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What is driving housing prices – risky speculation or sound calculation?

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Residential property prices in Germany continued to rise strongly in 2020. So it is a good idea to remain watchful as to whether a price bubble is building that could burst with grave consequences for the economy as a whole. The present analysis has found that for now there is no cause for alarm. However, the risk of price drops is growing and with it evidence that speculative bubbles are building in some regions. This in turn has further increased the risks for the banking sector that real estate property as loan collateral may be overvalued. In addition, income risks have risen as a result of the coronavirus crisis. Further trends therefore need to be carefully monitored to be able to manage possible risks to overall economic stability through macroprudential measures in a timely manner, should they become necessary.

Is a housing price bubble threatening to burst in Germany?

Residential real estate prices continued on an upward trajectory in 2020 and the surge in prices intensified yet again. Last year the prices of detached and semi-detached houses increased 5 to 10% in both rural and urban districts and cities with district status (Figure 1). The price increase across Germany has been around 35% since 2015. The longer this trend continues, the more the question arises whether a housing price bubble is building that could burst with grave consequences for the overall economy. In order to answer this question, three matters need to be clarified:

1. Are investors buying alarmingly high numbers of properties at inflated prices because they are speculating on further price or rent increases?

2. Are developments to be expected in the housing markets that could lead to a sharp drop in property prices and rents with the consequence that real estate no longer serves as adequate loan collateral or investors are no longer able to meet their payment obligations because of high income losses?

3. Have credit institutions relaxed their credit standards or are investors leaning towards riskier financing arrangements so that a considerable portion of investors become insolvent and default on their interest and principal repayment obligations?

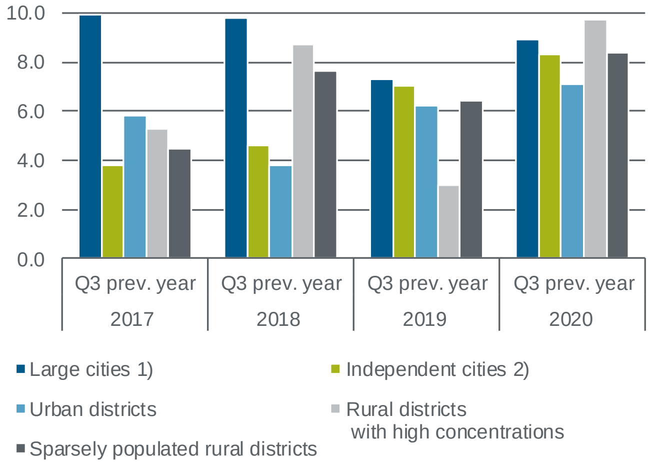
To answer these questions, we must distinguish between owner-occupied homes and rental housing.

Figure 1: Residential real estate prices have risen strongly in Germany in 2020 as well

Variations in prices for detached and semi-detached houses on the previous year's quarter (3rd prev. year = 3rd quarter), in per cent

1) Top 7: Berlin, Hamburg, Munich, Cologne, Frankfurt am Main, Stuttgart, Düsseldorf

2) Without the top 7



Source: Federal Statistical Office, own rendition.

Are investors buying alarmingly high numbers of properties at speculatively inflated prices?

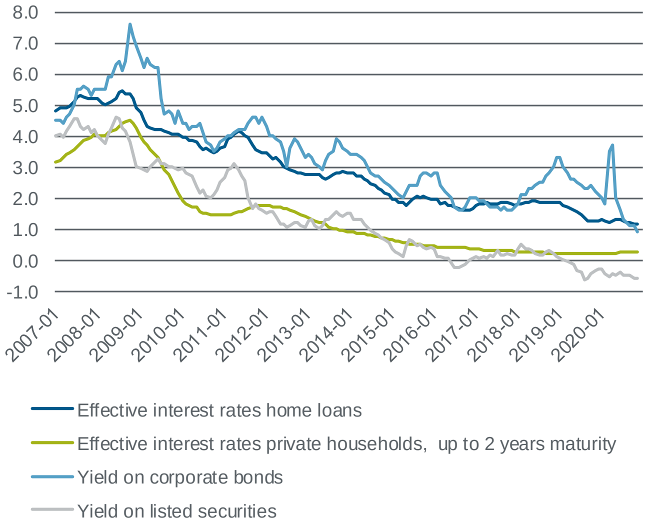
Looking at Germany as a whole without any regional differentiation, we can answer this question in the negative. Various indicators and reasons indicate that the prices of dwellings are driven by rising demand that is not motivated by speculation.

– From 2004 to 2019 the prices of dwellings in Germany did rise by nearly 70%[1] but disposable incomes of private households rose by 41% at the same time. In addition, average annual interest rates on housing loans dropped from 4.7 to 1.5% during the same period (Figure 2). Income growth and interest rate reductions largely financed the price increases.

– The demographic trend is making private pension plans even more important. Owner-occupied property saves rental payments and thereby provides relatively good social safety, which has become financially more attractive in times of low interest on loans and investments. At 47%, the homeownership rate in Germany remains low in international comparison, although it has grown by six percentage points in the last 20 years. In some eastern German states it has grown much more strongly as a result of catch-up effects.

Figure 2: Interest rates on home loans have fallen steeply, as have interest rates on investments

Interest rates and returns in per cent



Source: Deutsche Bundesbank, own rendition.

- The temporary *Baukindergeld* home finance grant scheme for families has also made buyers more willing and able to purchase residential property. Under the current rules, the grant is approved only if the building permit has been issued or the purchase agreement signed by 31 March 2021. The limited availability of the grant has likely increased demand additionally, which is also reflected temporarily in prices.

- The high rental increases in urban centres and sought-after cities are likely to have been a motive for many households to acquire residential properties in the more affordable peripheries. That is likely to have contributed to price increases there.

- Landlords have been able to pass on most of the property price increases to rents on new tenancy agreements. Rents on new agreements have not increased as steeply as property prices but they did rise by some 50% in all of Germany from 2004 to 2019. Analyses show that rental returns have fallen in recent years[2] but that also applies to the returns of alternative asset investments.

The facts and reasons set out above indicate that the strong increases in real estate prices – looking at Germany as a whole – were not based on speculation. Besides, so far there is nothing to suggest a credit boom that is characteristic of real estate price bubbles. The volume of home loans extended to private households increased strongly from 2010 (when the upward trend in loan portfolios set in) to 2019 but not more than disposable incomes. According to surveys by the Deutsche Bundesbank, that has even led to decreases in annual payment obligations on home loans for private households in relation to incomes. Nor is an increase resembling a bubble evident in home loans granted to domestic companies and self-employed persons. Commercial housing loan portfolios increased at the rate of gross national product since 2010 (Figure 3).

Is there a likelihood of developments that may cause price drops which threaten stability?

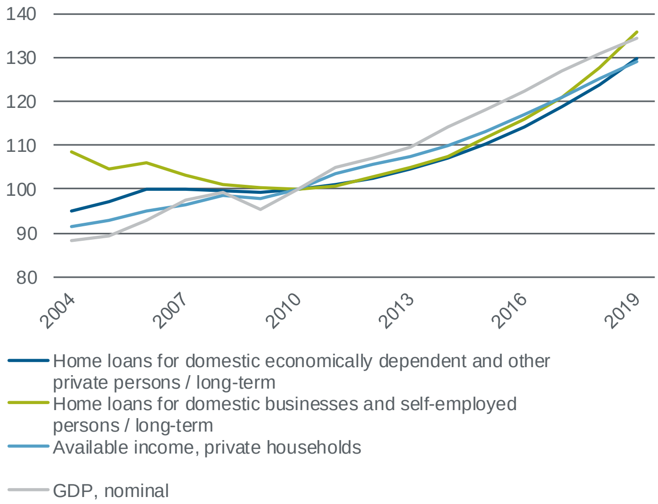
How real estate prices and rents develop essentially depends on demand. This, in turn, is heavily influenced by demographic trends. According to the current population projection by the Federal Statistical Office, Germany will have between 83.1 and 84.4 million inhabitants in 2030. The population would thus shrink by around 300,000 in the lowest scenario and grow by 1 million people in the highest scenario compared with 2020. Population statisticians predict a possible decline by 2.4 million or a further increase by 200,000 inhabitants for the period from 2030 to 2040. A major difference between the scenarios lies in the annual migration balance, which is estimated at 110,000 to 300,000 net immigrants from 2030.

Demand for housing in Germany would therefore continue to develop quite steadily overall this decade in any case. Demand for new housing is unlikely to drop as per capita floor areas continue to increase, the trend towards smaller households remains and people continue to migrate to economically strong urban centres. Nonetheless, the situation would still be different from the past years. Between 2012 and 2019 the number of inhabitants grew year after year by a total of 2.8 million and demand for housing rose accordingly.

Such a sharp increase is currently no longer expected and the opposite could also occur. Between 2003 and 2011 the population decreased year after year by a total 2.2 million. Migration flows are very volatile and forecasting them involves great uncertainty.

Figure 3: Housing loan portfolios have not grown more than incomes and GDP

Variations in loan portfolios, nominal GDP and disposable income in EUR bn, index 2010=100



Sources: Deutsche Bundesbank, Federal Statistical Office, own illustration.

In addition, regionally diverse developments must be expected. To be sure, it is plausible to expect that economically strong large cities and conurbations will attract workers, students and apprentices from Germany and abroad in the coming years as well. But they might increasingly divert to places where housing is more affordable – the work-from-home trend and the expansion of high-speed internet infrastructure are likely to accelerate this development. What applies at national level therefore applies even more at regional level: migration flows are very volatile and difficult to predict. It would therefore be speculation to assume that property prices and rentals will continue rising in cities that are already expensive. Instead, it would be more appropriate to expect possible decreases as well.

In view of this outlook, there are indications of regional speculative inflated prices, specifically where increases go far beyond what would be justified by interest rate reductions and rent increases. According to analysts, this is the case in a number of large and medium-sized cities where prices have risen most steeply.[3] These include Berlin, Frankfurt am Main, Munich and Stuttgart. More or less pronounced price drops may occur in these cities. But not only there. Real estate prices could also drop substantially in structurally weak regions. Whether and where that will happen essentially depends on regional housing demand and, thus, essentially on demographic developments. Another aspect that plays a role is to what extent the construction of additional dwellings can reduce housing shortages.

Are investors and credit institutions leaning towards riskier financings?

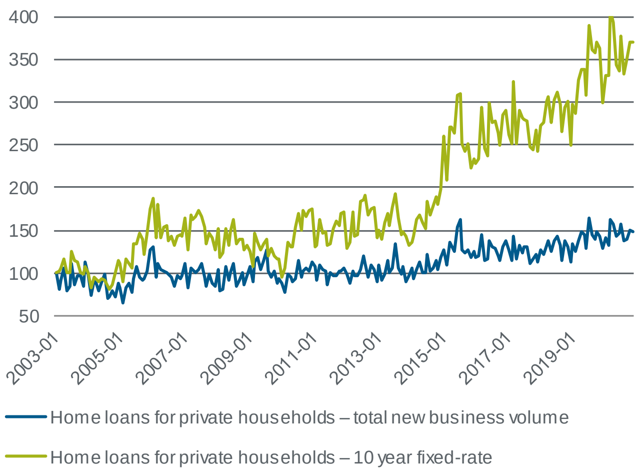
There are no signs of this; the only housing loans to private households that boomed were those with more than 10-year fixed-interest rates (Figure 4). Many investors are obviously keen to lock in low construction interest rates for the long term. Follow-up financings may mean higher interest rates. But given the high sovereign debt levels in the euro area, and with the aim of not jeopardising economic growth after the coronavirus crisis, the ECB is likely to leave interest rates low for some time. However, if inflation were to move up sharply, higher interest rate increases would be likely. But there are no signs of this. Furthermore, higher inflation would also mean higher income growth and declining real values of debt. Experience shows that the ability to pay off real estate debt thus actually improves amid rising inflation even with rising interest rates.

The Bank Lending Survey of the Eurosystem also did not detect a trend towards looser credit standards nor an increase in high-risk loans in Germany in the past years. Rather, banks tightened credit standards for residential construction loans in 2020 as well, especially in the form of interest premiums for riskier loans and increased collateral demands.[4] That is how they responded to higher risks resulting from the coronavirus pandemic. However, there are gaps in the data relating to credit standards for residential construction loans to private households that are yet to be closed, so this is not a final assessment.[5]

Conclusion: Economic risks are not yet a cause for concern but have continued to rise

There is no Germany-wide housing bubble yet. High price increases can be explained by increased demand for housing in many places and a growing preference for real estate as an investment, whether it be to meet the need for private provision for old age or whether it be because loans have become cheaper and other forms of investment are less profitable. For the most part, higher purchase and construction prices can be financed from increased incomes and rents on new tenancy agreements and by using lower interest rates and temporary *Baukindergeld* grants.[6] However, studies have found evidence of speculatively inflated real estate prices in some regions of the housing market. Investors who speculate that the strong rental and price increases will continue for years to come will probably miscalculate their investments in many places. Population projections for the remainder of the decade point to slower rates of increase in housing demand across Germany than in the past years, which is likely to reduce the potential of further price and rental rises and initiate decreases in many places as well. For the banking sector, this also raises the risk of residential properties being overvalued as collateral and borrowers defaulting on loans. The loan default risk is now additionally increased by possible income losses resulting from the coronavirus crisis. It therefore appears advisable to continue monitoring the developments in order to prevent early the build-up of a national price bubble that would pose a high risk to the overall economy, if necessary with macroprudential measures, i.e. measures aimed at reducing risks in the banking sector in order to safeguard macroeconomic stability.[7] This is also largely in line with the assessment presented by the Financial Stability Committee in its latest report.

Figure 4: New business volume is booming only for long-term home loans



Monthly new business volume, home loans to private households, index, January 2003=100

Source: Deutsche Bundesbank, own rendition

[1] According to data from the Deutsche Bundesbank based on surveys by bulwiengesa. The published time series begins in the year 2004 https://www.bundesbank.de/de/statistiken/indikatorensaetze/indikatorensystem-wohnimmobilienmarkt/indikatorensystem-zum-wohnimmobilienmarkt-775496.

[2] Cf. Möbert, J. (2020): Renditen im Wohnungsmarkt: Rot und Orange dominieren (*Housing market returns: red and orange predominate* – our title translation, in German only), Deutsche Bank Research, https://www.dbresearch.de/servlet/reweb2.ReWEB?rwsite=RPS_DE-PROD&rwobj=ReDisplay.Start.class&document=PROD0000000000514981.

[3] Müller, M. (2017): Germany is approving enough new residential units – they just need to be built (in German only), Focus on Economics No. 188, KfW Research and empirica (2017, ed.): Herausforderungen und Perspektiven für den deutschen Wohnungsmarkt (*Challenges and perspectives for the German housing market* – our title translation, in German only), study commissioned by KfW, p. 97 ff.

[4] Cf. Deutsche Bundesbank (2020): October results of the Bank Lending Survey in Germany, https://www.bundesbank.de/en/press/press-releases/october-results-of-the-bank-lending-survey-bls-in-germany-848942

[5] Cf. Financial Stability Committee (2020): 'Siebter Bericht an den Deutschen Bundestag zur Finanzstabilität in Deutschland' (*Seventh report to the German Bundestag on financial stability in Germany* – our title translation, in German only), p. 9, https://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Internationales_Finanzmarkt/2020-07-06-Siebter-Bericht-BT.pdf?__blob=publicationFile&v=2; Wuermeling, J. (2020): Zur Regulierung gibt es keine Alternative (*There is no alternative to regulation* – our title translation, in German only), interview in the magazine Immobilienzeitung, https://www.bundesbank.de/de/presse/interviews/-zur-regulierung-gibt-es-keine-alternative--824768 and German Savings Banks Association (2020): Wohnungsmarkt in Deutschland: Corona und die Folgen (*Housing market in Germany: coronavirus and its consequences* – our title translation, in German only), p. 5.

[6] The strong increase in construction activity has caused prices of new dwellings to rise much faster. The cause for this is ultimately the exacerbated housing shortage in urban centres triggered by migration inflows. See also: Müller, M. (2021): A ray of light: Residential construction continues to grow despite coronavirus crisis, Focus on Economics No. 319, KfW Research.

[7] For details on macroprudential measures cf. Bittorf, M. (2016): Makroprudenzielle Instrumente für den Immobilienmarkt: Einsatz mit Augenmaß (*Macroprudential instruments for the property market: a proportionate intervention* – in German only), Economics in Brief No. 113, KfW Research.