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Economic policy positions

Housing market in Germany: Boom without end?

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Summary

- **Residential property prices continued to rise in 2020 despite the Corona pandemic and against expectations.**
- **The pandemic has not undermined the laws of the housing market: construction activity, economic development, monetary policy and housing preferences continue to determine price trends. At best, the signs are pointing to a slight easing – and not everywhere.**
- **According to current findings, there are no risks to financial stability. Macroprudential relief has not affected this resilience. The recovery of the economies has been postponed by the third wave of infection. Therefore, a tightening of macroprudential regulation should be avoided until at least the end of 2022.**

1. The situation in the housing market

Many real estate experts had expected that the development of residential property prices in Germany would at least suffer a setback in the wake of the Corona pandemic and the economic crisis it triggered. Stronger price declines also seemed conceivable. Even if there are such developments in some segments of the commercial real estate market (e.g. retail, see box on page 7), this scenario has not yet occurred in the case of residential real estate. On the contrary: prices for houses and apartments rose even more in 2020 than in the previous year. This can be plausibly explained – but the question remains whether and when there could still be a decline in prices.

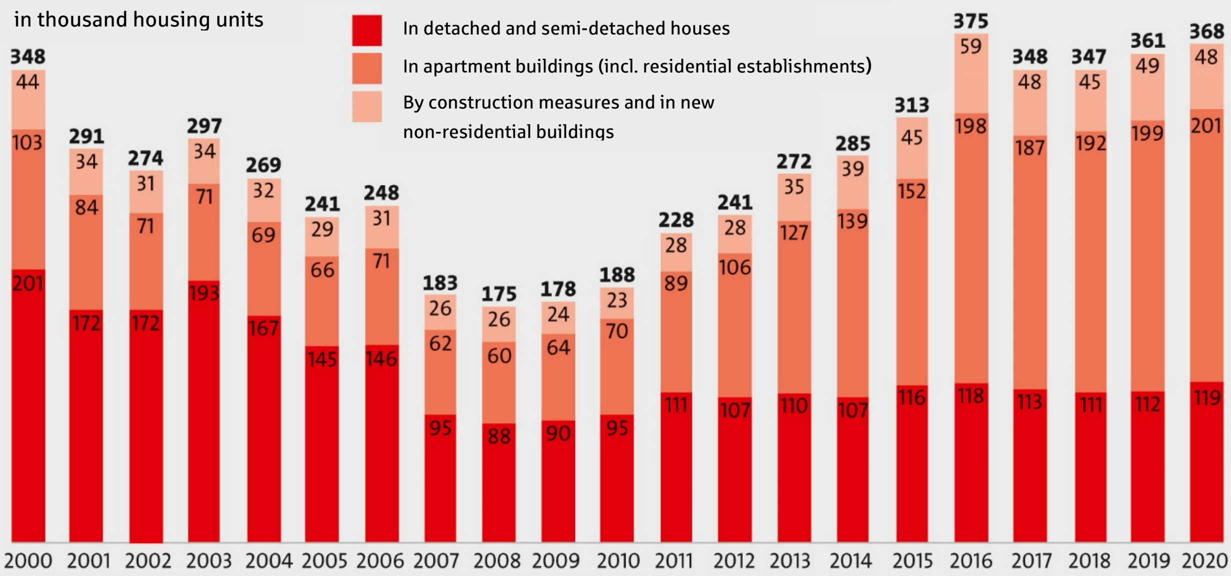
As long as the rise in property prices in Germany is a consequence of scarcity – i.e. the fact that demand for housing has grown faster than the supply in many regions – it is also justified. It is therefore important to look at the fundamental price determinants.

2. Housing demand and construction needs

The demand for housing has risen continuously in recent years due to demographic factors. Labour migration, especially from Southern and Eastern Europe, as well as the influx of refugees has led to a nationwide increase in the number of inhabitants in Germany. In urban areas, internal migration from rural regions and the growing number of single households have further increased demand.

However, for some time now, a further trend has been observed within the rather broadly defined metropolitan regions, which also influences property prices: On balance, the core cities are losing inhabitants to the surrounding districts, as research in the empirica regio database shows. Whether Berlin, Hamburg, Cologne, Düsseldorf or Stuttgart – in recent years most of the top seven cities have registered more departures to the surrounding areas than supraregional arrivals from Germany. Munich even has a negative population balance compared to the whole of Germany; only

Development of Building Permits in Germany



Source: Federal Statistical Office

in Frankfurt am Main is the picture somewhat more balanced. In other words, the population growth of Germany's largest cities has recently been exclusively the result of foreign immigration.

In addition to (regional) population development, household size and the amount of housing to be replaced also influence the need for new construction. The German Economic Institute (IW) arrived at a calculated new construction demand in Germany of just under 342,000 flats per year for the period from 2016 to 2020. In the following years until 2025, however, only 260,000 flats would be needed annually. The real estate research institute empirica is in a similar range with its current calculation of demand for 311,000 additional housing units for each of the years 2019 and 2020, 271,000 for 2021 and 2022 and 242,000 for 2023 to 2026.

3. Housing supply and construction activity

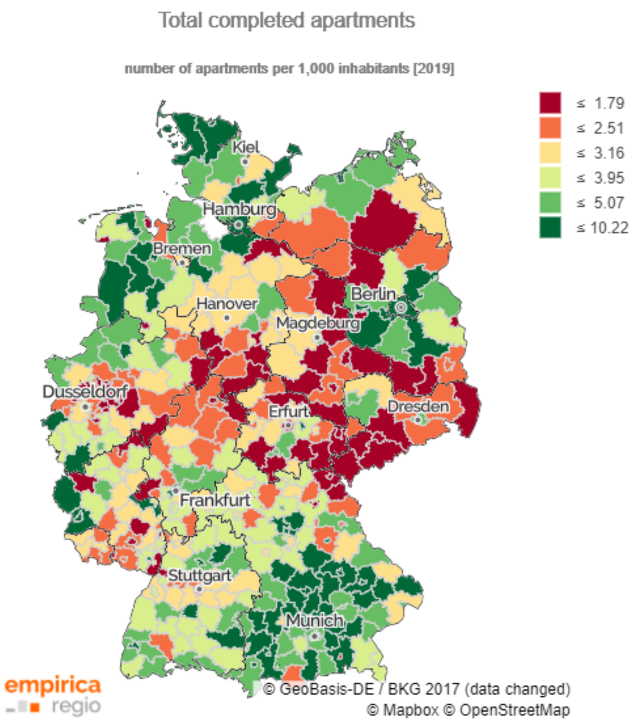
Building permits: The long-term trend in residential building permits is pointing strongly upwards: since 2011, the number of building permits has again been on the rise, and in the past six years it has even been well above 300,000 (chart). In 2020, the building authorities gave the go-ahead for 368,000 dwellings – an increase of 2 percent compared to the previous year. The long-term increase is largely driven by apartment buildings: Last year, 201,000 flats were approved – three times as many as ten years earlier. The number of flats approved in one and two-family houses fluctuated in a relatively narrow corridor between 107,000 and 118,000 in the years from 2011 to 2019, but rose quite strongly by 6 percent to 119,000 flats in 2020. This small jump is likely to be mainly due to the final spurt of approvals before the expiry of the "Baukindergeld" state subsidy in March 2021. Recently, more and more dwellings were planned and approved through extensions, conversions and in non-residential buildings.

Although the year 2020 was marked by the Corona pandemic, this apparently had little effect on building permit activity. In the first month of the current year, the number of approved dwellings, seasonally and calendar-adjusted, once again increased by 5.1 percent compared to the previous month. Nevertheless, the Munich-based ifo Institute forecasts a slight decline in permits to around 350,000 in 2021, which would still be relatively high in a long-term comparison.

Housing completions and construction backlog: An approved flat is far from being ready for occupancy. Although the number of annual completions has also been increasing for some time, it is significantly lower than the number of approvals: In 2019, a total of 293,000 new dwellings came onto the market – almost twice as many as in 2009 and a good 2 percent more than the year before. The ifo Institute's completion forecast for 2020 is 285,000 housing units. Thus, the problem described as a construction backlog by the Federal Statistical Office is not likely to have become any smaller in the past year. At the end of 2019, a cumulative total of almost three quarters of a million approved flats were awaiting completion. The reason for the ever-increasing construction backlog is primarily capacity bottlenecks in the construction industry.

Accordingly, there cannot be said to be too much building going on in Germany. Despite all the progress that has been made, this also applies to the sought-after cities, as the analysis at district level shows. Some metropolitan areas stand out on the map of Germany with brisk construction activity (chart): Hamburg, Berlin, Frankfurt, Munich and its environs achieved 5 to 6 new apartments per 1,000 inhabitants in 2019, clearly exceeding the national average of 3.5. In Cologne and Stuttgart, on the other hand, new construction continues to weaken with only two completions per 1,000 inhabitants. Measured against their population development, however, the cities are still not building enough.

Overall, construction activity in Germany is approaching the estimated need for additional housing, but a gap still exists. In the future, too, there will probably not be an excessive amount of construction in this country, as the forecasts of the ifo Institute for Europe show (chart page 4). According to this, around 3.4 new dwellings per 1,000 inhabitants will be completed in Germany in 2021. For Austria and Finland, ifo expects more than 6, for Switzerland, France and Norway just under 6 and also for Sweden, Poland and Denmark more than 5 new dwellings. Only the three southern European countries that were formerly in crisis, Spain, Italy and Portugal, are currently considerably more reluctant to build.



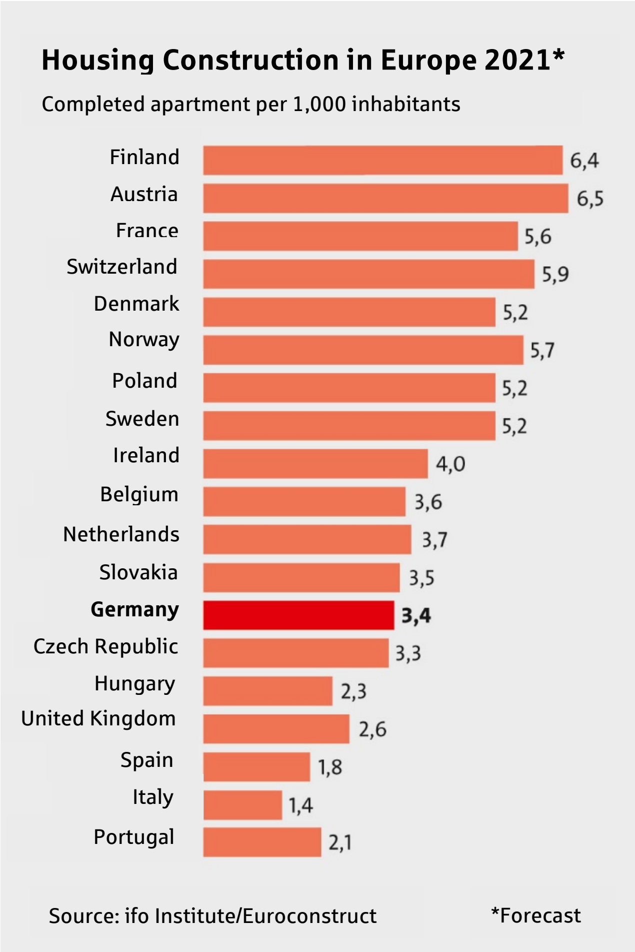
Source: Federal and Regional statistical offices / empirica regio

4. The price development of residential real estate: What effect is Corona having?

Contrary to what many experts expected, the economic slump resulting from the Corona pandemic did not dampen price development in the residential property market. On the contrary: the house price index of the Federal Statistical Office climbed by 7.4 percent in 2020 – even more than in the previous three years. Within ten years, the house price index has thus increased by 65 percent. Moreover, the real estate price boom did not and does not only take place in local metropolitan areas and other popular cities, but is a nationwide phenomenon. For example, owner-occupied apartments in the top 7 cities cost almost 63 percent more at the end of 2020 than in 2015, and detached and semi-detached houses 59 percent more. In the sparsely populated rural districts, they were 39 and 45 percent more expensive, respectively.

The index of the Federal Statistical Office is based on the actual sales prices determined by the expert committees and is therefore always published with a slight delay. The property price index of the Berlin research institute empirica comes even closer to the current edge. Empirica also calculates a hedonic price index from a large amount of supply data from various sources. According to this index, the price rally for residential property continued unabated in the first quarter of this year: owner-occupied apartments of all construction years cost an average of 13.3 percent more than in the same quarter of the previous year, and detached and semi-detached houses were also advertised at 12.3 percent higher prices. Rents, on the other hand, rose by only 3.9 percent during this period. The actual purchases also reflect this trend, as shown by the property brokerage statistics of the real estate companies of LBS and Sparkassen.

In view of the upward trend in real estate prices that has continued since the financial crisis in 2009, the question of the impact of the Corona pandemic is all the more intriguing. In a survey on the impact of the pandemic at the beginning of this year, the real estate experts of the Landesbausparkassen and the savings banks provided information on what they expect for the future. According to the survey, an increase in supply due to distress sales is unlikely, but almost 60 percent of the respondents consider it quite likely that the demand of certain target groups could decrease, such as freelancers and solo self-employed persons. Nevertheless, an almost overwhelming majority of 87 percent assume that purchase prices for residential property in the core cities will not fall as a result of the Corona crisis.



Since construction activity has clearly suffered very little from the Corona crisis, but also does not have much room for improvement at present due to capacity, price development in 2021 will again depend more on demand determinants than on supply determinants. The demand for owner-occupied homes and apartments, in turn, is influenced on the one hand by economic development, but also by capital market interest rates. Due to the pronounced and prolonged third wave of infection and the slower than hoped vaccine rollout, most forecasts for economic growth in Germany in 2021 have since been revised slightly downwards. The German Council of Economic Experts, for example, expects a recovery of 3.1 percent – assuming that the lockdown measures can be ended in the second quarter.

On the other hand, the low interest rate level helps to keep real estate attractive as an investment and affordable for prospective homeowners. The extent to which the European Central Bank (ECB) will be able to maintain its loose monetary policy in the face of increasing inflation expectations is an issue that will require further observation. However, most experts still assume that the ECB will not raise key interest rates – at least not until the Corona crisis has been overcome.

Open questions include not only the development of immigration from abroad, but also the extent of regional shifts in internal migration. It is already clear that the demand for residential property in the surrounding areas of the major cities is increasing. One reason for this is the high prices in the cities. However, after the experiences of lockdown, home office and home schooling, people are increasingly interested in having more space and living closer to nature. It is also an open question whether individual regions will be hit harder by the aftermath of the Corona crisis. This would be the case if major employers which are important for a region were to run into difficulties.

5. The discussion about real estate bubbles in Germany

Whether a real estate bubble has developed in Germany, the bursting of which could lead to serious distortions in the financial sector and in the real economy, can be assessed at different levels using various indicators. Strictly speaking, the question consists of three components:

1 Is there a bubble? Price bubbles, i.e. speculative price exaggerations, are referred to when price increases are primarily fed by the fact that the mere prospect of value increases generates a willingness to pay on the part of buyers that is detached from the fundamental factors. The Bundesbank, for example, has stated that residential property in Germany is overvalued by 15 to 30 percent for years – and it is not alone in doing so. For its bubble index, the empirica Institute evaluates the relevant indicators such as the ratio of purchase prices to annual rents (multiplier) and annual income separately for all 401 districts and independent cities on a quarterly basis. According to this, in the first quarter of 2021, 75 percent of the districts were overvalued in terms of rent development and 83 percent in terms of income. Empirica puts the potential for price setbacks in the top seven cities at 46 percent, while the national average was 28 percent. Thus, the diagnosed overvaluation has again increased both in its extent and in its regional distribution in the 12 pandemic months.

2 Could the bubble burst – and if so, when? Theoretically, prices fall when scarcity disappears, i.e. demand decreases and/or supply increases excessively. The fact that the Corona crisis has so far not led to a noticeable drop in demand and prices is seen by various experts as proof that there is no real estate bubble. However, the crisis is not yet over: It is still possible that the economic Corona consequences will affect the property buying mood.

Based on a broad-based analysis of historical house price cycles and taking into account the relevant current influencing factors, Deutsche Bank Research recently concluded that the current cycle in Germany could end in 2024 and that there would then be a moderate decline in prices of around 5 percent.

What can be said is that construction activity does not currently pose a widespread risk of a bubble. Empirica recently diagnosed "rather too much" new construction in just 16 percent of the districts. Although more flats are now being built in some cities than a few years ago, this is still not enough to meet demand or cause vacancies. Conditions such as those in Spain shortly before the financial crisis in 2008 are a long way off: there, at times, more than 15 new flats per 1,000 inhabitants came onto the market every year. At present, in the most expensive German cities, it looks more as if a slowly declining demand from both tenants and buyers – due to displacement to the surrounding areas and a shift to cheaper cities – will meet a slowly increasing supply of housing. Both together suggest that the price trend could also slowly ease, but that there will be no sudden downward corrections.

3. Would the bursting of a real estate bubble endanger financial stability? After the experience of the global financial crisis in 2009, this point in the bubble question is certainly the most sensitive and also the most complex. The Bundesbank and the Financial Stability Committee see risks to financial stability when sharply rising housing prices are compounded by excessive lending and eroding lending standards. In order to be able to assess this, the Bundesbank monitors a whole range of ratios. These include:

The **stock of housing loans** granted by banks to private households has increased in recent years as a share of gross domestic product (GDP): The ratio was 38.3 percent in the first quarter of 2020, before the Corona pandemic started. The last time the credit-to-GDP ratio was higher was at the end of 2009, when it was 38.6 percent. In the fourth quarter of 2020, the ratio was 40.4 percent and thus, as expected, slightly lower than in the second quarter, when it was as high as 42.6 percent. These fluctuations can be attributed to the sharp slump and the subsequent slight recovery in economic output. However, such a high level of housing loans in relation to GDP is not entirely unheard of: in the years 2003 to 2006 it was already over 40 percent.

However, the stock of housing loans on the banks' books has indeed grown increasingly strongly recently: In the fourth quarter of 2020, it was 6.5 percent above its previous year's level, whereas a year ago the growth, which was also quite high, was only 5.4 percent. Ultimately, this lending dynamic is also a reflection of the rise in property prices.

The **total debt of private households in** the third quarter of 2020 was 57.7 percent of gross domestic product – 3.5 points higher than a year earlier. The last time the debt ratio was higher was in 2009 and 2010. But here, too, the crux of the ratio is noticeable: The strong increase in the course of last year is primarily due to the decline in the denominator, i.e. economic output, and not due to an increase in the numerator, i.e. excessive new debt of private households, as the Bundesbank also noted in its monthly report for April.

Lending standards are surveyed quarterly for all euro area countries in the ECB's Bank Lending Survey. After credit institutions in Germany had reported somewhat relaxed standards on balance in 2017 and 2018, this picture reversed again as early as 2019. Finally, in the Corona year 2020, lending was noticeably more restrictive for both residential real estate and consumption purposes. On balance, there was no further change in standards in the first quarter of this year.

Surveys conducted by the Association of German Pfandbrief Banks (vdp) among its member institutions also make it clear that home ownership financing in Germany can still be classified as conservative through and through. The analysis of around 1,500 financing cases from 2019 showed that although the debt ratio for financing owner-occupied residential property has risen slightly overall to 82 percent, it has fallen to 76 percent in the lower income quartile in particular. The debt service burden on disposable income averaged 26 percent, the same level as ten years earlier. Credit conditions are increasingly security-oriented: The low interest rates continue to be used for a high initial repayment. The average repayment was 3.01 percent. The fixed-interest period is now 15 years, compared to ten years in 2009.

This finding is consistent with the statistics of the Deutsche Bundesbank: at the end of 2020, half of the housing loan volume in Germany had a fixed interest rate of more than ten years – in 2010, this applied to only one third of the loans and also in 2015 only to 38 percent. The share of variable-rate loans has fallen from a good 15 to 10 percent within ten years. Such long-term fixed interest rates also protect the banks from payment difficulties on the part of their customers.

It is also worth mentioning a substantial difference between real estate lending in Germany and the situation in the USA: In Germany, borrowers are personally liable for the repayment of their loans. In contrast, in the US states where the subprime crisis took its course, it was possible to get out of debt by surrendering one's property to the bank in case of imminent insolvency. However, the values of these houses had mostly fallen sharply. Moreover, real estate in Germany is not re-leased on the basis of value increases in order to finance consumption. The Housing Credit Directive imposes strict lending standards on private consumers: The assessment of their creditworthiness is based on strict guidelines for creditworthiness analysis, and the value of the property may only be taken into account to a very limited extent. The mortgage lending value of real estate is also determined according to conservative guidelines. All of this reduces the probability of default on loans and limits the bank's losses in the event of a default.

In recent years, the most frequent criticism of German real estate financing by the supervisory authorities has always been the insufficiently granular and standardised data collection on lending, especially with regard to income-related ratios. These data gaps will now be gradually closed on the basis of the Financial Stability Data Collection Regulation (FinStabDEV) published in February 2021, probably from end of 2022.

The bottom line is that the ratios observed by the Bundesbank for financing residential property do not indicate that even a substantial decline in residential property prices would put the banking industry in distress.

6. Financial supervision measures

The European and German banking supervisory authorities reacted quickly when the severity of the economic consequences of the Corona pandemic became clear. Thus, capital requirements for banks were temporarily relaxed, the **countercyclical capital buffer in** Germany was set back to zero and the implementation of planned regulatory measures was postponed. The creation of so-called non-statutory moratoria has meant that deferred loans are not to be treated as defaulted for regulatory purposes. As a result, credit institutions have been prevented from having to procyclically restrict their lending. The Federal Financial Supervisory Authority (BaFin) assumes that the countercyclical capital buffer will not be reactivated until at least the end of 2021 and that an increase will only be considered once the pandemic has been overcome.

In addition, the "lessons to be learned" also make it necessary to discuss whether countercyclical capital buffers should be reactivated at all. At an international level, at least, this is no longer taken for granted. Also with regard to Germany, it can be stated that the introduction and increases always came at critical times. In this respect, the non-activation could also be a sign of stability and reliability with regard to the plans in the banking industry to support the catch-up process as the pandemic subsides.

Even before Corona, the activation of two further macroprudential instruments was on the agenda – provided the prerequisites for this are met: the **"limitation of the LTV"** and an **"amortisation requirement"** (minimum repayment). The aim of these measures would be to limit the risks of new residential real estate loans on the part of borrowers. The financial supervisory authority would thus enforce minimum standards for lending beyond the already existing requirements of the Residential Property Credit Directive and the Regulation on the Determination of the Mortgage Lending Value (Beleihungswertermittlungsverordnung). This would represent a far-reaching intervention in the housing finance market and the freedom of the contracting parties.

In view of the Corona crisis, which is far from over, the continuing great economic uncertainty and the solid situation of housing loans, it does not seem advisable at present to tighten the macroprudential reins again or more strongly. As a result, this would also make it more difficult to finance the urgently needed new housing construction.

7. Housing policy

Despite all the discussion about real estate bubbles and bank regulatory security measures, it is also important not to lose sight of the housing policy necessities: It is and remains a political goal to create more – and thus almost automatically more affordable – housing. In addition, strengthening asset formation and private old-age provision remains on the agenda – and this implies that it must once again become easier for broad sections of the population to acquire residential property.

The recipes for this are well known and some of them have been addressed politically in the legislative period that is now coming to an end. It is a matter of building enough in the right places, strengthening the equity base of prospective homeowners, reducing ancillary acquisition costs and construction costs, and creating attractive regions to take the pressure off the cities on the one hand, and to stabilise property values far from the centres on the other.

However, excessive rent regulation, such as a nationwide rent cap based on the Berlin model, which seems to be on the minds of many now that the Federal Constitutional Court has brought the capital back to the ground of the Basic Law, is not a good idea. What happens when politics wants to override market mechanisms could be well observed in Berlin and should be warning enough: Investors withdraw, the supply of housing decreases and the chances of finding good and affordable housing dwindle. At the same time, with (artificially) low prices, demand is rising. What is also often forgotten: Compared to other European countries, Germany has a well-developed tenant protection system and, not only since the Mietpreisbremse (rent brake), socially balanced instruments that prevent an unchecked rise in rents.

Spotlight on commercial real estate

Office: The office property market has so far defied the negative effects of the Corona crisis and, according to the vdp, showed a slight price increase of 1.75 percent in the fourth quarter of 2020 compared to the same quarter of the previous year. Overall, the continued very tight supply of office space – especially in the metropolitan areas – is counteracting the decline in demand due to the economic situation and has kept the price level stable so far. According to BayernLB, office prices are nevertheless expected to fall slightly in 2021 due to reduced demand for space as a result of the increased trend towards mobile working and, above all, the foreseeable increase in corporate insolvencies. The top 7 cities, which will continue to have extremely low vacancy rates, will be exempt from price declines.

Retail: Despite Corona, retail sales increased in 2020. The main reason for this is the strong online trade. In over-the-counter non-food retail, however, especially in the clothing/shoe sector and in department stores, turnover slumped. As a result, the existence of many of these businesses is threatened and they are dependent on state aid. The structural change away from over-the-counter to online retail has been further accelerated by Corona. Declining sales and even the closure of bricks-and-mortar shops are already leading to higher vacancy rates and falling rents in city centres and shopping centres. As a result, according to the vdp, there was already a nationwide decline in prices for retail properties of just under 2 percent in the fourth quarter of 2020 compared to the same quarter of the previous year. It is true that online retail will continue to expand its on-site presence in bricks-and-mortar retail in order to strengthen customer loyalty and offer a personal shopping experience. However, the demand for space in these shops will be lower than in traditional retail.

Hotel: Higher operating costs and occupancy ceilings due to the implementation of the required hygiene measures, as well as the ban on tourist overnight stays in the lockdown months, weigh heavily on the hotel industry. Turnover in accommodation establishments fell by 45.8 percent in 2020 compared to the previous year, according to the Federal Statistical Office. A full recovery of travel activity and especially business travel is not expected in 2021 either, threatening further revenue losses. This means that the existence of hotel operators will continue to be threatened in 2021 and they will remain dependent on state aid. Accordingly, the uncertainty of investors is also great. According to CBRE, the transaction volume in the hotel segment collapsed by almost 60 percent to 1.95 billion euros in 2020.

Logistics: The decline in demand for logistics space from industry due to the economic situation could be compensated for in 2020 mainly by the rapidly growing online trade. In principle, the expected future regionalisation of production will go hand in hand with increased warehousing in Germany and thus result in a continued high demand for warehouse space. The already very scarce supply of space will be exacerbated by the increasingly restrictive designation of new commercial space. Rising rents and prices are the result. Therefore, logistics properties will remain in the focus of institutional investors in the medium term.

Care properties: In the shadow of the health crisis, Germany is heading for a serious shortage of care places. There is therefore an urgent need to expand the supply of care. Investors expect demand in the care sector to rise, irrespective of the economic cycle, and to meet a long-term shortage of supply. Nevertheless, there are risks in the form of operator insolvencies and increased uncertainty due to the frequently changing legal situation. Overall, the advantages of investing in care properties still seem to outweigh the disadvantages for investors, which is why a high transaction volume of 2.4 billion euros (up 46 percent compared to 2019) was also achieved in 2020.

Conclusion

Overall, the more cyclically sensitive commercial properties are more affected by the consequences of the economic downturn than residential properties. Nevertheless, there is a pronounced dichotomy between the segments in the commercial property market. While logistics and office properties mostly defy the crisis, the hotel industry close to city centres, with a focus on business travel and non-food retail in the clothing sector as well as department and department stores, will remain hard hit in 2021. In order to maintain leeway for credit institutions in this situation, which is difficult to determine, crisis-related macroprudential relief should be maintained for the time being.

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