

## »» A ray of light: Residential construction investment is up despite coronavirus crisis

No. 319, 23 February 2021

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Residential construction investment continued to grow in 2020 and completions are likely to have increased as well. The volume of orders also increased further last year, with permits issued for the construction of 98,000 homes in single-family and two-family dwellings and 151,900 housing units in multi-story buildings by October 2020. The overhang of approved but as yet unbuilt housing units has likely grown to more than 750,000. That suggests a further increase in completions for the year 2021. This year the number of completed homes may potentially exceed 300,000 again for the first time in 20 years. Besides a shortage of building sites in urban centres, the shortage of skilled workers continues to hamper residential construction growth, even in the coronavirus crisis.

New homes have already eased pressure on housing markets. They were built primarily in places where population growth has driven up housing demand. However, housing will still remain scarce and expensive in growing urban centres as the trend towards urbanisation is set to continue. Population growth in metropolitan regions is due in large part to the migration of workers from abroad which Germany increasingly needs to tackle its growing skills shortage. The number of foreigners working and looking for work in Germany continued to increase in 2020 despite the pandemic.

There are two ways in which excess demand in expensive housing markets with rising rents can be reduced: First, by creating new homes there and second by diverting migration flows through measures that revive the economies of less populated regions, make them more attractive and improve their transport links. Accelerating the expansion of digital infrastructure and regional public transport can play an important role. This can be the case particularly when more people than before work from home permanently as a result of the coronavirus crisis. A better separation of the workplace and residence should help ease the pressure on housing markets in expensive urban centres over the long term. But that could lead to more traffic, creating the challenge of introducing low-emission transport modes that consume less space.

### Residential construction continues to grow despite coronavirus

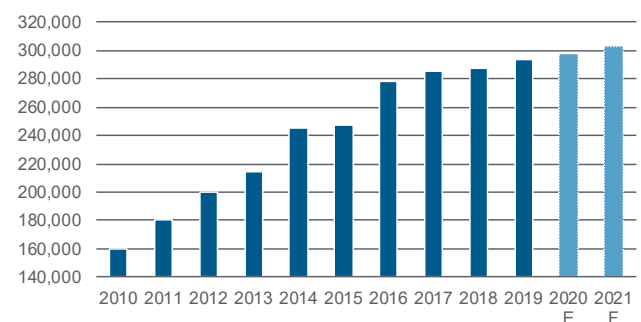
Nearly 300,000 homes were presumably completed in the year 2020 (Figure 1). The number of completions is therefore likely to have again marginally exceeded the high level of the previous year despite the coronavirus crisis.

Various economic indicators show an increase in overall construction activity which, except for below-ground construction, is also driven by residential construction:

- In the first ten months of 2020, production in the main construction industry expanded by a seasonally and calendar-adjusted 4.7% over the same period in the previous year. In the finishing trades the increase was 0.4% (Figure 2).
- In the first ten months, the number of hours worked in the residential construction segment of the main construction industry was 5.7% above the same period in the previous year (Figure 3).<sup>1</sup>
- Residential construction investment was 2.1% higher in 2020 than in the previous year. Even in the second quarter, which was severely affected by the lockdown, it was higher than in the previous year. Residential construction is thus proving to be a supporting pillar of the crisis-stricken economy.

Figure 1: Residential building completions continue to rise

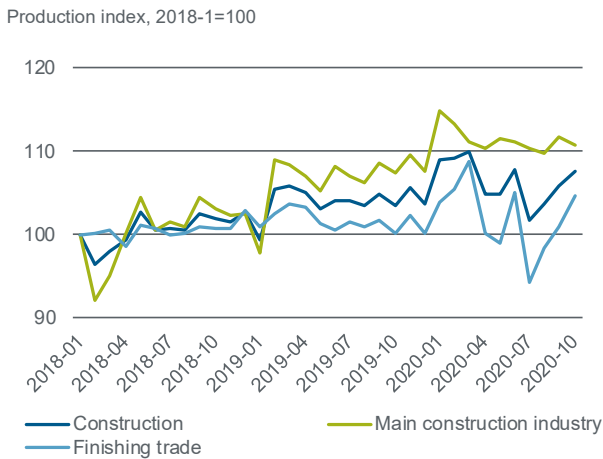
Completed housing units in Germany



E=own estimate, F=own forecast

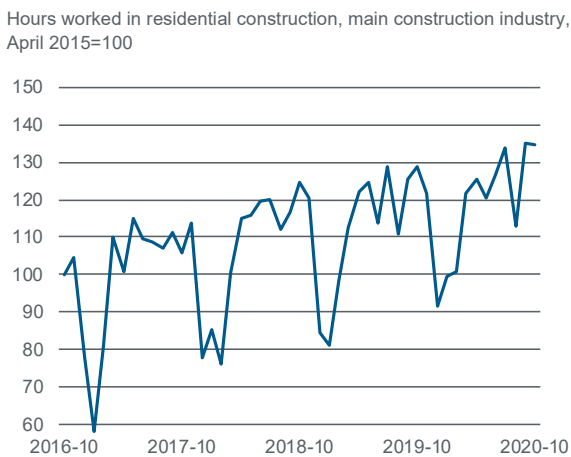
Source: Federal Statistical Office, KfW Research.

**Figure 2: Production in the construction sector remains robust in the pandemic**



Source: Federal Statistical Office, own rendition.

**Figure 3: Hours worked in residential construction continued to grow in 2020**



Source: Federal Statistical Office, own rendition.

**Further increase in completions expected for 2021**

In 2021 the number of completions may potentially exceed the 300,000 mark again for the first time in 20 years, if only marginally. The shortage of skilled workers remains a significant barrier to residential construction even in the coronavirus crisis. According to the KfW-ifo Skilled Labour Barometer, skills shortages hampered the operations of 18% of small and medium-sized main construction firms and 21% of large firms in the first quarter of 2021 despite the lockdown.<sup>2</sup> In the preceding quarter, a much greater share of 32% of firms in the main construction industry still reported disruptions from skills shortages.

Both the order volume in the construction industry and the construction permits suggest a further increase in completions this year. The level of existing and new orders in the residential construction sector continued to rise in 2020, climbing to new highs in the third quarter (Figure 4). From January to October 2020, building permits were issued for nearly 300,000 housing units in new and existing buildings, 3.3% more than in the same period in the previous year (Figure 5). The number of approved new housing units in single-family and two-family houses and multi-story residential buildings grew at nearly the same rate. By October 2020, permits were issued for the construction of 98,000 housing units in single-family and two-family houses and 151,900 homes in multi-story buildings. The construction overhang probably increased to more than 750,000 homes in 2020. These housing units were approved but have not yet been completed.

**Figure 4: Existing orders and orders received for housing units reached new record levels in 2020**

Existing orders and orders received for new residential construction, construction and civil engineering, Volume index, 2015=100

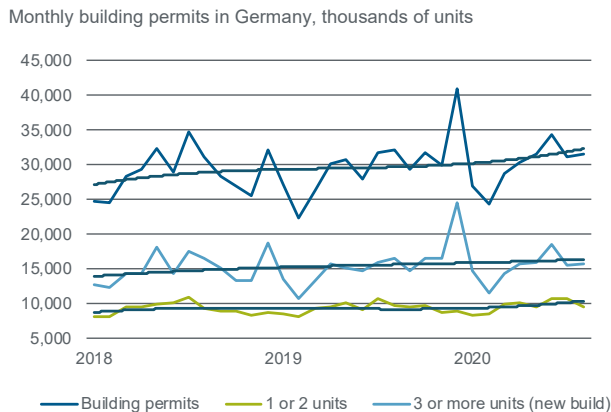


Source: Federal Statistical Office, own rendition.

**Dwellings will likely remain in short supply in many growing urban centres**

In 2021 as well, the number of completions is likely to remain well below the annual demand of 350,000 to 400,000 new housing units estimated for 2019. To be sure, excess demand in sought-after locations in urban centres is likely to have dropped because renters have shifted to less expensive residential areas. But the supply of housing is set to remain scarce in many growing urban centres. The reason is that labour migration from abroad has continued despite restrictions on movement in the pandemic. The number of non-German citizens working or looking for work in Germany was 4.4% higher from January to September 2020 than in the same period in the previous year.

**Figure 5: Permits for detached dwellings and multi-story housing units are on the rise**



Source: Federal Statistical Office, own rendition.

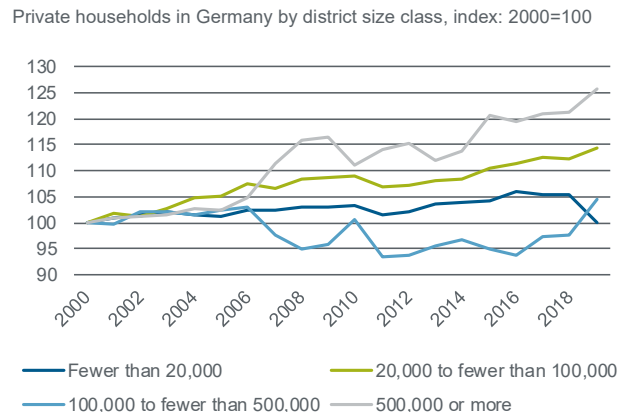
**Figure 6: The number of foreigners working and looking for work in Germany continues to rise despite the coronavirus**



Source: Federal Employment Agency, own illustration.

In the past two decades, the number of private households and thus demand for residential dwellings has grown particularly in large cities with more than 500,000 inhabitants (Figure 7). However, medium-sized cities with 20,000 to fewer than 100,000 inhabitants also recorded an increase in households and population. This trend has continued until today. In the past years, large cities with 100,000 to fewer than 500,000 inhabitants have also grown considerably. At the same time, the number of households and inhabitants has dropped in small municipalities with fewer than 5,000 inhabitants. The trend towards urbanisation does not just mean that large cities have grown. If the trend continues, rents might continue to rise particularly in large cities and their immediate surroundings – areas where housing is already scarce and expensive.

**Figure 7: More and more people want to live in cities; large cities in particular have grown**



Source: Federal Statistical Office, own rendition.

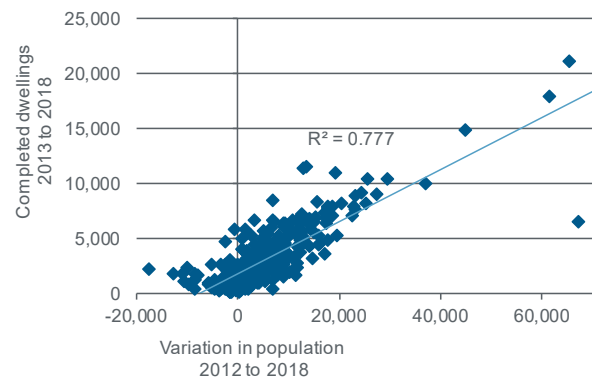
**Rents on new tenancy agreements falling slightly, prices of owner-occupied homes continue to rise sharply**

In many places, the construction of new dwellings has helped to ease pressure on housing markets. An analysis conducted for Germany's districts and district-free cities for the period of 2012 to 2018 revealed that most new dwellings were built in locations where demand had been driven up by population growth. The coefficient of determination for the number of completed housing units and population growth is 0.78, confirming a high statistical correlation (Figure 8).

Data collected for the 'F+B Wohnindex' housing index, a survey of owner-occupied home prices and rents conducted by F+B GmbH, shows that rents on new tenancy agreements stagnated in Germany in 2018 and 2019. In 2020 they fell by 0.9% from the second to the third quarter.<sup>3</sup> That is an indication that the housing shortage has eased at least slightly in many regions with housing shortages. Net rents in new and existing dwellings in Germany rose by 1.4 and 1.5% from 2017 to 2020. That rate was roughly equal to the increase in the overall consumer price index (Figure 9).

**Figure 8: Most homes are being built where the population is growing**

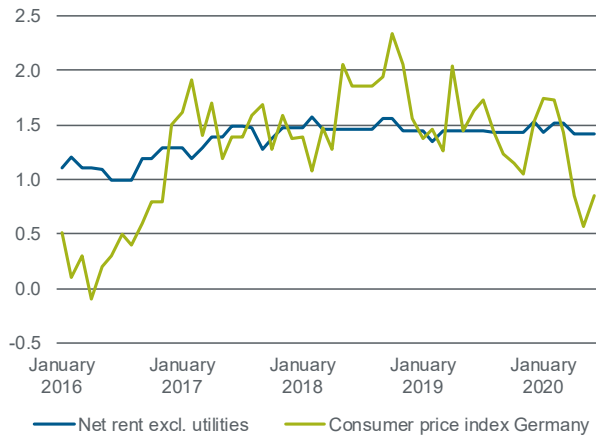
Variation in population and number of completed dwellings in districts, variation in population from 2012 to 2018.



Source: Federal Statistical Office, own rendition.

**Figure 9: Rent increases have remained largely constant in Germany since 2017**

Variation in net rents excluding utilities and consumer prices year on year in per cent



Source: Federal Statistical Office, own rendition.

By contrast, the price of owner-occupied homes continued to rise considerably from 2019 to 2020.<sup>4</sup> According to the house price index of the Federal Statistical Office, the prices for single-family and two-family houses were 7 to 10% higher in the third quarter of 2020 than in the third quarter of 2019<sup>5</sup> in all district types. There were many causes for the strong surge in prices:

- The low interest rate level has dropped yet again, making owner-occupied housing an attractive investment again. Owner-occupiers, particularly those who need to borrow or extend the terms of their mortgages, are among the winners of the low-interest rate policy unless prices start falling sharply. That may happen in some cities in the coming years as a result of exaggerated price rises.
- The demographic trend is making private pension plans even more crucial. Owner-occupied dwellings provide pensioners with relatively good social safety by saving rental payments.
- The deadline for the *Baukindergeld* family home ownership grant expires in 2021. The current provisions require buyers of owner-occupied homes to conclude their purchase agreement or secure a building permit by 31 March to be able to successfully file an application.

Demand for owner-occupied homes and homebuilding has risen strongly as a result of these factors, leading to significant increases in construction prices, which have increased by 18% for new dwellings since 2015. This price increase was mostly driven by costs. The cost of labour in the construction sector increased by roughly the same rate. The rising costs also translate into rising new rentals for tenanted dwellings.

**Suitable measures to address regional housing scarcity and further increases of high rents**

A number of measures can be taken in growing urban centres to address housing shortages and limit the pressure of housing costs for middle and low-income earners. Effective measures include:

- Making use of building land reserves and building opportunities, primarily through inner urban development and by keeping municipal stocks of land.
- Incentives for developing unutilised building sites.
- Regional housing supply strategies that relieve pressure from urban centres and expanding public regional transport to enable environmentally-friendly commuting and make it more attractive.
- Providing more incentives and infrastructure to create jobs in municipalities and regions that have less pressure from inward migration and are less densely populated. Expanding digital infrastructure can play an important role here. It also improves conditions for more people to work from home, enabling a further decoupling of workplace and residence. In many places it may also be worthwhile to upgrade town centres and residential areas in order to make them greener, more diverse and more attractive.<sup>6</sup>
- Housing allowance and social housing promotion.

By contrast, a rent cap that bans rent increases and potentially requires landlords to reduce rents is not suited for reducing the housing shortage because it makes housing investments less profitable and discourages investments. From a longer-term perspective, that would be inevitable if the costs incurred by housing companies and private landlords, for example for wages, salaries and construction work, were to continue rising without the ability to increase revenues at the same rate.<sup>7</sup>

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<sup>1</sup> Without calendar and seasonal adjustment.

<sup>2</sup> Müller, M. (2021): Skills shortages in the coronavirus crisis: The new KfW-ifo Skilled Labour Barometer: January 2021, KfW Research.

<sup>3</sup> Cf. F+B Forschung und Beratung für Wohnen, Immobilien und Umwelt GmbH (2020): F+B-WOHN-INDEX DEUTSCHLAND III-2020, <https://www.f-und-b.de/beitrag/fb-wohn-index-deutschland-iii-2020.html>.

<sup>4</sup> This raises the increasingly urgent question whether a price bubble is building in Germany's housing market and might burst with serious consequences for the economy as a whole. See Müller, M. (2021): Residential real estate: what is driving the prices – risky speculation or sound calculation? (forthcoming).

<sup>5</sup> The top seven large cities, the remaining district-free large cities, urban districts, rural districts with densification processes and sparsely populated rural districts.

<sup>6</sup> In Nova Scotia and Newfoundland, for example, where the weather is often grey, rainy and foggy, people paint their houses in lively colours which, according to the OECD Better Life Index, may help make them among the world's most content people and, in particular, very satisfied with their housing situation despite the regions' weak economic structure and rather dismal weather.

<sup>7</sup> See also Müller, M. (2019): Housing market: The social market economy can do better than freezing rents, Focus on Economics No. 272, KfW Research.