

House Price Convergence: Evidence from India

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December 2022, WP #893

ABSTRACT

The “club convergence” of sub-national house prices has so far been studied in respect of a number of advanced economies and emerging markets, but not for India. As such, this study contributes to this gap in literature by analysing long-run convergence of regional house prices for a major emerging market. This study finds that city house prices in India do not converge to a single steady state, rather they form at least three clusters and converge to their respective steady state paths. The house prices are found to display conditional convergence driven by several factors, which *inter alia* include initial price levels, mortgage loans, and population density. The outcome of this study could be useful for policy makers in designing cluster-specific policy measures. It could also be useful for real estate fund managers, in achieving better fund diversification strategies, and the mortgage market forecasters, in reduced forecasting and modelling efforts.

Keywords: House Prices, Mortgage Market, Loans, Convergence, Club, Sub-National, India.

JEL classification: O18, R3, R21

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The views expressed in this paper are those of authors' alone and do not represent the opinion of the Banque de France or the Eurosystem or the Reserve Bank of India. We are especially grateful to Unal Seven for discussion and feedbacks on the paper. Authors are thankful for comments in the DGSEI seminar at the Banque de France. Comments from Remy Lecat is also acknowledged.

NON-TECHNICAL SUMMARY

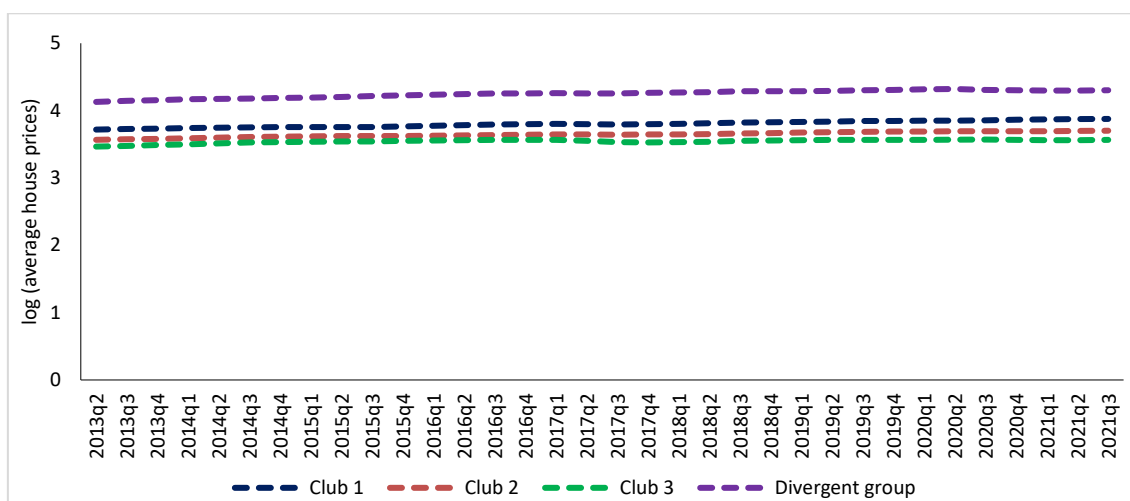
House prices at the sub-national level are characterised by marked heterogeneity. Nevertheless, they could form clusters portraying similar dynamics. In other words, regional house prices could display club convergence. This implies that city house prices could organize into clubs within each of which they achieve convergence with the decline in dispersion of house prices of constituent cities over time. This convergence might be conditional and could, *inter alia*, be due to commonality of dynamics facing them. In a country, there could be multiple convergence clubs of house prices.

The evidence of club convergence behaviour of sub-national mortgage markets could be useful for policy makers in designing cluster-specific policy measures, especially for large countries, including ways to reduce differences across “regional clubs”. For instance, identification of housing clusters and the associated common drivers could better guide policy makers in stabilizing demand-driven localized house price shocks through region-specific policy measures. Also, it could guide in better addressing the issue of housing shortages and affordability through apposite demand and supply-side interventions. The club convergence understanding could also be useful for the real estate investors/ fund managers/ investment trusts, *etc.* as they could implement better fund diversification strategies. Furthermore, this could also save modelling and forecasting efforts of the forecasters since they could study the groups together.

Though several house price club convergence studies have been conducted in the context of both advanced and emerging market economies, to the best of our knowledge, there is no study so far for India on this area. As such, this study contributes to the literature in the Indian context. It seeks to investigate the following issues: (a) Do the sub-national residential house prices in India converge to a single long-run equilibrium?; (b) If not, do they form respective convergence groups (“convergence clubs”) wherein those with common trend converge; and (c) What are the drivers of convergence in those groups?

With these in hindsight, this study analyses the quarterly sub-national residential house prices data for 50 cities of India and implements tests on the shape of convergence (notably log(t) test) and clustering algorithm as suggested by Phillips and Sul [(2007) and (2009)]. Our findings suggest that sub-national house prices in India do not converge to a single steady state. Rather, they form clusters, wherein they exhibit conditional convergence to the respective steady states. Of the 50 cities, residential house prices of 48 cities form three distinct convergence clubs (see Figure). Two cities, with the highest residential price levels, form a divergent group. The clubs appear to differ in terms of price level. The transition path of cities within a club may be quite distinct from one another. However, they all display catching-up to the club-specific average transition path.

House prices across the convergence clubs



Source: Authors.

Furthermore, to understand the drivers of this club convergence, we estimated an ordered probit model. Initial residential price, house rent, home loans, population density, literacy and city inflation determined convergence club membership. Estimates suggest that the prospect of a city belonging to higher house price club improves with higher initial house price, home loan, rent, population density, and literacy. On the contrary, higher city inflation increase the chances of a city being associated with lower house price club. The findings of the study could be useful for policy makers, fund managers and the mortgage market forecasters.

Convergence des prix des logements: le cas indien

RÉSUMÉ

La convergence à long terme des prix des logements infranationaux a été étudiée jusqu'à présent pour un certain nombre d'économies avancées et de pays émergents, mais pas pour l'Inde. Cette étude contribue à combler cette lacune de la littérature en analysant la convergence à long terme des prix de l'immobilier régionaux pour un marché émergent majeur. Cette étude montre que les prix des logements dans les villes indiennes ne convergent pas vers un état stable unique, mais qu'ils forment plutôt au moins trois groupes et convergent vers leurs états stables respectifs. Les prix de l'immobilier affichent une convergence conditionnelle déterminée par plusieurs facteurs, notamment les niveaux de prix initiaux, les prêts hypothécaires et la densité de population. Les résultats de cette étude pourraient être utiles aux décideurs politiques pour concevoir des mesures politiques spécifiques aux clusters. Ils pourraient également être utiles aux gestionnaires de fonds immobiliers, pour mettre en place de meilleures stratégies de diversification des fonds, et aux prévisionnistes du marché hypothécaire, pour réduire les efforts de prévision et de modélisation.

Mots clés : Prix des maisons, marché hypothécaire, prêts, convergence, club, sous-national, Inde

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1. Introduction

Housing forms one of the core needs (food, cloth and shelter) of human beings. It also constitutes an important form of asset for the house-owning households. This notion of housing as a wealth stock for households binds this sector intricately with economic activity. Changes in house prices is believed to influence the spending behaviour of households through the ‘wealth effect’¹. Also, the housing sector remains inter-linked with other sectors of the economy in a significant way. As housing sector constitutes a significant chunk of gross domestic product (GDP), a boom or bust in house prices could significantly influence economic activity. Sharper change in prices in the housing market could also become a source of vulnerability or crisis. The Great Recession, which essentially originated in the sub-prime mortgage market, is a case in point.

Furthermore, as housing forms a core component of retail inflation, changes in house prices have a bearing on inflation in the economy. Hence, policy makers attach high importance to monitoring the house price movements. Besides, the financial stability and inflation perspective, maintaining house affordability for the first-home buyers has also recently engaged the attention of policy makers for monitoring house price movements. In the case of New Zealand, the Monetary Policy Committee of its Central Bank² considers house prices while making monetary policy decisions since early 2021.

House prices at the sub-national level are characterised by marked heterogeneity. Under perfect factor mobility condition over time, *ceteris paribus*, regional house prices are expected to converge to a long-run steady state. But, the presence of several rigidities may constrain the possibility of achievement of such a steady state. Notwithstanding this, the city house prices across regions may, however, in some way display similar trend over time and converge to a particular steady state. This could be driven, *inter alia*, by initial conditions, migration, population pressure, *etc.* For a country, understanding of regional differences in house prices and the associated dynamics may offer significant policy insights. Differences in house prices behaviour across cities may also reflect the regional income disparities (Apergis, *et. al.*, 2015).

¹ A behavioural theory suggesting that higher house prices cause a rise in value of people’s asset holdings (wealth) and, in turn, encourage them to spend more, which boosts economic activity and growth.

² Since March 2021, as per the Government’s direction, the Monetary Policy Committee of the Reserve Bank of New Zealand (RBNZ) is required to assess how its interest rate decisions and other policy instruments (at its disposal) affect the government’s objective of house price sustainability. Furthermore, the RBNZ has also been directed to dampen investor demand so as to improve house affordability of first-home buyers. (See <https://www.rbnz.govt.nz/>)

Several studies in the context of both advanced and emerging market economies have established existence of club convergence in the mortgage markets. Club convergence implies that regional house prices form clusters within which they achieve convergence. In simple terms, within each club the dispersion of house prices declines over time.

An in-depth understanding of differential behaviour of mortgage markets at the sub-national level can be of significant importance to the public policy makers in devising targeted policy interventions³. Recognition of the fact that a group of sub-national mortgage markets may witness similar dynamics could enable policy makers in deciphering the underlying common driving factors and accordingly institute apposite policy measures. For a large country like India, given acute shortage of housing and its affordability, grouping of cities based on price trends could enable policy authorities in making apposite demand and supply-side interventions. Also, given heterogeneity of regional mortgage markets in large countries, identification of similarly behaving clusters could guide policy makers better in stabilizing localized house price shocks through regionally-differentiated policies. In this regard, Funke, *et. al.* (2021)⁴ specifically highlighted the efficacy of sub-national macro-prudential policies (such as loan-to-value ratio) in stabilising house prices if they are region-specific and originate on the demand side. Information about housing club convergence could also be useful for financial stability (Matysiak and Olszewski, 2019).

The evidence of club convergence behaviour of sub-national mortgage markets could also be useful for the real estate investors, especially the real estate investment trusts and other real estate fund houses. Identification of clubs could enable them in designing better fund diversification strategies. Furthermore, understanding and awareness of house club convergence at regional level could also save modelling and forecasting efforts of the forecasters as the groups could be studied together. Such an analysis becomes all the more relevant for sheer-sized countries with larger number of sub-national mortgage markets. Despite significant merits of understanding club convergence behaviour of sub-national house prices for policy formulation, it has remained less explored area, especially in the context of a large number of emerging market economies (EMEs), including India.

³ See Matysiak and Olszewski (2019).

⁴ They analysed sub-national house price dynamics in a multi-regional DSGE model for the UK economy. Their findings suggest that given significant regional house price differences in the Great Britain, regionally differentiated macro-prudential policies achieve better policy outcome than the ‘one-size fits-all’ national policy.

To the best of knowledge, there is no study, so far, on club convergence of house prices for India. This study, therefore, contributes to this literature gap. The present study attempts to investigate empirically if the housing market in India is characterised by a long-run equilibrium to which the individual city house prices converge. If not, whether there are convergence clubs wherein the sub-groups with common trend converge to their steady states. In the process, the study also seeks to unravel the underlying factors that could be driving this behaviour.

Against this backdrop, this paper analyses the quarterly sub-national residential house prices data for 50 cities of India and implements $\log(t)$ test and clustering algorithm as suggested by Phillips and Sul [(2007) and (2009)]. Findings suggest that sub-national house prices in India do not converge to a single steady state. Of the 50 cities, residential house prices of 48 cities form three distinct convergence clubs and the remaining two cities form a divergent group. The transition path of cities within a club may be quite distinct from one another. However, they display catching-up to the average transition path.

This paper is organised as follows. Section 2 lays down a synoptic literature review in this area. Data and methodological discussions are covered in section 3. Characteristics and recent trends in house prices in India is covered in section 4. Empirical estimation and relevant discussions constitute section 5, and lastly section 6 concludes.

2. Literature Review

The regional house prices could, *inter alia*, be also influenced by ripple effect of one region on other area(s). A large number of studies have investigated the dynamics of regional house prices. Earlier convergence studies used techniques such as unit root, cointegration, beta, sigma, dynamic panel data methods, *etc.* The heterogeneous transitional dynamics, nevertheless, may not get adequately captured through these conventional convergence tests. These conventional convergence methods do not perform well in the presence of heterogeneous transitional behaviour of cross-sections. The convergence methodology proposed by Phillips and Sul (2007) takes into account individual heterogeneity and transitional dynamics. This methodology is popular given its better performance *vis-à-vis* other conventional methods and accordingly has been used widely for studying house price convergence.

A number of studies have examined the issues of house price convergence across various economies. Akin to the convergence of house prices, few studies have also been undertaken in the

context of understanding convergence in housing rentals⁵ at the sub-national level in respect of Poland and Germany. The club convergence of house prices has been studied extensively in respect of a number of advanced and EMEs; notably in respect of Eurozone countries, UK, USA, South Africa, Poland, Spain, China, Turkey, Australia, *etc.*

Few notable studies examining club convergence of house prices in the case of United States are that by Apergis and Payne (2012); Kim and Rous (2012); and Apergis and Payne (2020). Using quarterly house prices data for 1975q1 to 2010q4, Apergis and Payne (2012) reported three convergence clubs. Clubs I, II, and III consisted of 29, 19, and two states, respectively. Kim and Rous, *op. cit.* reported strong evidence of multiple convergence clubs. They also examined the general characteristics of the various convergent and divergent sub-groups as well as some important driving forces of convergence clubs. They found that housing supply regulation together with climate remained important determinants. Apergis and Payne (2020) explored the regional housing prices across 21 metropolitan areas of Florida (USA). Using quarterly house price data for 1987q2 to 2017q3, they reported four convergence clubs.

In the case of the United Kingdom, Holmes and Grime (2005) and Montagnoli, *et. al.* (2015) examined the clustering behavior of UK cities. Holmes and Grime, *op. cit.* analysed the regional house price convergence for the thirteen regions using quarterly data for 1973q4 to 2005q1. They derived the largest principal component from regional house price differentials. This was found stationary suggesting a common stochastic trend driving regional house prices, which could be regarded as exhibiting strong long-run convergence. They observed higher level of persistence in regional house price differentials. Montagnoli, *et. al.* (2015) analysed the quarterly house prices for 1983q1 to 2012q4 across twelve different regions of the United Kingdom and found that regions could be grouped into four clusters.

For Australia, Churchill, *et. al.* (2018) and Bashar (2020) analysed the clustering behavior of house prices across the Australian cities. Churchill, *op. cit.* examined the issue of convergence in the residential property price index across the eight Australian cities from 2003q3 to 2017q4. They identified two convergence groups and one non-divergent group. Bashar, *op. cit.* examined convergence of regional house prices across 300 odd suburbs of the Melbourne metropolitan area

⁵ Tomal (2021) reported club convergence of housing rent across Polish provincial capitals being driven by city area, housing stock, unemployment rate, and number of students. Semerikova, *et. al.* (2022) reported convergence of house rental prices for 397 German regions for the period 2004 to 2020.

in Australia. They found evidence for conditional convergence in presence of spatial effects as also population, employment, crime rate, and education.

A number of studies [Blanco, *et. al.* (2016); Matysiak and Olszewski (2019); Maynou, *et. al.* (2020); Miles (2020); Maynou, *et. al.* (2021); Trojanek (2021)] have been carried out in respect of clustering behavior of house prices across European countries. Blanco, *et. al.* (2016) attempted to identify convergence clubs in house prices among Spanish regions over the period 1995q1 to 2007q4 and investigated determinants. They found four groups for club convergence, which were influenced by initial house supply, population growth, size of the rental market, and geographical situation.

Matysiak and Olszewski (2019) investigated the evolution of residential property prices in sixteen major cities of Poland over the period 2007q1 to 2018q4 and found evidence for three convergence clubs. They also established that few demand and supply factors, in conjunction with initial price conditions, accounted for the club groupings.

Maynou, *et. al.* (2020) analysed the issue of house price convergence across the European countries, both members and non-members of Eurozone. They reported five convergence clubs for Europe, which, in turn, were driven by private debt, unemployment, and long-term government interest rate. Miles (2020) applied probabilistic pairwise approach for analyzing convergence across euro zone housing markets. They didn't find strong evidence for house market convergence for euro zone countries. Maynou, *et. al.* (2021) examined the issue of convergence in house prices across the Eurozone countries using quarterly data for 2004q2 to 2016q3. They found evidence for five convergence clubs. They attributed unemployment and fiscal policy as the drivers of this clustering. Trojanek (2021) analysed 18 regional housing market for Poland. The study identified two house price convergence clubs in Poland for the period 2000q1 to 2019q4. However, in the split sample analysis for pre and post Great Recession periods, the study identified four convergence clubs along with a number of divergent housing markets.

In contrast to above studies for European countries, which established club convergence across the countries, Tsai (2018) reported the contrary. Tsai, *op. cit.* examined if the adoption of Euro increased house price convergence amongst the European countries. Using quarterly data for 1984q1 to 2015q1, for select EU and non-EU countries, Tsai, *op. cit.* reported that before implementation of Maastricht Treaty in 1992, house prices in European countries remained non-convergent, nevertheless, after 1992, it converged.

The clustering behavior of house prices has also been examined in the case of several emerging market economies as well. In the case of Korea, Kim (2011) established existence of multiple

convergence clubs of house prices. Meng, *et al.* (2015) used monthly house price data for ten key cities of China (for the period from January 2005 to November 2013) and found evidence for four convergence clubs. In the case of South Africa, Apergis, *et al.* (2015) examined the issue of law of one prices across the residential markets of nine provinces. They found that house prices in nine provinces did not converge to a single steady state, rather they formed three convergence clubs.

In the case of Turkey, notable work has been done by Ganioglu and Seven (2019) and Ganioglu and Seven (2021). Employing quarterly nominal house price data for 26 Turkish cities for the period 2010 to 2018 to see if the prices converged, Ganioglu and Seven (2019) reported prevalent heterogeneity in Turkey's housing market. They reported existence of seven convergence clubs and one divergent group. In a similar analysis, Ganioglu and Seven (2021) contended that income, population, education, refugees, earthquake zone, and unemployment explained the cluster behavior of the cities. Gunduz and Yilmaz (2021) analysed house price convergence across 55 major cities in Turkey for the period 2010q1 to 2018q4. They reported the role of population density, climate, employment rate, metropolitan municipality in influencing convergence club membership.

On the whole, these studies have established the existence of club convergence in the sub-national housing markets of both the advanced and emerging market countries. Most of these studies have also suggested the determinants of such club convergence behaviour of house prices, which could vary from one country to another. These studies have established several factors for club convergence of house prices, which could be listed *inter alia* as supply and demand factors, initial prices, housing supply, climate, private debt, unemployment, long-term government interest rate, population growth, size of the rental market, geographical situation, income, education, earthquake zone, and refugees.

In the context of housing study in India, available literature have, by and large, discussed, various aspects such as housing prices and its interaction with interest, income, bank credit, regulatory guidelines, monetary policy shocks, and the macro-prudential regulation. Joshi (2006)⁶, and Mahalik and Mallick (2011)⁷ examined the influence of interest rates, income level, and bank credit on house prices in India. The influence of monetary policy on the house prices has been examined

⁶ He estimated a structural VAR model and found that interest rate and non-food credit accounted for more than two-thirds of forecast variance in house prices in India, which remained more important than income.

⁷ They estimated a vector error correction model and found that while income had positive influence on house prices in India, real non-food bank credit had an adverse impact.

by Singh and Pattanaik (2012)⁸; Singh and Nadkarni (2017)⁹; and Naikoo, *et. al.* (2021)¹⁰. The response of house prices to macro-prudential regulation has been examined by Singh (2020) who reported that macro-prudential indicators such as loan-to-value (LTV) ratio, risk weights, and provisioning requirements also had a binding influence on housing price movements in India.

The literature on housing price convergence in the Indian context, nevertheless, is all the more scanty. The only available study is that by Aye, *et al.* (2012) who using panel unit root test on house prices (for the period 2007 to 2011) for 15 bigger cities reported that house prices did not converge in India. Nevertheless, there is no study, so far, in Indian context, which has highlighted the issue of club convergence behavior of regional house prices. This study, hence, contributes and fills this void in literature. Besides establishing the club convergence of regional house prices, the study also unravels the factors influencing this.

3. Data and Methodology

3.1. Data

Currently, two public sector agencies, *wiz.*, National Housing Bank (NHB) and the Reserve Bank of India (RBI) are involved in release of housing price data in India. The housing price index released by the NHB is called the RESIDEX. Comparatively¹¹, the NHB RESIDEX has wider geographical coverage of 50 cities (of which 33 are smart cities) located across 21 states¹². Based on wider coverage of data for a large number of cities, NHB data has been used in this study. *Ipsa facto*, the first official statistics on house prices in India was released by the NHB in 2007¹³. Since its launch, the NHB has updated the base year four times - the current base year being 2017-18

⁸ They investigated asset prices and monetary policy interactions and reported interest sensitivity of housing credit demand in India.

⁹ They found that monetary policy and bank credit shocks had a dominant role in influencing stock and house prices, respectively.

¹⁰ He found that monetary policy shocks did not have a significant impact on house prices in India.

¹¹ The housing data published by the RBI covers just 10 bigger cities.

¹² NHB (2020).

¹³ In 2005, the NHB first conducted a pilot study in Mumbai, Delhi, Bangalore, Bhopal and Kolkata before officially launching the NHB residex based on the house price data for these five cities on half-yearly basis, to begin with. Subsequently the coverage of NHB residex was widened to 26 cities and 2007 base year chosen. Since 2017, when the base year was shifted to 2012-13, the NHB has been publishing house price data in respect of 50 cities.

since June 2018.¹⁴ The NHB house price index is computed using the base year quantity using the Laspeyres' index method. The city-wise house price index (HPI), calculated for the 50 cities, are weighted, based on 2011 census population, to derive the composite HPI.

The NHB releases two house price indices. Assessment price of ready residential properties is based on valuation data as received from the banks and housing finance companies, while the market price for under-construction properties derives from the market survey of project financing details of the banks and HFCs for collecting data in respect of unsold stock. Besides the house price indices, the NHB also releases four-quarter moving average city-wise house assessment prices – Indian Rupee (INR) per square foot. The city-wise assessment price was used in the study. For empirical estimation, the nominal house price data was deflated by city inflation¹⁵ derived from the Government of India. Mortgage loan from the banks were sourced from the RBI, which was then deflated by number of loan accounts. Data on population density, literacy and house rent were sourced from the Government of India sources (Table 1).

Table 1: Data sources

S. No.	Variables	Source
1	House price	National Housing Bank
2	Consumer price index	Government of India
3	Mortgage loan	Reserve Bank of India
4	Number of mortgage loan accounts	Reserve Bank of India
5	Population density	Government of India
6	Literacy	Government of India
7	House rent	Government of India

3.2. Methodology

The heterogeneous transitional dynamics may not get adequately captured through conventional convergence tests such as unit root, cointegration, beta, sigma, dynamic panel data methods, *etc.* These conventional convergence methods do not perform well in the presence of heterogeneous transitional behaviour of cross-sections. The convergence methodology proposed by Phillips and Sul (2007) is a non-linear time varying factor model that accounts for individual heterogeneity and transitional dynamics. It involves a one-sided t-test in which null hypothesis of convergence is considered against the alternate hypotheses of partial convergence amongst sub-groups or

¹⁴ Previous base years have been 2001, 2007, and 2012-13.

¹⁵ In case of unavailability of inflation data for few cities, the inflation of proximate city was considered.

divergence [Phillips and Sul (2009)]. Given its inherent advantages and better performance, this method has been widely used in a number of related studies as stated earlier.

A panel data series X_{it} may be decomposed into a permanent (g_{it}) and a transitory component (a_{it}) as follows:

$$X_{it} = g_{it} + a_{it} \quad (1)$$

Since both the said components have a common factor (μ_t), equation (1) could be rewritten as:

$$\begin{aligned} X_{it} &= \{(g_{it} + a_{it})|\mu_t\} \mu_t \\ X_{it} &= \mu_t \delta_{it} \end{aligned} \quad (2)$$

where δ_{it} is a time-varying idiosyncratic element, which captures the deviation of series i from the common component (μ_t), which is common (say a technological development available to all) across cross-sections. δ_{it} are individual transition factors measuring as to how the cross-sections relate to μ_t over time.

In this framework, the panel entities are expected to converge (either the full sample or in some clusters) to steady state at some future point if $\lim_{k \rightarrow \infty} \delta_{it+k} = \delta$ for all $i=1,2,\dots,N$. The transition paths of different panels could be significantly different. Since δ_{it} cannot be estimated directly from equation 2, the common component μ_t is eliminated through rescaling by the cross-sectional average:

$$h_{it} = \frac{X_{it}}{\frac{1}{N} \sum_{i=1}^N X_{it}} = \frac{\delta_{it}}{\frac{1}{N} \sum_{i=1}^N \delta_{it}} \quad (3)$$

where h_{it} in the above equation is relative transition parameter. It measures the relative share of factor loading, δ_{it} , in respect of individual cross-section at time 't' and captures the transition path with respect to the panel average.

Furthermore, cross-sectional variance of h_{it} is measured as H_t , which is defined as follows:

$$H_t = \frac{1}{N} \sum_{i=1}^N (h_{it} - 1)^2 \quad (4)$$

For the convergence, the following semi-parametric form of δ_{it} is assumed:

$$\delta_{it} = \delta_i + \sigma_{it} \varepsilon_{it} \quad (5)$$

where $\sigma_{it} = \frac{\sigma_i}{L(t)t^\alpha}$; $\sigma_i > 0$, $t \geq 0$, and ε_{it} is weakly dependent over t .

$L(t)$ is a slowly varying function like $\log(t)$. And, $L(t) \rightarrow \infty$ as $t \rightarrow \infty$.

The average difference between δ_{it} and δ_i is expected to decline overtime. This decline occurs at a proportional rate of inverse of $t^\alpha L(t)$.

Under the above specific form of δ_{it} , the convergence is ensured if $\delta_i = \delta$. In the event of $\delta_i = \delta$, h_{it} converges to 1 and H_t tends to 0.

The convergence can be tested in the framework of the following $\log t$ regression:

$$\log\left(\frac{H_1}{H_t}\right) - 2 \log L(t) = c + b \log(t) + u_t \quad (6)$$

The convergence hypothesis can be tested by the null hypothesis of $b=0$ in the equation above. Rejection of null hypothesis of the equation (6) above implies non-convergence or divergence. As such, there could be clusters within which few entities could be converging and also some divergent members in the panel. Absolute (level) convergence is achieved if $b \geq 2$. Relative (conditional) convergence is achieved if $0 < b < 2$.

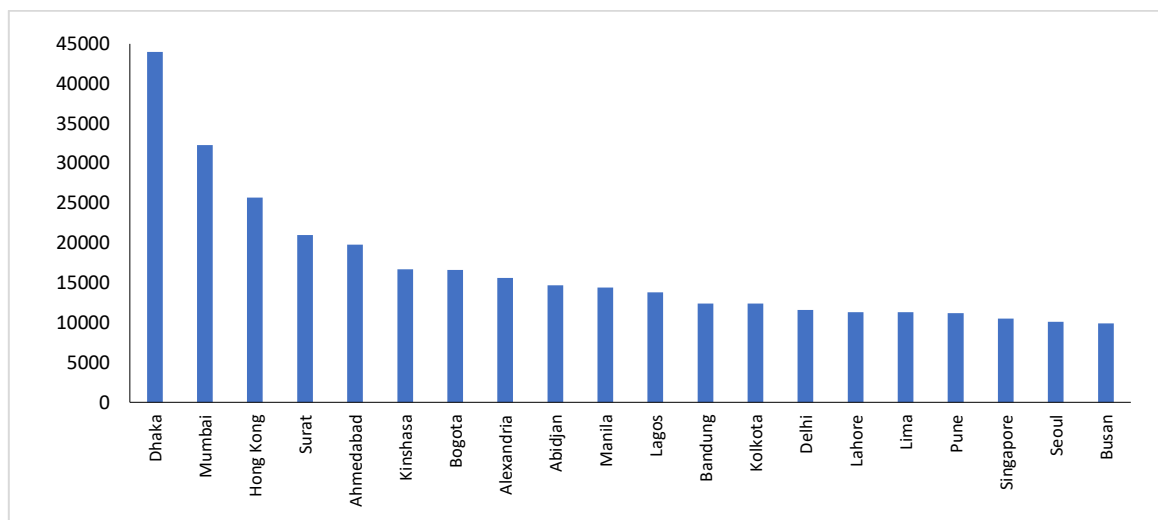
After testing the null hypothesis (considering entire panel), clustering algorithm as proposed by Phillips and Sul [(2007) and (2009)] is implemented following the suggested four steps:

- a) Step 1 involves ordering of the cross-section based either on the basis of last observation of the average of second half of the observations.
- b) Step 2 implicates forming a core group from the cross-sections such that they form a sub-group for $2 \leq k \leq N$ and tested using the $\log t$ regression for that sub-group. The core group size is chosen by maximising t_k over k subject to $\min \{t_k\} > -1.65$.
- c) Step 3 is associated with sieving the data for new club members by adding one cross-section at a time to the core group so formed and running $\log t$ regression again. Keep adding new cross-sections if the associated t -statistics exceeds the critical value.
- d) Step 4 is about recursion and stopping rule. From the cross-section not selected in Step 3 constitute a sub-group and run the $\log t$ regression for this sub-group to see if it satisfies the convergence test. In case it satisfies the convergence condition, then conclude that there are two convergence clusters. Otherwise, replicate steps 1–3 to see if the second group itself can itself be divided into sub-groups. In case there is no core group in Step 2, then the remaining cross-sections are deemed to diverge.

4. House prices in India – Characteristics and recent trends

In India, the real estate sector accounted for 6.7 per cent in GDP in FY 2021. Owing to its significant inter-linkages with manufacturing, construction, financial services and other sectors, it is the second largest employment generating sector (around 55 million jobs), next to agriculture, in the country. Given its larger economic significance, understanding the dynamics of this sector can offer vital policy lessons. Another compelling reason for studying the Indian residential house market is the fact that the country accounts for six of the world’s top twenty most populated cities (Figure 1). Hence, study of the Indian property market could help better understand the influence that population pressure could have on house prices in a larger economic setting. Another dimension which makes the study of Indian real estate market topical is the fact that one of its cities, Mumbai¹⁶, is portrayed as one of the most expensive real estate markets in the world. Mumbai, having the most expensive real estate market, remains an outlier in the country. As such, this study enables a better understanding of convergence dynamics of sub-national house prices in presence of outlier cities.

Figure 1: World (top-20) cities by population density - 2014



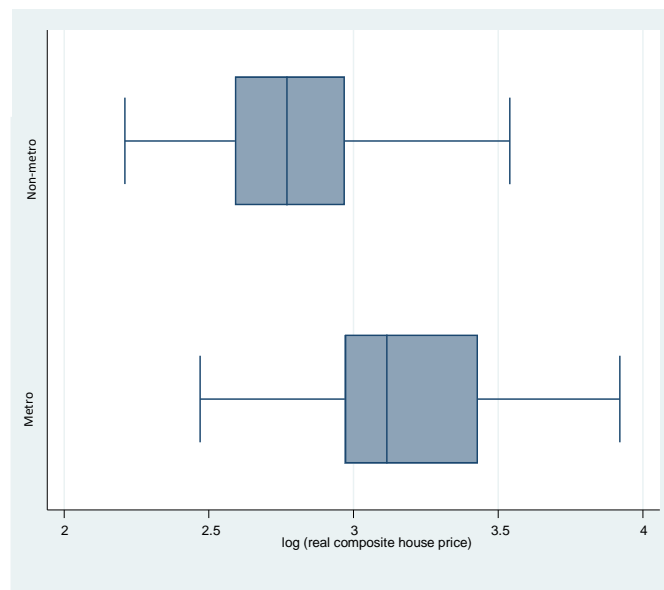
Source: Our World in Data.

The sub-national Indian housing market is characterised by significant heterogeneity. This heterogeneity could emanate from socio-economic, locational, climatic, and other factors. The

¹⁶ As per Knight Frank’s Prime International Residential Index, as in December 2018, Mumbai remained the 16th most expensive prime residential property market in the world.

residential property prices in metro cities in India remain higher than those in non-metro cities (Figure 2). Mann-Whitney test validates the significant difference in house prices across metro and non-metro cities in India¹⁷. There also remains significant variation in property prices across various regions of the country (Figure 3). Kruskal-Wallis¹⁸ test validates significant differences in residential property prices across the regions. The Western region has the highest median house prices, while the Central region has the lowest median. Also, residential property prices across 50 cities depict distinct trends (Figure 4).

Figure 2: Box plot of house prices in metro *versus* non-metro cities

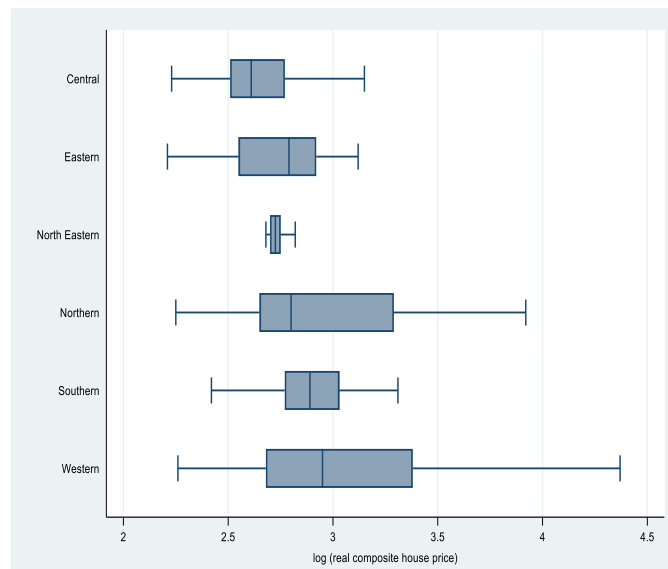


Source: Based on authors' calculations.

¹⁷ p-value = 0.00.

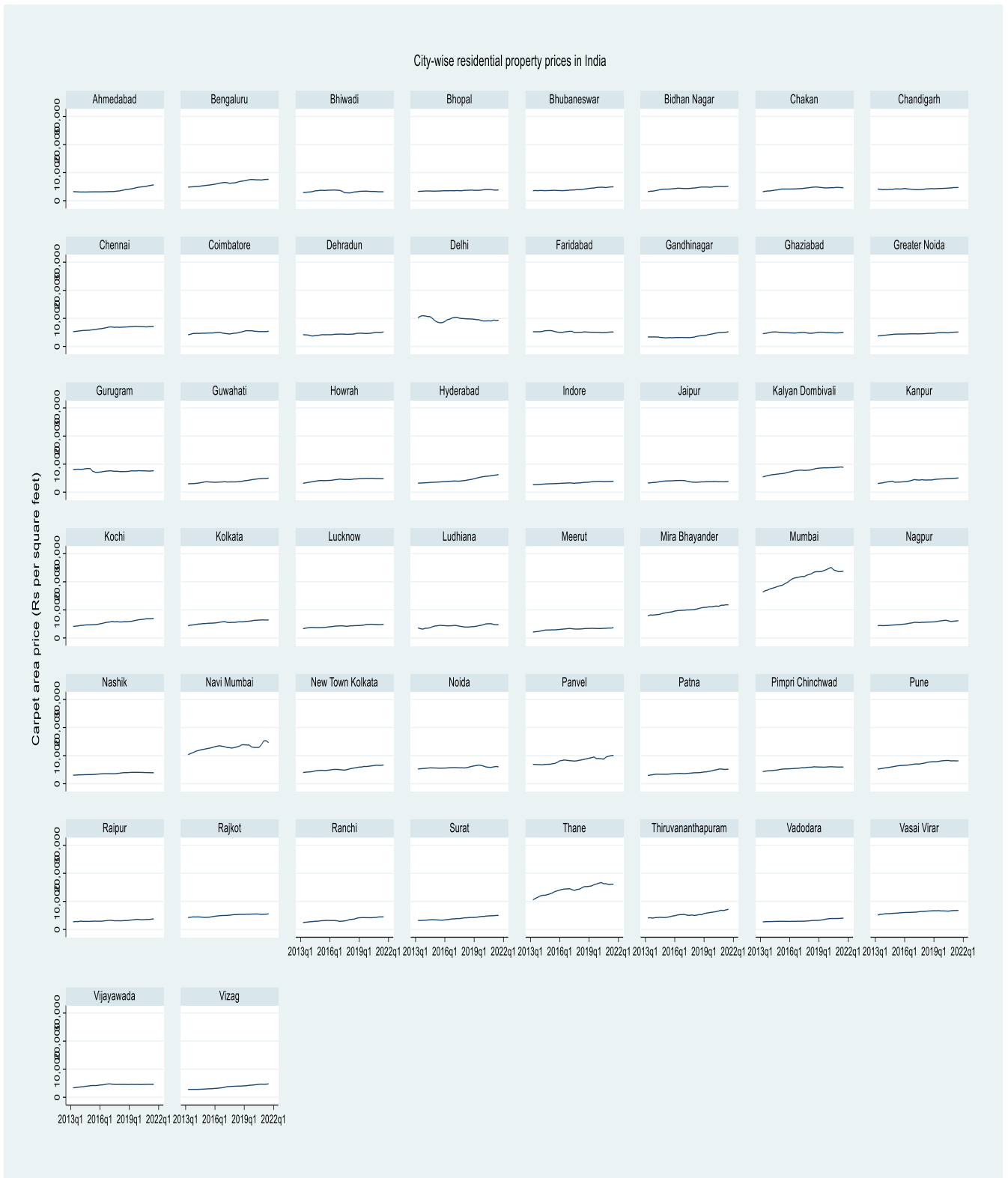
¹⁸ Chi² = 281.5 (p-value=0.0001).

Figure 3: Box plot of house prices across the regions in India



Source: Based on authors' calculations.

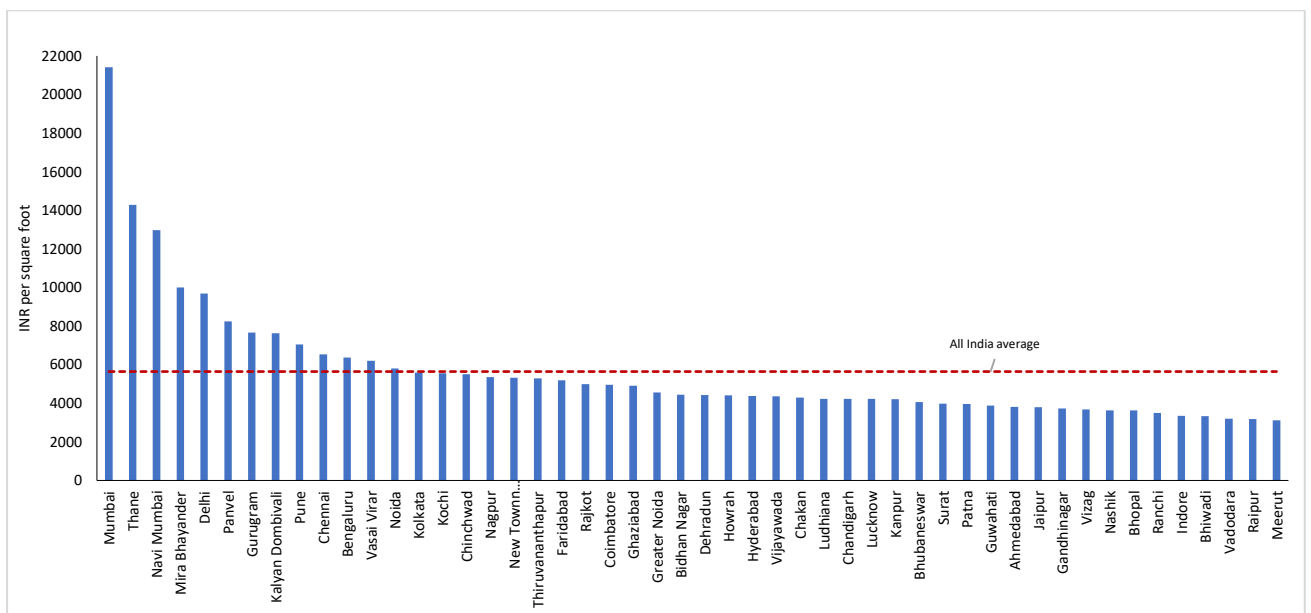
Figure 4: City-wise house prices



Source: Authors.

Besides, there remains significant disparity in the sub-national residential house prices in the country. Amongst the 50 cities, average house prices remained the highest in Mumbai and the least in Meerut; with the price in the former being roughly seven-times the latter (Figure 5). Furthermore, the house prices in Mumbai remained one-and-a-half times that of Thane, the city with the second highest house prices. Also, many of cities in India are characterized by lower residential house prices than the national average. Average house prices (for the period 2013q2 to 2021q3) in only 13 cities remained higher than the national average. There also remains a significant disparity in the residential house prices across the metro cities. Residential house prices in three metro cities such as Kolkata, Hyderabad and Ahmedabad, remained even lower than the national average (Figure 5).

Figure 5: Average city-wise house price in India (2013q2 to 2021q3)

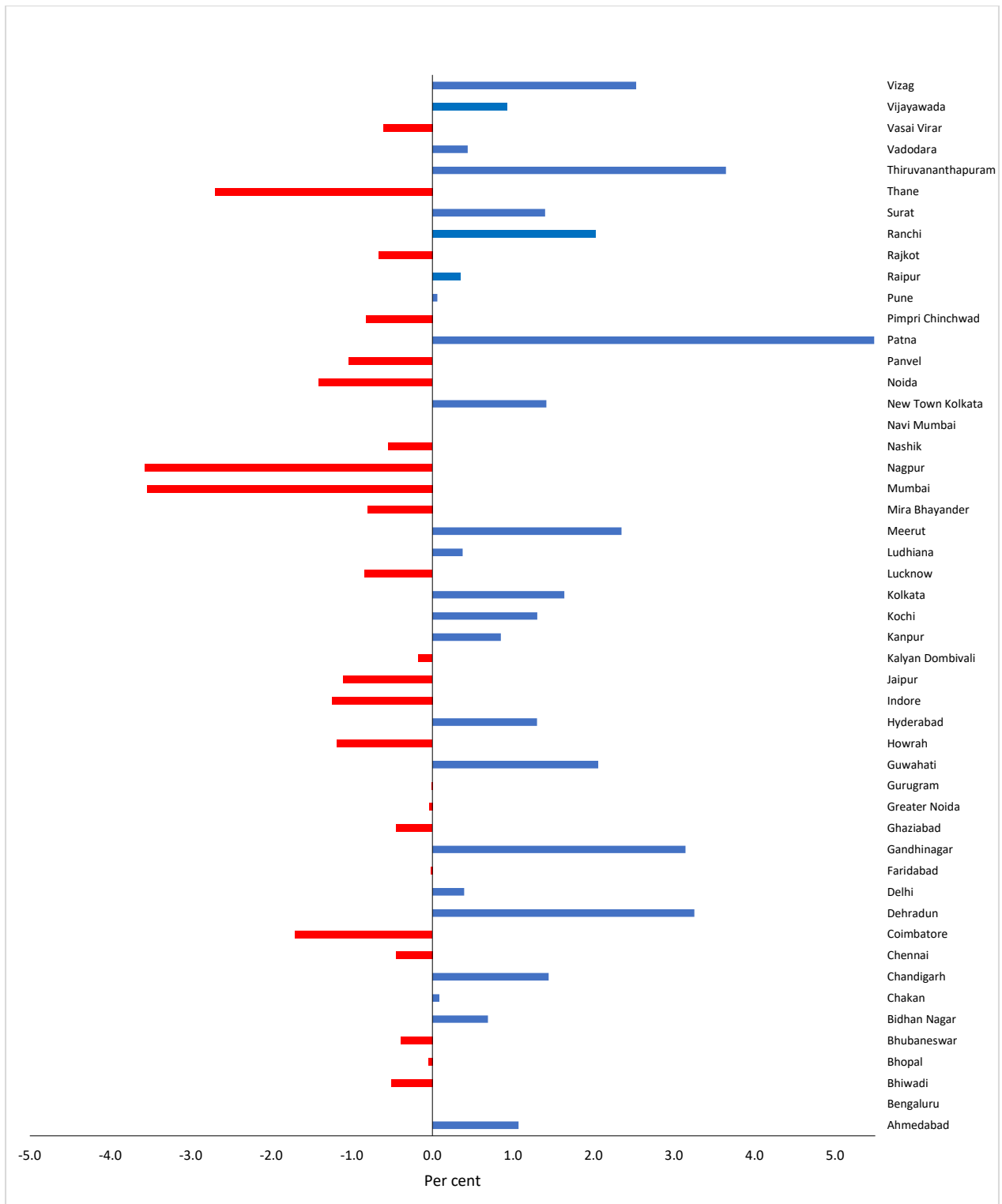


Source: National Housing Bank.

The heterogeneous behavior of sub-national residential property prices in India was very much evident even during the covid-19 pandemic, which can be considered as a common shock. Asymmetric quarter-on-quarter and year-on-year changes in residential house prices across cities in 2020q3 (just the quarter following the covid-19 lockdown¹⁹) was observed. While house prices increased in some cities, it declined in others (Figures 6 and 7).

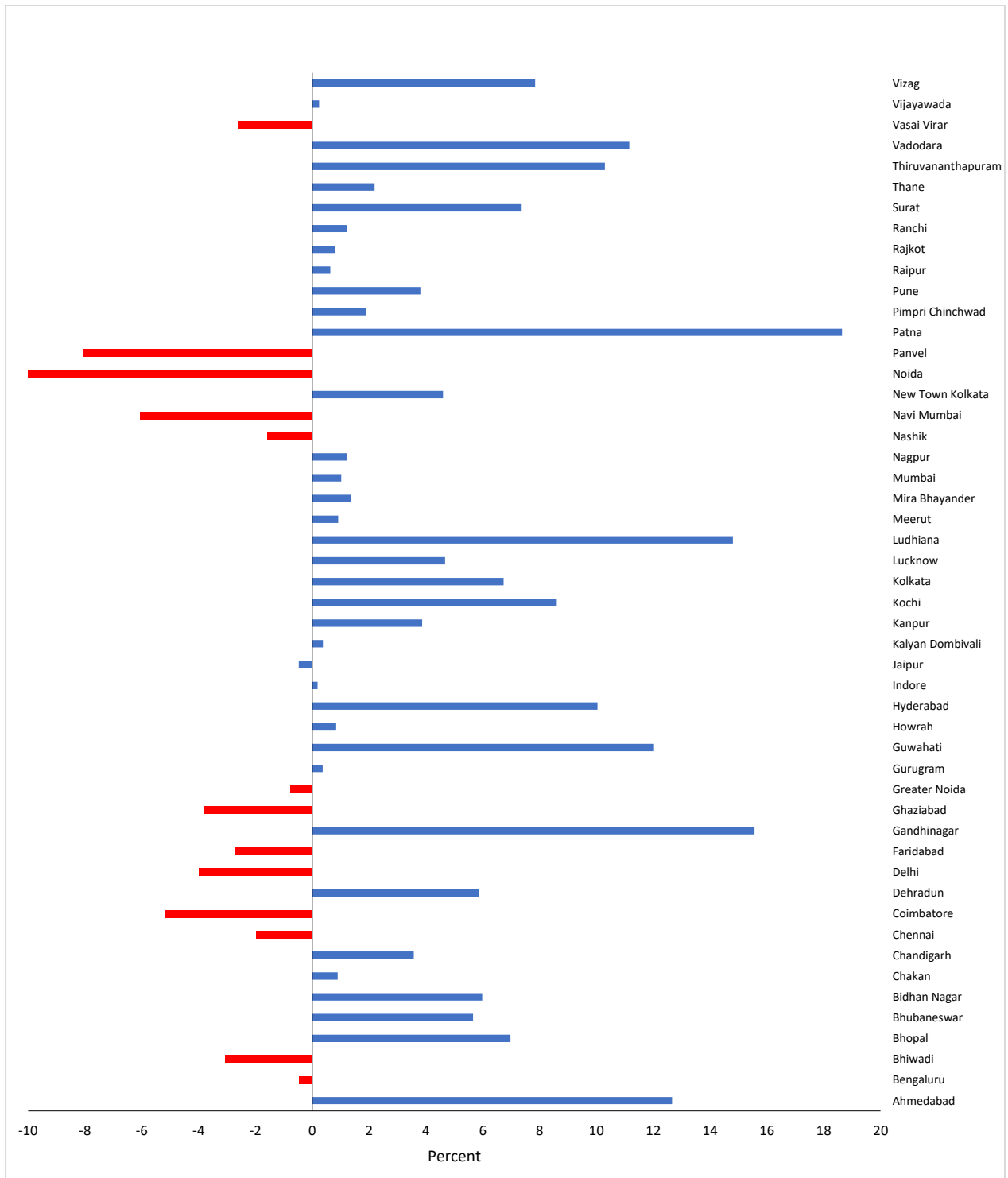
¹⁹ Nation-wide lockdown was enforced in India in four phases from March 25, 2020 to May 31, 2020 for preventing the spread of covid-19 pandemic in the country. Subsequently, unlocking of economy was undertaken in a phased manner, which lasted for a year or so.

Figure 6: City-wise house price (quarter-on-quarter) change in 2020q3



Source: National Housing Bank.

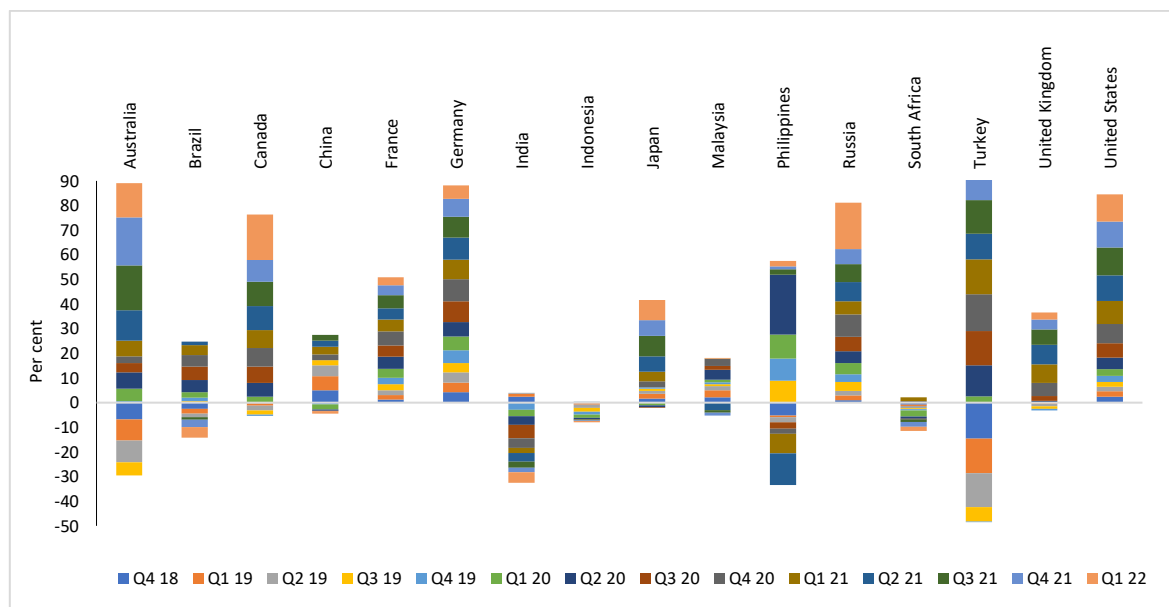
Figure 7: City-wise house price (year-on-year) change in 2020q3



Source: National Housing Bank.

Moving away from heterogeneity of housing prices at sub-national level, we now discuss the trend in house prices in India in the last couple of years. The residential property market in India has been lacking traction in the last couple of years. The residential housing market, in India, lacked significant activity even before the pandemic in line, *inter alia*, with lackluster growth in the last couple of years and a huge stock of unsold residential house inventories. Hence, the house prices in India have witnessed significant correction. In real terms, the house prices in India²⁰ have continued the slump even after the outbreak of covid-19. This experience of residential house market of India stands in contrast with many of the advanced economies wherein the residential housing segment boomed during the covid-19 pandemic (Figure 8).

Figure 8: Trend in house prices (real) in select economies (y-o-y change)



Source: Bank for International Settlements.

The correction in property prices in India in recent years has helped improve residential house affordability²¹ across many cities (Figure 9). Karmali and Weng (2022)²² also highlight

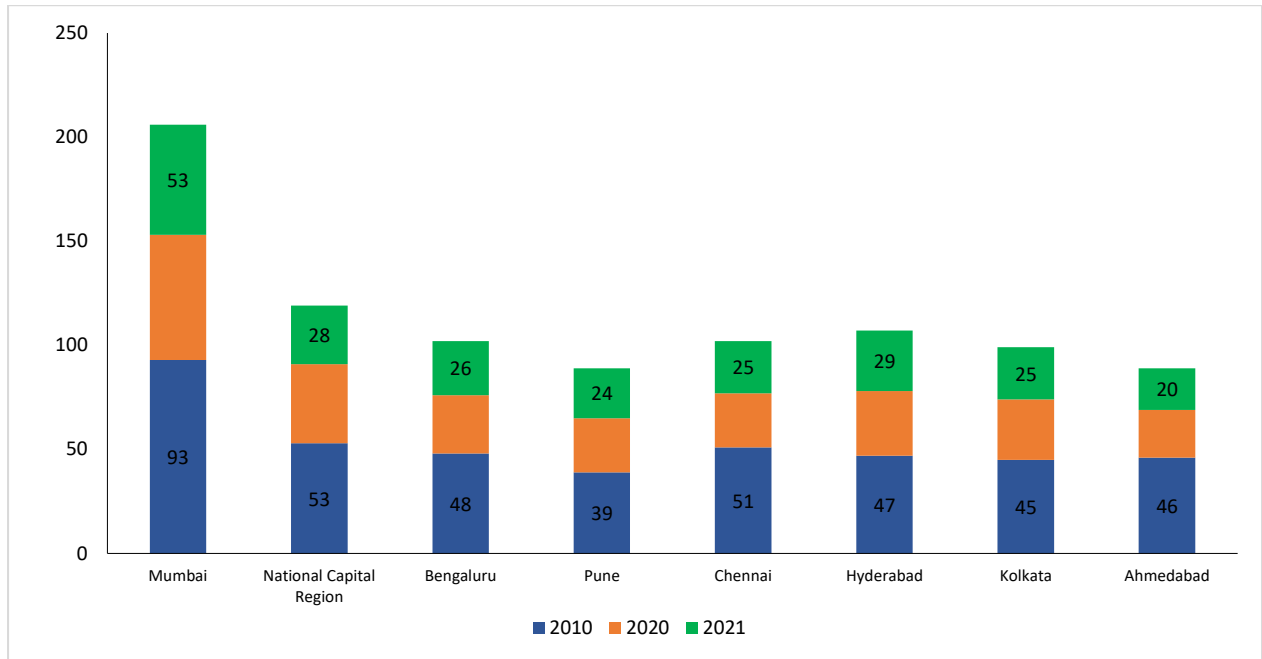
²⁰ Owing to different base years, *etc.* y-o-y growth figures reported by the BIS could differ from that reported by the RBI and the NHB.

²¹ This is based on Knight Frank Affordability Index. The index indicates the proportion of household income that would be required to fund the equated monthly instalment (EMI) of a house purchased through mortgage loan.

²² They find that income elasticity of house demand is high in India and therefore advocate that public policy interventions should essentially be more on the supply side rather than demand side. Supply-side interventions could aim at increased level of housing supply through better service infrastructure and amenities such as water, sanitation, and connectivity.

improvement in house affordability in India. The improvement in house affordability is good given significant urban housing shortages²³ in the country (Figure 10). The affordability could have benefitted, *inter alia*, from near stagnant or correction in residential house prices, softer interest rate regime, and higher disposable income, especially in the pandemic period. Nevertheless, Mumbai still remains unaffordable despite marked improvement in affordability statistics²⁴.

Figure 9: Residential house affordability across cities in India



Source: MOSPI and Knight Frank Research.

²³ A Technical Group constituted by the Ministry of Housing and Urban Poverty Alleviation had estimated urban housing shortage in the country on the number of households, available housing stock, acceptable housing stock, overcrowding/congestion in the existing dwelling units and obsolescence factor by using the Census 2011 data.

²⁴ Beyond the threshold of 50 percent, EMI to income ratio is considered unaffordable. This, broadly, remains the limit adhered to by the banks in the loan process (Knight Frank, 2021).

Figure 10: Urban housing shortage in India (2012) (in millions)



Source: Government of India (2013).

5. Empirical Estimation

As discussed in the preceding sections, Phillips and Sul (2007) log(t) convergence test was undertaken. This suggests rejection of null hypothesis of convergence of residential prices of the cities to a single price level (Table 2). Rejection of null hypothesis of convergence, however, does not rule out convergence of sub-groups or divergent members in the full panel [Phillips and Sul (2007)]. Further, the possibility of convergence to respective steady states at sub-groups level was explored.

Table 2: log(t) test result

Variable	Coefficient	Standard error	t-statistics
House price	-0.757***	0.010	-78.66

Source: Authors' calculations.

Initially, cluster analysis suggested existence of five clubs (Table 3). The regression coefficients for all the five clubs are found significantly positive suggesting support for club classification. Following the clustering procedure, further possibilities were explored if the proximate clubs could be merged to form larger convergence clubs. Merger analysis suggests that clubs (1 and 2) and clubs (3 and 4), could be merged, respectively (Table 4). In both the club classifications, Mumbai and Thane (having the most expensive real estate market in the country) form a divergent group.

Table 3: Initial classification

Club	No. of units	Coefficient	t-statistics
Club 1	5	0.200**	2.516
Club 2	15	0.118**	2.205
Club 3	15	0.372***	3.765
Club 4	8	0.588***	6.518
Club 5	5	0.242***	7.211

Source: Authors' calculations.

Note: **: 5% level of significance; ***: 1% level of significance.

Table 4: Final classification

Final Club	Merged clubs	No. of cities	Coefficient	t-statistics
Club 1	Clubs: 1, 2	20	0.073	1.141
Club 2	Clubs: 3, 4	23	0.065	1.001
Club 3	Club 5	5	0.242***	7.221

Source : Authors' calculations.

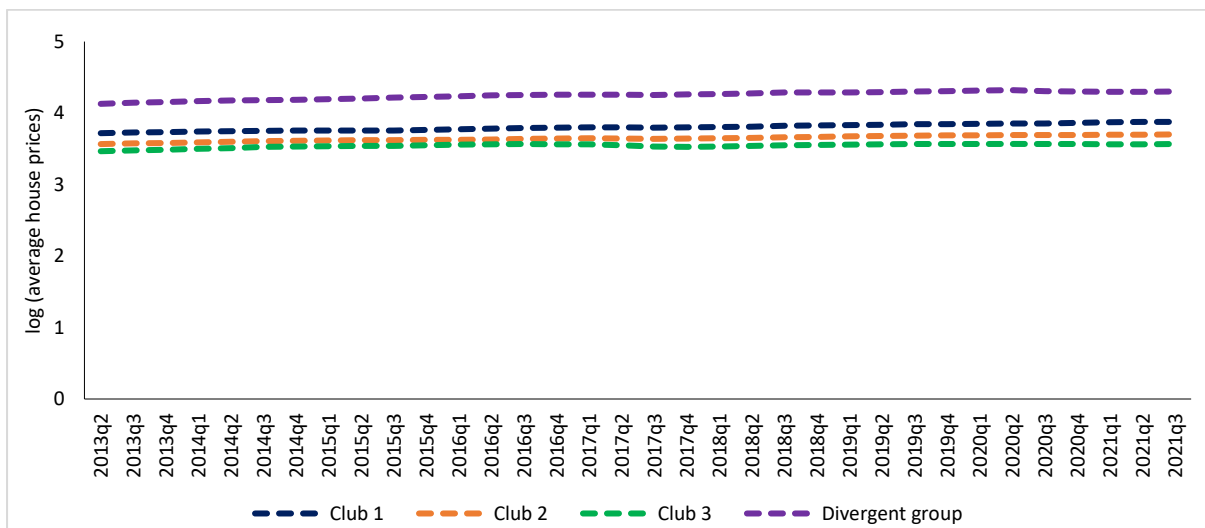
The cities, finally have been categorised in three different clubs as per the trend in the house prices (Table 5 and Figure A1). Club 3 exhibits higher speed of convergence followed by club 1 and club 2. It is noteworthy that the club of cities so formed do not share contiguous geographical location - as one would expect that cities located closer to each other (say within a state) would witness similar price dynamics. Nevertheless, evidence from studies across different countries suggests that club membership of cities or regions need not necessarily be driven by geographical neighbourhood. In this regard, Kim and Rous (2012) contend that usual concepts of economic areas (say, census region) may not be best-suited to study regional differences in house prices. Gunduz and Yilmaz, *op. cit.* also highlighted non-conformity of convergence clubs to conventional geographical regions of the country.

Table 5: Residential house clubs of cities

<p>Club 1 :(20) Kalyan Dombivali, Gurugram, Bengaluru, Chennai, New Town Kolkata, Pune, Kolkata, Navi Mumbai, Mira Bhayander, Hyderabad, Ahmedabad, Gandhinagar, Panvel, Delhi, Vasai Virar, Kochi, Thiruvananthapuram, Surat, Vizag, and Vadodara.</p>
<p>Club 2 :(23) Ludhiana, Vijayawada, Patna, Nagpur, Bhubaneswar, Indore, Ranchi, Coimbatore, Bidhan Nagar, Faridabad, Noida, Rajkot, Guwahati, Howrah, Pimpri Chinchwad, Greater Noida, Dehradun, Chandigarh, Ghaziabad, Kanpur, Lucknow, Chakan, and Raipur.</p>
<p>Club 3 :(5) Jaipur, Bhopal, Nashik, Meerut, and Bhiwadi.</p>
<p>Not convergent group :(2) Mumbai, and Thane.</p>

The divergent group is characterised by the highest level of residential prices (Figure 11). Club 1 comprising of the metro cities, barring Mumbai, displays the highest level of residential prices followed by club 2 and club 3, respectively.

Figure 11: House prices across the convergence clubs

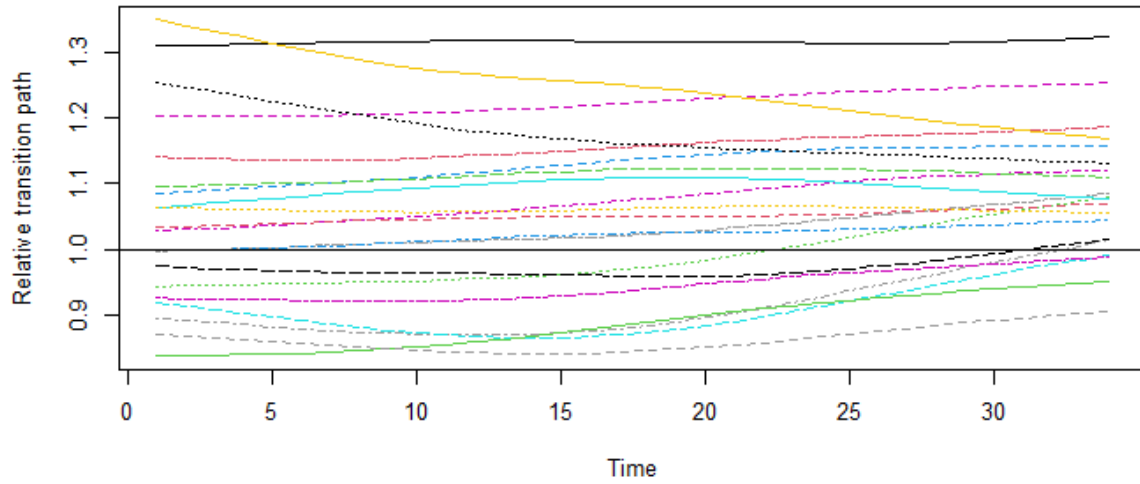


Source: Authors.

Figures 12a to 12c display the transition paths of city residential prices in the respective clubs. City-house prices within the clubs may display distinct transition paths. But, they display a tendency of

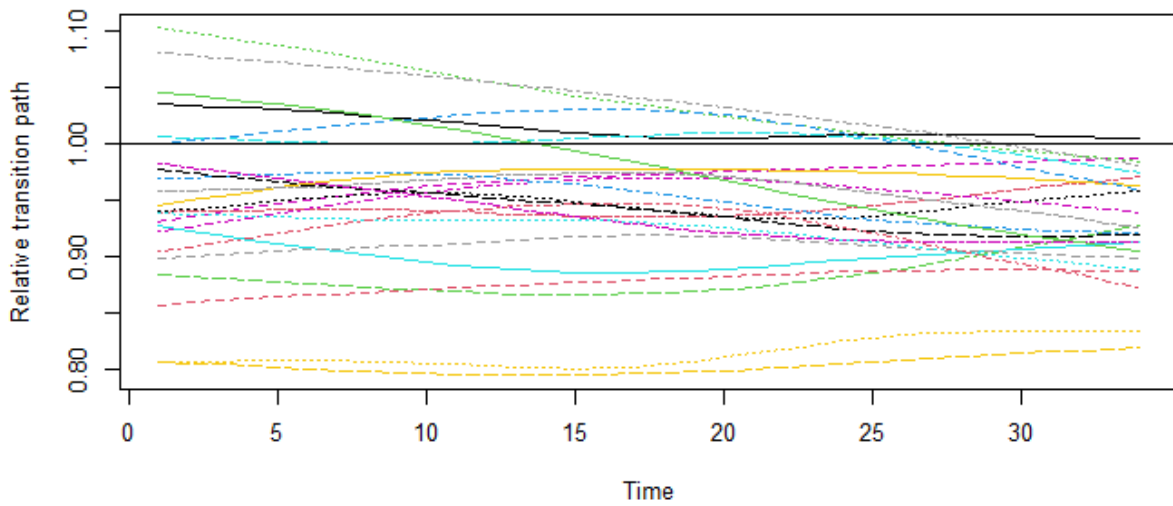
catching-up to the average transition path and convergence within the respective clubs. Figure 12d shows the average transition paths of respective clubs.

Figure 12a: Relative transition paths for Club 1



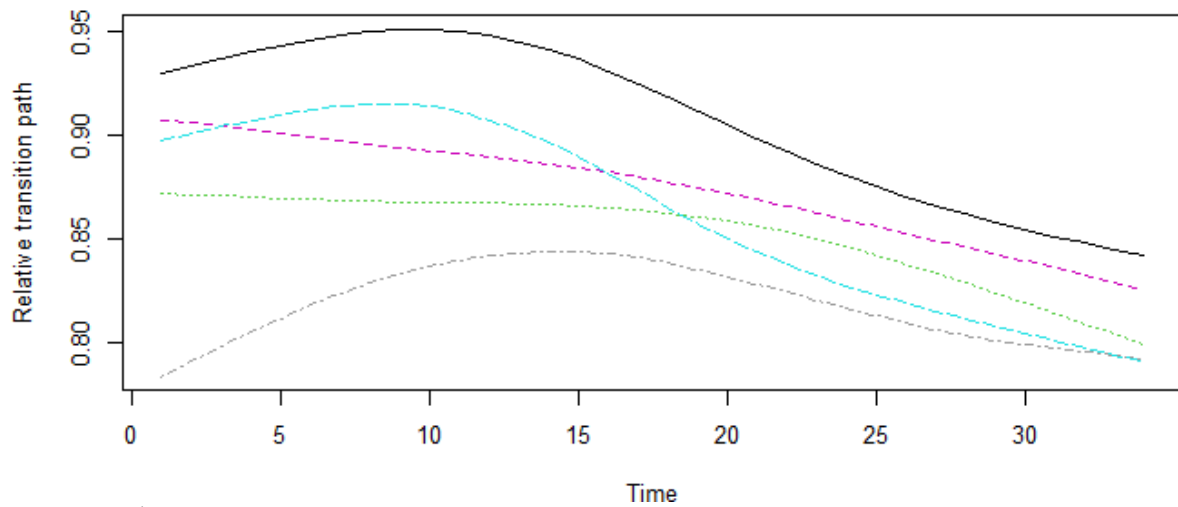
Source: Authors.

Figure 12b: Relative transition paths for Club 2



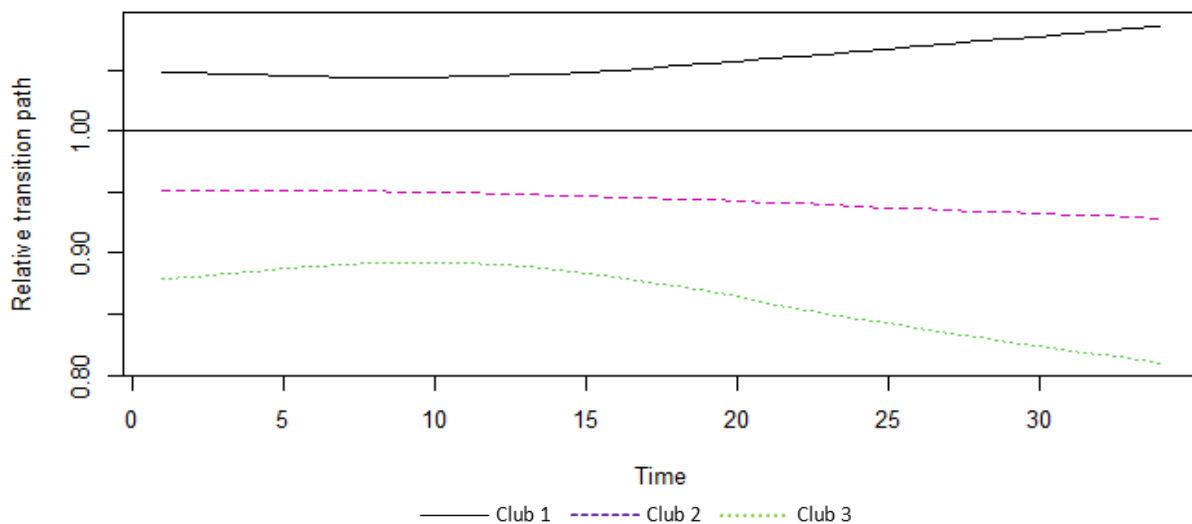
Source: Authors.

Figure 12c: Relative transition paths for Club 3



Source: Authors.

Figure 12d: Relative average transition paths for all the clubs



Source: Authors.

Having explored the club convergence of the cities, we now examine the factors that could drive this. Initial situation, the evolving conditions and dynamics in the cities could provide push and pull factors in such club formation. Based on data availability, we focus on six factors that could contribute in the club formation of the cities. Initial residential price of the city, house rent, home loans, population density, literacy and city inflation were considered to gauge if they had a binding influence on the club formation. All the said variables, barring the city inflation, were found to be the highest for club 1 followed by clubs 2 and 3 (Table 6).

Table 6: Club-wise summary statistics

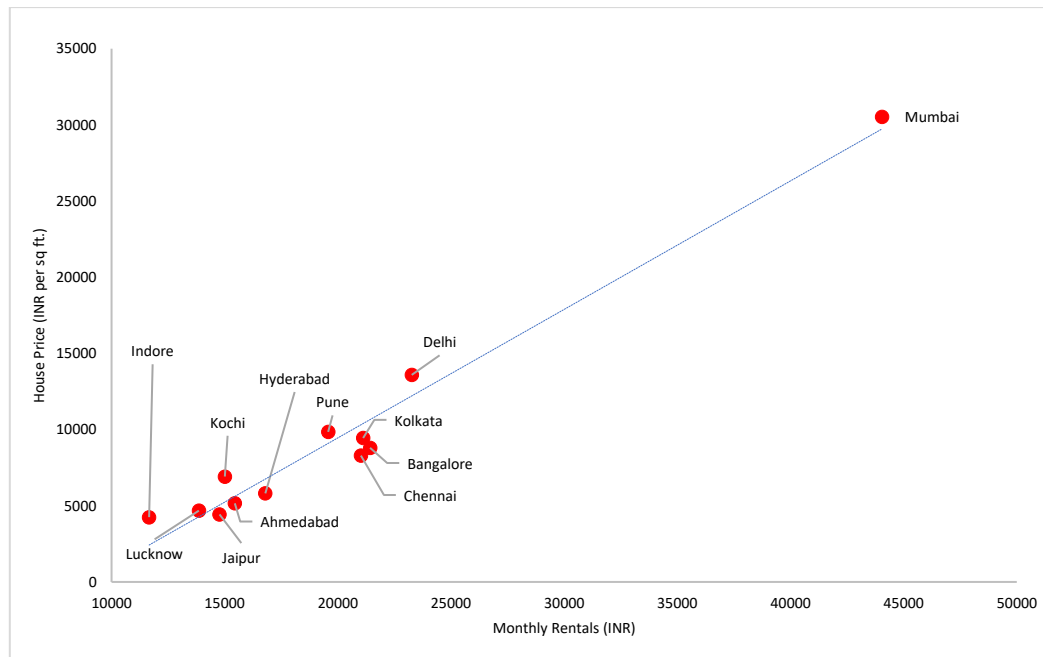
	ln(initial price)	ln(mortgageloan)	ln(houserverent)	ln(popdensity)	Literacy	ln(city inflation)
Club 1	3.068	5.844	4.880	8.933	89.439	5.619
	(0.015)	(0.018)	(0.007)	(0.034)	(0.138)	(0.005)
Club 2	2.764	5.671	4.879	8.739	87.044	5.652
	(0.008)	(0.014)	(0.006)	(0.021)	(0.113)	(0.006)
Club 3	2.532	5.509	4.901	8.652	80.238	5.657
	(0.012)	(0.025)	(0.012)	(0.020)	(0.469)	(0.012)

Source: Authors' calculations.

Note: Figures in parentheses are standard errors.

For exploring the determinants of club formation, ordered probit model was estimated. The clubs were ranked based on the average prices for the said period in ascending order (club 1 having the least price). A set of variables such as initial house price, house loans, rent, population density, literacy and inflation were considered. A city with higher initial prices, *ceteris paribus*, is expected to have inertial higher price and accordingly qualify into a higher price club. Larger quantum of house loan is expected to fund home buying in a city having relatively higher real estate prices. A city in the higher price residential club is expected to have higher rental levels. This is corroborated in the Indian case wherein residential rentals in select cities were found to be positively associated with house prices (Figure 13). Increased population pressure is expected to create higher demand for housing and, thereby, higher house prices. Higher literacy is positively associated with income, which improves house affordability. Hence, increased literacy is expected to have a salutary influence on the house prices. City inflation in the club of cities with higher level of house prices was found to be relatively lower than that of the club with lower house prices (see Table 6). Hence, higher city inflation increases the probability of membership in cities with relatively lower prices. The estimation result is produced in Table 7, which is on the expected lines.

Figure 13: House prices and rental values across select cities in India



Source: NHB and Arthayantra Buy vs Rent Report 2019 (sourced from www.magicbriciks.com).

Note: INR - Indian Rupee.

Table 7: Club convergence determinants - ordered probit model

Explanatory variables	Coefficient	Std. error
ln(initial price)	1.164***	0.146
ln(mortgageloan)	0.974***	0.114
ln(houserent)	1.633***	0.343
ln(popdensity)	0.159***	0.048
literacy	0.184***	0.010
ln(city inflation)	-3.775***	0.365
transition parameter 1/2	11.105	1.526
transition parameter 2/3	13.464	1.533

Source: Authors' calculations.

Note:***: $p < 0.01$.

The estimated marginal effects show the impact of each variable on the change in probability of belonging to a club. These are also on the expected lines. Increase in initial price increases the probability of higher residential price club membership, while decreasing the probability of lower residential price clubs membership (Table 8). The same logic applies in the cases of loan, rent,

population density, and literacy wherein any increase in the explanatory variables is associated with a rise in probability of higher house price club membership. On the contrary, as expected, an increase in city inflation is found to have a higher chance of being associated with lower price clubs.

Table 8: Marginal effects

Variables	Club 1	Club 2	Club 3
ln(initial price)	-0.063	-0.372	0.435
ln(mortgageloan)	-0.053	-0.311	0.364
ln(houserent)	-0.089	-0.522	0.610
ln(popdensity)	-0.009	-0.051	0.059
literacy	-0.010	-0.059	0.069
ln(city inflation)	0.205	1.206	-1.411

Source: Authors' calculations.

6. Concluding Observations

While studies on regional house price convergence have been undertaken in respect of advanced economies and few emerging market countries, literature remains scarce in respect of some significant and large EMEs like India. This study seeks to bridge this gap. In the present study, an analysis of house prices of 50 cities of India was undertaken. It was found that the city residential house prices across the country do not share homogenous movements. As such, they do not converge to a unique steady state. Rather, we found evidence that the cities form distinct clubs wherein they exhibit a tendency for conditional convergence.

Of the fifty cities, 48 cities were found to form three distinct clubs wherein the house prices converged to their respective steady state paths. Two cities, with the highest level of residential house prices, were found to form a divergent group. The convergence club of cities (based of residential prices) are not found to share geographical contiguity. The transition path of cities within the clubs are quite distinct from one another, nevertheless, they display catching-up to the average transition path.

To explain the drivers of club formation of cities, an ordered probit model was estimated. Initial residential price of the city, house rent, home loans, population density, literacy and city inflation were found to be the determinants facilitating club formation. An increase in initial house price,

home loan, rent, population density, and literacy was found to be associated with increased probability of higher house price club membership. City inflation, on the contrary, was found to have increased chances of being associated with lower price clubs.

The findings relating to diverse behaviour of house prices at sub-national level and recognition of the fact that within cluster(s) the regional house prices may witness similar dynamics could enable policy makers in probing the common driving factors and accordingly devising apposite policies. An important policy implication arising from this study is that given significant heterogeneity of house price trends at the sub-national level, the regional house prices could be at variance from one another as also against the national trend. Hence, implementation of nation-wide uniform regulatory policy may not be apposite, especially in the context of geographically large-sized countries. In this regard, identification of housing clusters could guide policy makers better in stabilizing demand-driven localized house price shocks through regionally-differentiated policies. Funke, *op. cit.* estimated a two-region dynamic stochastic general equilibrium (DSGE) model and highlighted the efficacy of sub-national macro-prudential policies in reducing the variance of house prices in the case of United Kingdom.

This study of residential house market of a large emerging market like India could offer several insights for other economies. From the sub-national housing price dynamics in a large and populous country like India, one can appreciate better the influence of population pressure on mortgage prices. Furthermore, for a large country such as India, given acute shortage of housing and concerns relating to affordability, grouping of cities based on price trends could enable policy makers devise apposite policy interventions.

The study considered select variables (based on availability of reliable data) for understanding the determinants of sub-national house price convergence in the Indian context. Housing inventory also has a significant influence on house prices. Nevertheless, owing to unavailability of credible (official) data on housing stock, it could not be included in the present analysis. Future studies may be undertaken to bridge this gap when such a reliable data is available. Furthermore, given the paucity of literature in the area, it is also important that more studies as this are undertaken for India on different aspects of housing dynamics.

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Appendix

Figure A1: Club classification of cities as per house prices in the map of India



- Notes:
- (1) This map is not to scale.
 - (2) This map has been plotted just for visual purpose to show the location of cities as per the said convergence club classification. As such, this may not exactly match with the actual geographical coordinates of the cities.
 - (3) City names have been displayed in different font colours as per their club classification. Accordingly, club 1, club 2, club 3 and divergent group cities have been shown by blue, purple, green, and red font colours, respectively.
 - (4) Size of the bubbles is as per the average house price of the city for the said period of study.

Source: Authors' map.