumption expenditure, output, and real house prices.

Turning to a micro-perspective, we sketch a simple life-cycle model with households living for two periods, extending Skinner (1993). Even in such a simple framework, an unexpected shock to house prices will produce different wealth effects on households with different age. Our estimation analysis confirms that the impact of real estate appreciation on dissaving is very weak, households decreasing their savings by €50 to €100 corresponding to a €10,000 increase in housing capital gains.

The study does not allow to draw firm policy conclusions and this is by itself an important result, meaning that simple recipes and improvisation by politicians have no place here. Much more is to be understood as to why elderly people do not tap their housing wealth to finance their needs in old age. They are typically unwilling to contemplate moving to a smaller house. This is due to a precautionary motive against future uncertain (particularly health) contingencies, or to other factors.

Even in countries (such as those we have studied) where health expenditure is normally covered by public insurance, fear of future catastrophic health contingencies could persuade households to view the housing equity as the best hedge against these risks and possibly as a wealth to be (informally) exchanged within the family to obtain assistance and care in case of necessity.