German house prices – no boom after correction has ended

Residential real estate prices in Germany have recently risen again, and an increasing number of transactions and stronger demand for mortgage loans suggest that the price correction is over. However, prices are likely to rise only moderately for the time being. This is because there is no sign of a significant fall in mortgage interest rates and the increasing shortage of housing is likely to push prices up only moderately.

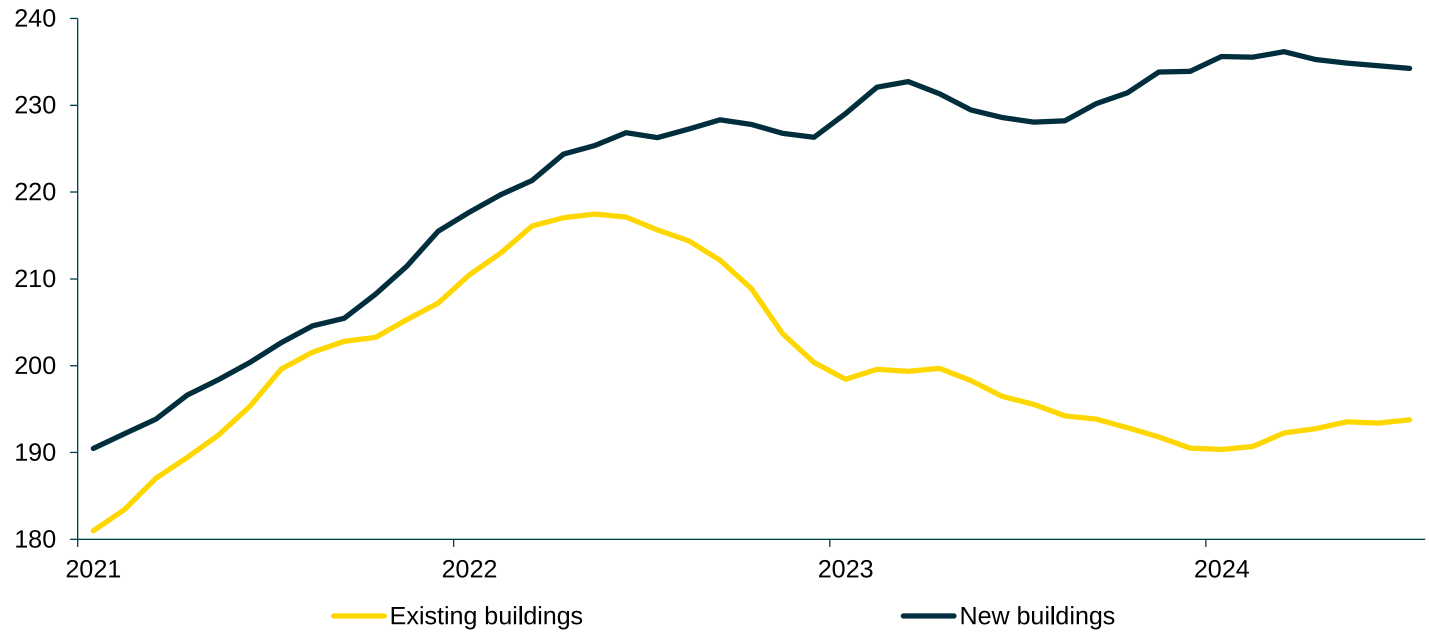
Dr. Marco Wagner

Price correction seems to be over, ...

as the price correction on the German real estate market triggered by the ECB's massive interest rate hikes come to an end? At least prices for existing properties have risen again slightly since the start of the year, after previously falling by more than 12% since spring 2022 (Chart 1).[1] This would mean that the price correction has ended sooner than we had expected. We had previously assumed that prices would continue to fall slightly until the end of this year. This is because real estate – based on model estimates and in relation to economic fundamentals – is still around 5% to 10% overvalued.

Chart 1 - Stabilizing property prices

Transaction prices for residential property, index August 2005=100



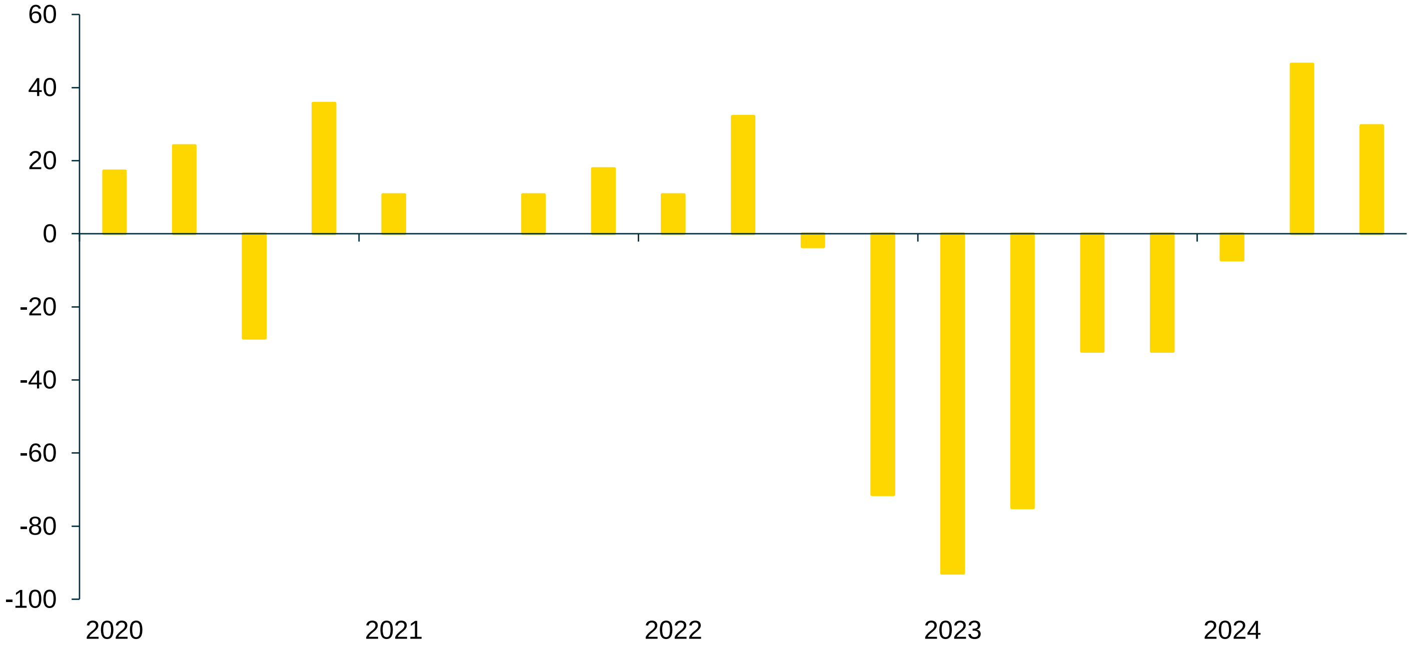
Quelle: Europace, Commerzbank Research

... as transactions and demand for mortgage loans increase

The increase in property transactions since the start of the year suggests that the price correction has come to an end (title chart). Obviously, the price expectations of potential sellers have come closer to those of potential buyers, which are lower as a result of the less favourable financing conditions, meaning that there is no need for a further correction. This picture is confirmed by increasing demand for mortgage loans. For the second time in a row, a clear majority of German banks stated in the ECB's quarterly Bank Lending Survey (BLS) that demand for mortgage loans has increased compared to the previous three months (Chart 2).

Chart 2 - Increasing demand for property loans

ECB Bank Lending Survey (BLS): Household demand for property loans in Germany compared with the previous quarter, net responses from banks in per cent



Quelle: ECB, Commerzbank Research

Further price growth ...

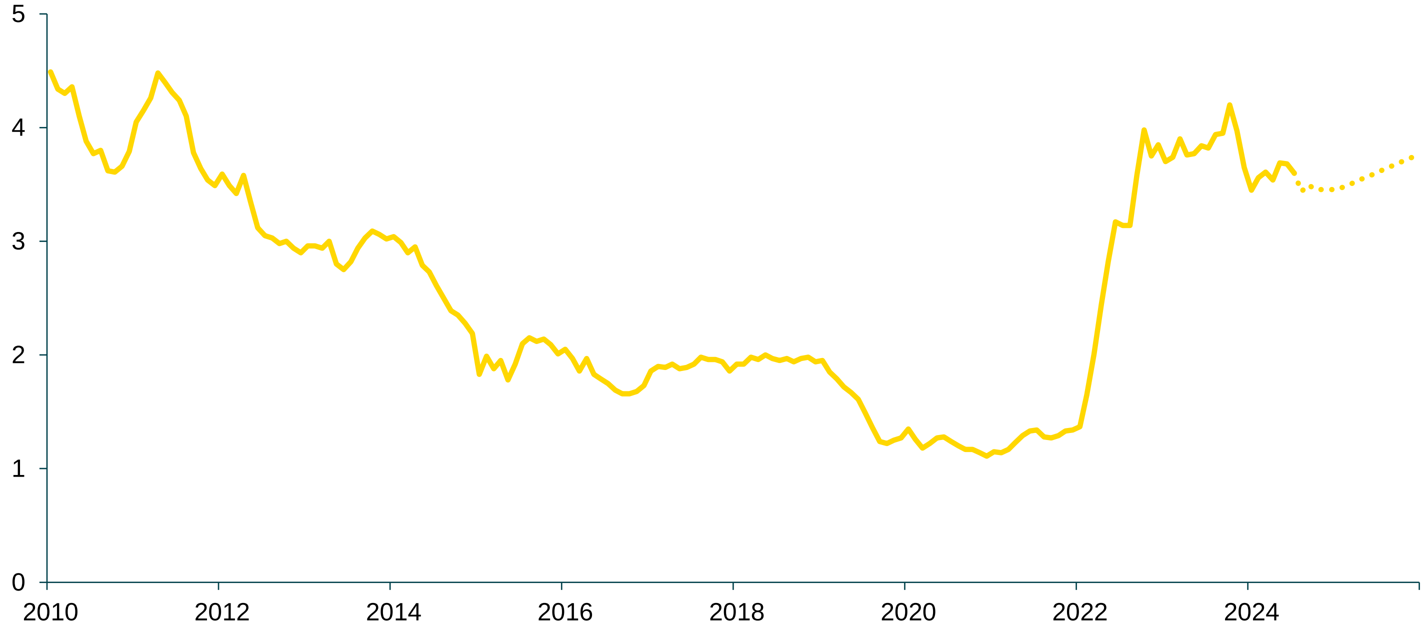
This has increased the likelihood that prices will continue to grow over the coming months. With prices and incomes rising, this is not out of the ordinary. Per capita disposable incomes have grown by more than 5% in each of the past two years and are likely to increase by a similar magnitude in the current year. It is true that inflation has diminished household purchasing power in recent years. However, those households that are considering buying a property are unlikely to spend their entire income on necessity goods. Therefore, inflation has probably only "eaten up" a portion of the increase in income, ultimately making property more affordable.

... but not a boom

However, the price increase is likely to remain moderate in the coming year. This is because interest rates are unlikely to provide much of a boost. The ECB is likely to cut interest rates by a further 100 basis points by next summer. However, this would be somewhat less than the market is currently expecting, meaning that the downward potential for yields on ten-year German government bonds and therefore also interest rates on ten-year mortgage loans is probably limited. At around 3½%, the latter are unlikely to be markedly lower in the coming months and into next year compared to today. Also, there is scope to expect rates to rise slightly in the second half of 2025 (Chart 3).

Chart 3 - Only slightly lower interest rates in the coming months

Interest rate on 10-year mortgage loans, in percent; from August Commerzbank forecast



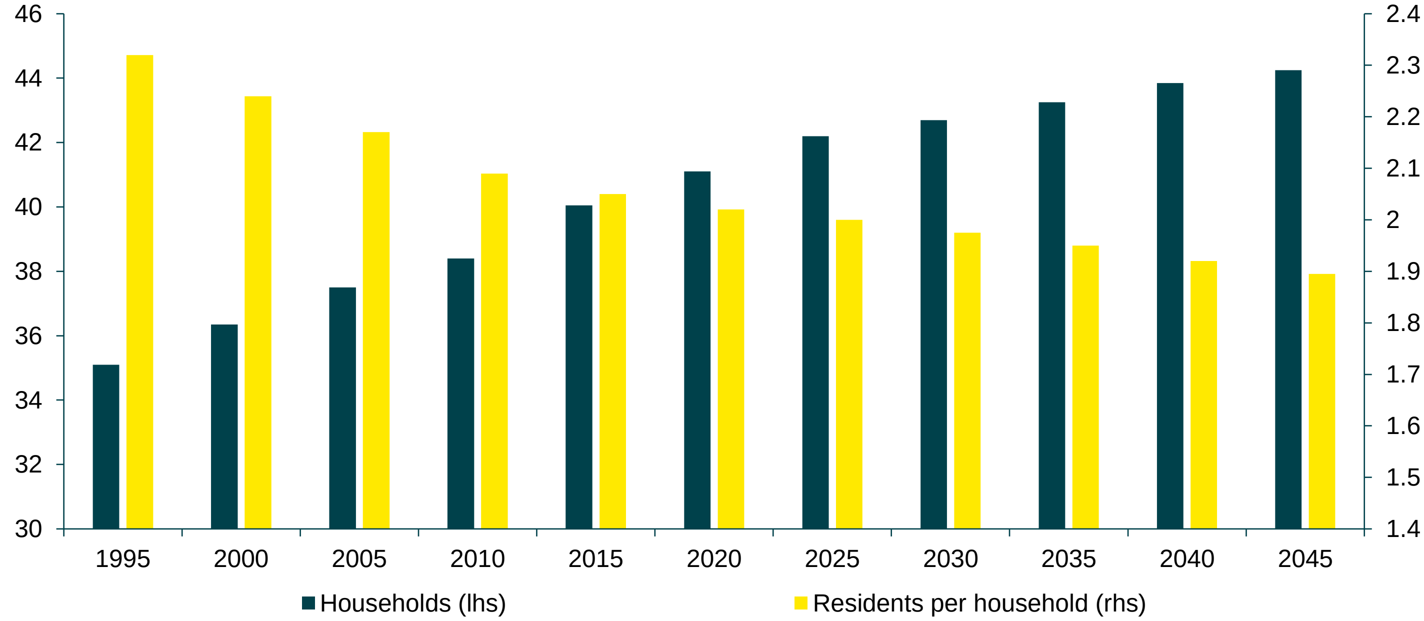
Quelle: Bundesbank, Commerzbank Research

... also due to shortages

Another possible driver for sharply rising property prices is the existing shortage of housing in many regions. For example, the **Cologne Institute for Economic Research**, estimates demand for new flats, up to and including 2025, to be at a good 370,000 units. For the years leading up to 2030, demand is estimated to be at 300,000 newly-built apartments annually. According to a **study** by the Arbeitsgemeinschaft für zeitgemäßes Bauen e.V. (ARGE) – a network of the construction industry in Northern Germany –, demand is being driven not only by immigration but also by the fact that fewer people are living in households, which is also causing the number of households to rise (Chart 4).

Chart 4 - Number of households rising steadily

Number of households, in millions; number of residents per household; from 2023 model calculation

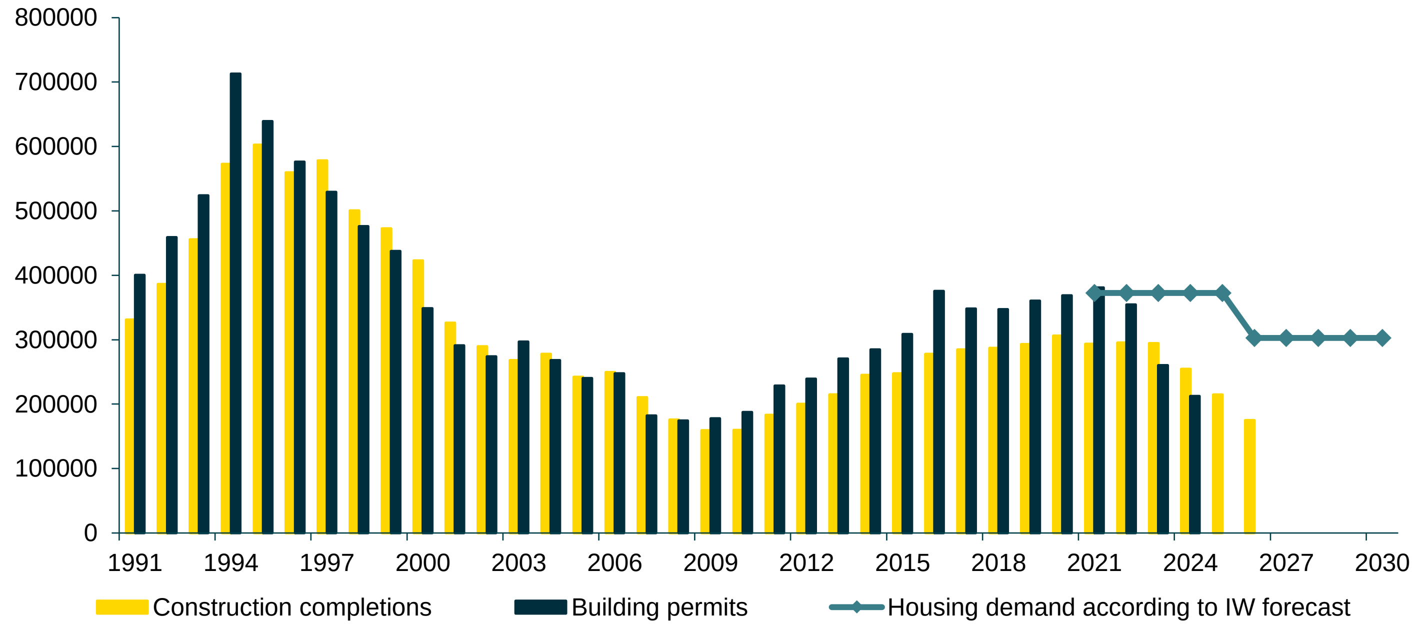


Quelle: ARGE, Commerzbank Research

Supply has not been keeping pace with this higher demand for some time. Between 2010 and 2022, fewer flats were completed each year than new building permits were issued. According to **forecasts** of the Munich-based Ifo institute, building completions are likely to fall below 200,000 units by 2026 and thus fall well short of the demand forecast by IW Cologne (Chart 5). The housing shortage is therefore likely to worsen in the coming years.

Chart 5 - Less construction in the future

Building completions, from 2024 Ifo forecast; building permits; housing demand according to IW forecast



Quelle: Federal Statistical Office, Ifo, IW Cologne, Commerzbank Reseach

One reason for the low level of construction activity in recent years is the worsening labour shortage. In fact, one in four construction companies named this as a major issue in the recent Ifo survey, whereas before the financial crisis, barely 3% of companies felt a shortage of labour. In addition, there are repeated references to the reluctance of local authorities to designate new building land.

However, the low level of construction activity in recent years is probably also partly a consequence of regulation. For example, building standards have been continously raised, which has noticeably increased costs for investors. At the same time, the regulation of the rental market is slowing down the rise in rents, meaning that investors are no longer able to realise the returns they are aiming for given the higher construction costs.

Property price growth seems to outpace consumer price inflation

Ultimately, real estate prices are likely to rise somewhat faster than average consumer price inflation or rents. This is supported by the shortages on the real estate market. However, we do not expect prices to boom again as they did in the ten years before the interest rate turnaround. This would require a drastic fall in interest rates for mortgage loans, which we do not expect in the coming years.

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[1] Prices for new builds have recently fallen somewhat. However, there had been no downward correction in the past two years. It is true that the financing conditions for them had also deteriorated noticeably. However, real estate developers and builders were obviously unwilling or unable to make any price concessions in the face of rising construction costs, meaning that the correction was primarily driven by volume - i.e. the number of new builds built and sold - rather than price. (back to the text)

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