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Misguided policy raises risk of housing bubble

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— Our baseline scenario sees little likelihood of a bubble emerging in Germany's housing market. Given Germany's still low house prices by international and historical standards and the feeble expansion of lending activity, we characterise the current cycle as a return to normal market conditions.

— The weak supply response could prove problematic. Since some indicators even point to a slowdown in the construction sector the demand overhang and the price pressure could intensify further. Both capacity restrictions, especially the lack of suitable skilled labour, and the tightening of regulatory requirements, the introduction of stricter rent control ("Mietpreisbremse") in particular, could dampen building activity. If a firm correlation emerges between slower building activity and rent control over the coming months, the Länder (federal states) should not implement it.

— Germany's housing market, with rental yields that are 2-4 percentage points higher than 10Y Bund yields, offers an attractive investment option. The increasingly negative yield on fixed-income instruments intensifies the pressure on domestic and foreign institutional investors to diversify into other asset classes. Similarly, mortgage rates, which have fallen again steeply until recently, are clearly inducing more and more households to buy a home when they face the decision of whether to buy or rent.

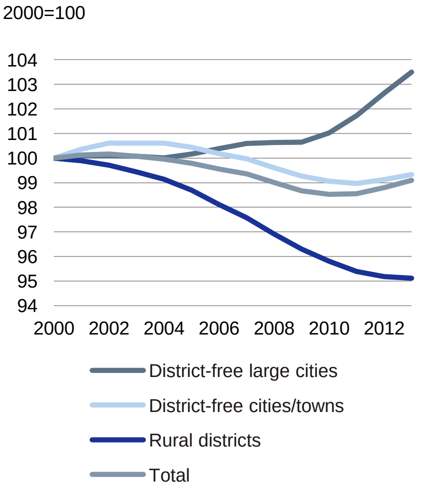
— The risk of a real estate bubble would increase particularly if mortgage rates were to continue to fall and loan-to-value ratios began to climb. In this scenario, returns on equity would skyrocket and significantly increase macroprudential risks in Germany.

Will policymakers "create" affordable housing?

Considering the tight situation in heavily populated conurbations, the ruling coalition's stated objective of enabling people to live in "affordable housing" is of economic and societal relevance. However, the government is only partly resorting to the right instruments. For instance, the current plan to increase housing benefit for low-income families could increase the price pressure in the low-range segment. We are positive on the new investment ordinance for insurance companies and pension funds, which underpins investment in infrastructure and thus may help to slightly lift house prices in conurbations. We expect the new rule on real estate agent fees to have a relatively minor impact on market prices. We believe the other amendments, such as rent control, the higher land purchase tax and charges from the "Energiewende" (Germany's transition to renewable sources of energy), all obstruct the target of creating affordable housing. Before we continue this discussion of housing policy we shall analyse the supply and demand situation in the German residential property market.

Germany's urbanisation gathering pace

2000-2013: German population type of administrative district 1



Sources: BBSR, Deutsche Bank Research

For centuries, the region where German is spoken was not a single nation-state in spite of a common language and culture, but instead a host of regional centres. As a result, German cities grew relatively slowly and no global metropolises developed. By comparison: the country's seven largest cities combined have fewer inhabitants than the metropolitan area of either Paris or London. The strong demand there, with building land in limited supply, is also mirrored in local house prices. The average prices in Paris and London are typically more than twice as high as in the most expensive cities in Germany (chart 3).

Over the past few years, though, urbanisation has gained momentum also in Germany, with the population increasing in the major cities and metropolitan regions. High wage levels and good job opportunities in Germany have attracted many migrants from eastern and southern European countries in recent years, with the immigrants preferring to settle in Germany's conurbations. At the same time, however, internal migration has also boosted the number of people living there. These trends could result in a sustained increase in the number of inhabitants in the economically thriving cities and conurbations.

Surge in demand from private, institutional and foreign investors

The current low interest rate environment provides an incentive for households to buy a home rather than rent. While rents have risen more slowly than house prices in conurbations in the current cycle, the pronounced decline in interest rates has in many cases heightened the appeal of buying. In cases of standard mortgage loans with equity backing, fixed-rate terms and average repayment, expenditure on housing will start to decline from practically the very first month that a currently rented home is purchased. As a consequence of this trend, Germany's home-ownership ratio, which is particularly low by international standards, could very well jump. The low interest rates, partly caused by the euro crisis, might thus lay the foundation for a development that had been unsuccessfully targeted for decades via a building allowance hinging on child benefit eligibility, the home-ownership allowance and other government subsidies.

Demand for real estate from institutional investors, such as insurance companies, pension funds and foundations, could gain momentum though, too. Over the past few years there has been much talk about the low sustainability of current business models in the low interest rate environment, but investors continued to benefit from rising prices in the bond market. Given the ultra-low yields on 10Y Bunds of far below 1% and a negative yield on maturities of up to five years, the risk-reward ratio has now deteriorated sharply since further price increases are limited and there is a risk of having to pay for a low or even negative return with high volatility. Therefore, institutionals have started to focus more heavily on property as an asset class. This applies in particular against the backdrop of ultra-expansionary monetary policy. With the ECB's quantitative easing programme of sovereign bond purchases having begun in March this is a quasi-guarantee of bond yields remaining low for the time being. Some investors had adopted a wait-and-see attitude up to now, thus stockpiling relatively large amounts of cash, and they are now under increased pressure to invest these funds.

The German residential property market also continues to appeal to foreign investors, with stable rental yields and potential market undervaluation only two incentives of several for investment. In recent months, the renewed flaring of the Greece crisis has boosted Germany's TARGET2 balance by more than EUR 80 bn since July 2014. Inflows were registered mainly from Italy and Greece. The political uncertainties could persist at high levels here since E(M)U-sceptic parties rate high in voter surveys in many countries. Correspondingly, further capital inflows into Germany would not come as a surprise and given the low bond yields the real estate market could benefit more from these inflows than in the past. Nevertheless, there are good reasons why the pretty wide spread between rental yields and bond yields as well as between rental yields and financing costs should remain in place for some time.

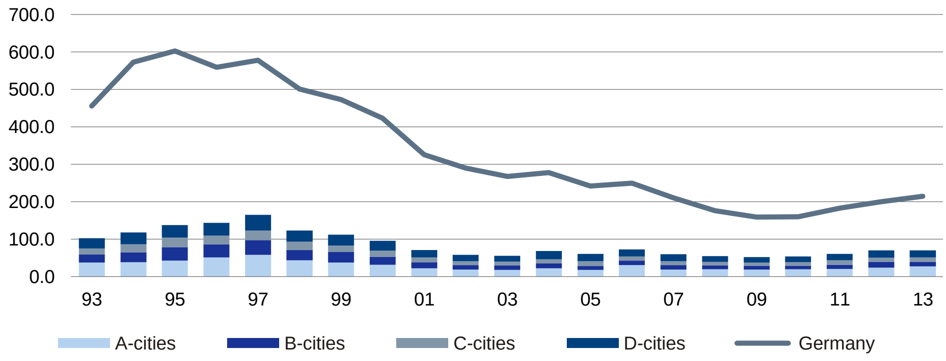
Imbalance between supply and demand

Germany is not adequately prepared for the high demand in its conurbations. Most real estate markets are typically inelastic on a short-term horizon because the implementation of building projects often requires considerable time for the planning stage, procurement of building permits and selection of tradespeople and building firms. In Germany, though, the housing supply will probably remain limited in the medium term or perhaps even in the long run. Germany's structural investment fatigue in the residential construction segment is distinctly noticeable on international comparison. Since 2000, German building completions have equalled only about 7% of the existing housing stock, while the percentage in many large European countries has ranged in the double digits. Even the OECD points to the low elasticity of supply and, in this context, to the high degree of sector regulation in Germany and strict rent regulation even before the introduction of the new measures (“Mietpreisbremse”).

The modest level of building activity has not changed substantially in the current cycle either. In the past few years the number of building completions relative to the total stock in France was nearly twice as high as in Germany, in spite of divergence in their economic performance. On a similar note, the volume of German building completions in euros per capita in real terms is still roughly 30% below the national average over time even though there has been a steady improvement in recent years. Surprisingly, building completions are still low in the conurbations – even though the number of inhabitants there is growing. In line with this trend, CBRE, the property consultants, say that the market-active vacancy rate is at extremely low levels − below 2% in Berlin, Dusseldorf, Cologne and Stuttgart and in fact even far below 1% in Munich, Frankfurt and Hamburg.

Building completions 2

No. of apartments in k



Sources: BulwienGesa, Federal Statistical Office, Deutsche Bank Research

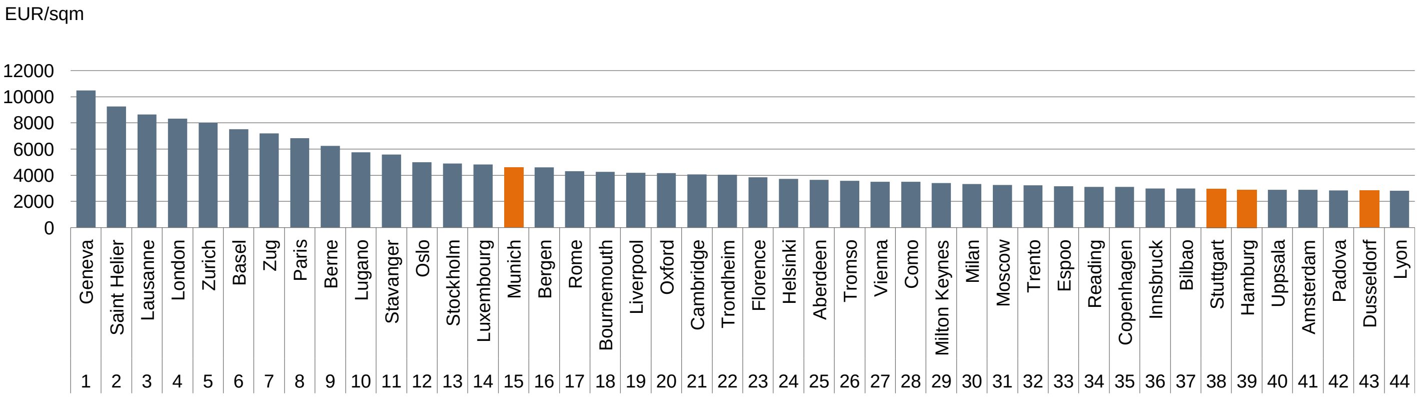
House prices continuing their climb

This market imbalance marked by little expansion of supply and dynamically growing demand results in pronounced price pressures. In the past six years prices have already increased by 30% nationwide on average, and in some cities by 50%, in fact. House prices across Germany were up 5.4% on the year again in 2014. This means that the price momentum has eased somewhat in nominal terms (2012: 6.3%; 2013: 6.3%), but adjusted for inflation the increases have remained virtually constant in the past three years at around 4.5%.

However, since household incomes and rents have also risen, the German affordability indices, such as the price-to-income and price-to-rent ratios, have only regained roughly 10% of their undervaluation and are now still around 10% below their historical averages. On international comparison, too, German cities are not expensive. According to Numbeo.com[1] there are 44 European cities with average house prices outside the urban centre totalling over EUR 2,800 per square metre. Eight of them are in the United Kingdom, seven in Switzerland, six in Italy, and five in Norway, but only four in Germany. Munich, Germany's most expensive city, ranks merely 15th. The other German cities are Stuttgart, Hamburg and Dusseldorf. Numbeo says that with a square metre price only slightly in excess of EUR 2,800 they are at the bottom of the ranking. Despite differing institutional, regulatory and legal environments, these figures call into question the Bundesbank's claim – based on a nationwide random survey – that property in Germany's major cities is overvalued by up to 25%.

[1] The Numbeo.com data are based on online surveys of users who list their prices. We have various reasons for believing that the data are meaningful: 1. Various other recognised media (Financial Times, The Economist etc.) have already cited Numbeo as a reference. 2. The prices in this unofficial data source usually approximate official urban statistics, to the extent that these are available. 3. They regularly reflect the experience and anecdotal evidence of market participants.

Apartment prices outside city centre above EUR 2,800 | 3



Download from Numbeo.com as of 15-May-15.

Sources: Numbeo, Deutsche Bank Research

Housing bubble unlikely considering weak lending growth

Moreover, a bubble in the housing market typically goes hand in hand with strong credit expansion. In the current house price cycle new mortgage lending has grown merely 15% since 2008, despite the halving of interest rate costs, since long-term mortgage rates have fallen from 5% in 2008 to below 2% now. However, since households have used the low interest rates to increase their repayment rates, lending volume has expanded by only 7%, i.e. by around 1% per year. By comparison, in many European countries with house price bubbles the annual rate of lending growth has often exceeded 10% per year.

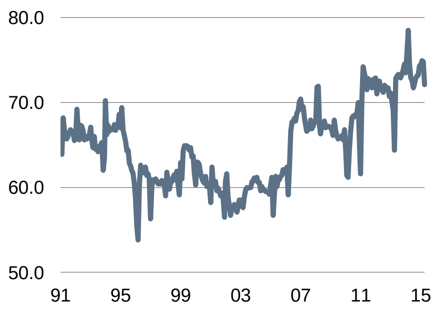
Relative to macroeconomic parameters, German lending growth has been pretty sluggish in the current cycle too. The volume of residential building loans has expanded at less than the inflation rate. Relative to economic strength, mortgage loans have in fact fallen significantly, from 50% to around 40% of GDP. Our well-known preliminary conclusion is that the German lending market is not at risk of overheating, and we interpret the price trend in the current cycle as a return to normal market conditions. Based on this analysis, we assume in our baseline scenario that lending and price growth will remain moderate for the time being. However, the demand pressure, the regulatory mechanisms and ultra-low interest rates could also result in a shift in policy and additional regulatory interventions.

Has building activity started to cool in recent months?

In order to cap the potential for market overheating in the next few years it is key to expand the housing supply in Germany's conurbations. In this context there has recently been a host of indices, such as the ifo business climate for construction and building completions, pointing to a relative flattening of growth (charts 6 and 7). This suggests there may be capacity restrictions at play that are blocking a further expansion of supply. Capacity utilisation in the construction sector has hit an historic high. According to the ifo survey, a relatively large number of building firms complain about a lack of workers and the Federal Employment Agency reports a shortage of skilled tradespeople in the plumbing and sanitary fittings sector in particular. In recent years the number of vacancies for this group of workers that is obliged to pay social security contributions has continued to surge and the number of job vacancies far exceeds the number of jobseekers. A bottleneck in one subsector of the construction sector could also have negative effects on building activity as a whole. Since the apprenticeship figures in construction are in fact slightly declining, the shortage of skilled workers could become chronic. Moreover, the large number of applications to draw a pension at 63 (roughly 280,000 in late March) may further exacerbate the shortage of skilled workers in the sector.

ifo: Capacity utilisation 4

in %



Sources: ifo, Deutsche Bank Research

ifo business survey: Construction 5

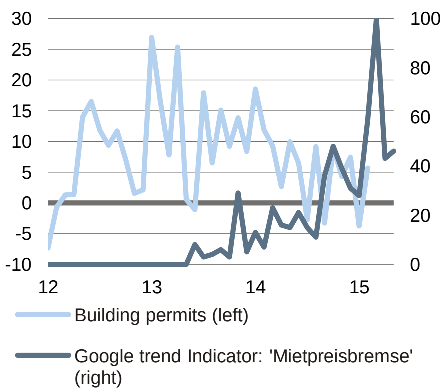
Share of "Yes" answers in %

Sources: ifo, Deutsche Bank Research

A further cause of the curbed building momentum could have been induced by political developments. In charts 6 to 8 we plotted the curve of the above-mentioned construction indicators against the frequency of searches for the term "rent control" ("Mietpreisbremse"), which we captured via Google Trend. The debate about "affordable housing" that began with the federal election campaign in mid-2013 presumably heightened investor uncertainty about the future regulatory environment. It remained unclear until recently just how the new law would apply to newbuild housing and the modernisation of existing stock. Construction-sector investors may have postponed some projects in order to await the impact of the new rules on their investment models. Given the pronounced volatility of the time series – we refer particularly to chart 8 and the jump in unfilled orders at the end of 2014 – building activity will have to be closely observed and analysed over the next few months, above all following regional implementation of the new rent control legislation.

Building permits & "Mietpreisbremse" 6

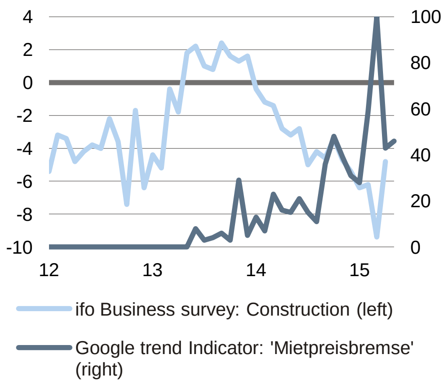
left: Building permits % yoy
right: Google trend indicator in index points



Sources: Federal Statistical Office, Google, Deutsche Bank Research

ifo Construction & "Mietpreisbremse" 7

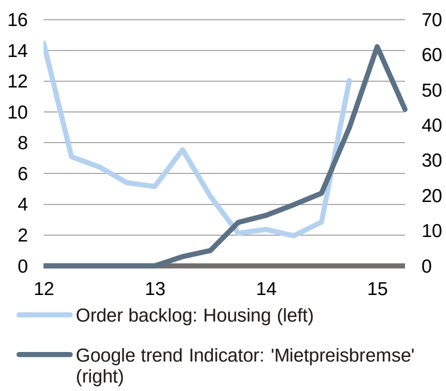
left: ifo Construction, balance in survey, sa
right: Google trend indicator in index points



Sources: ifo, Google, Deutsche Bank Research

Order backlog & "Mietpreisbremse" 8

left: Order backlog %yoy
right: Google trend indicator in index points



Sources: Federal Statistical Office, Google, Deutsche Bank Research

Regulation limits supply

As discussed above, German building activity had been sluggish even before the debate on the recent housing policy measures started. There are numerous reasons for this: First, there has been too little zoning of new building land. In some cities with narrowly drawn boundaries this is a permanent obstacle. Second, building rules that strictly regulate, for example, the height of storeys in residential buildings also contribute to the scarcity of supply. A third point is lengthy authorisation processes and approvals of building projects that are tied to the condition of building inexpensive housing.

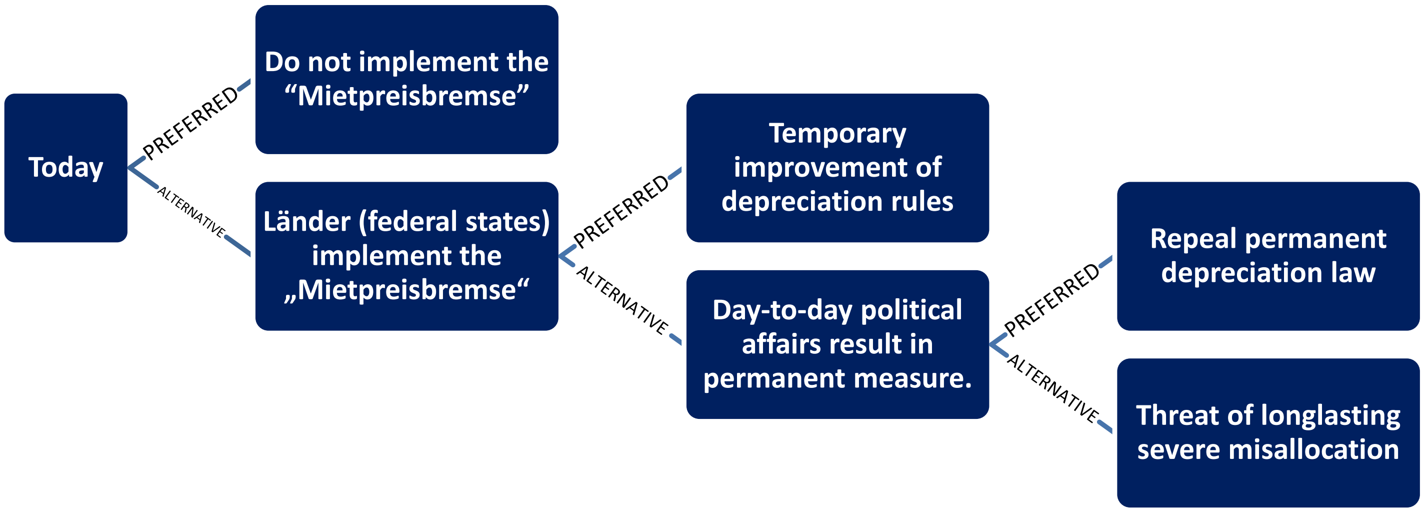
So far, the German parliament has not attempted to create investment incentives to mitigate the scarcity of supply. Indeed, the current administration has further tightened the degree of regulation by introducing rent control. The literature on rent control ultimately does not enable any clear expectations to be derived on market outcomes, since the market outcome of rent control hinges on a multitude of details. But naturally there is a risk of a longlasting negative impact. In any case, the uncertainty of potential investors could rise. There is talk about constitutional complaints being filed against rent control. Equally, the lack of legal underpinning for the calculation of “usual local rent levels” (“Mietspiegel”) will lead to legal squabbles – according to the new law, the rent charged when re-letting existing stock must not exceed 10% of the usual local level at the maximum. In May 2015 a district court in Berlin already classified the local rent index ("Mietspiegel") as unscientific and rejected it as a guideline for the legislation.

The regular increases of the land purchase tax, with the rate having doubled within a few years in several Länder (federal states), is a stumbling block on the way to achieving the goal of "affordable housing". In combination with the additional burdens caused by the Energiewende many building projects could have ended up being shelved. Thermal insulation quickly boosts costs by EUR 100 per square metre, while there is no guarantee of increased economic efficiency, i.e. lower running costs that recoup the procurement costs, especially in a phase of low oil prices. Moreover, in February 2015 the grand coalition put the planned tax incentive for installing new boilers, insulated windows and insulated façades on ice.

Policy recommendation to create affordable housing

If the temporary slowdown in building activity becomes a longlasting problem, the implementation of rent control should be stopped. Note that the federal law merely allows the Länder the possibility of regional implementation. If this recommendation is ignored at the Länder level, the federal government should seek to stimulate building activity via improved depreciation rules. These rules ought to create investment incentives in the conurbations in particular and – in order to ultimately avoid an oversupply of homes at the end of the current house price cycle – should be limited to a certain time period. However, politicians may be tempted to implement a permanent subsidy, in particular in the run-up to elections. History teaches us that such permanent measures would do more harm than good. Our ranking of policy recommendations therefore is shown below.

Chain of policy recommendations to avert misallocation 9



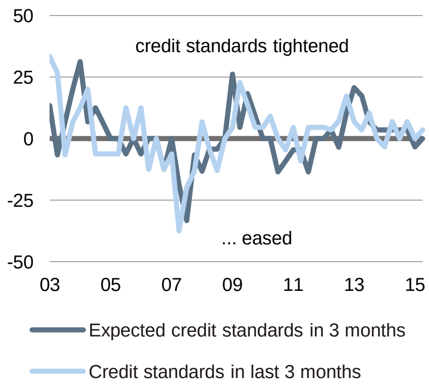
Source: Deutsche Bank Research

Should a chronic shortage of skilled labour materialise, the federal government should develop a targeted immigration strategy also for the construction sector. In addition, improvements to regional transport infrastructure would help vent the price pressure on Germany's conurbations. Better transport links ought to reduce demand in the conurbations themselves and/or enable housing demand to be diverted to the surrounding regions. This is an area where government could provide further stimuli, especially in the expansion of municipal infrastructure in the conurbations.[2] The new investment ordinance for insurance companies and pension funds should also trigger new stimuli, since improved establishment of infrastructure loans as an asset class would enable additional funds to flow into transport infrastructure.

[2] Oliver Rakau (2014). Case for higher investment in infrastructure – despite questionable "gap analysis". Standpunkt Deutschland. December 5, 2014.

Bank lending survey: Mortgages 10

Net percentage balance, nsa



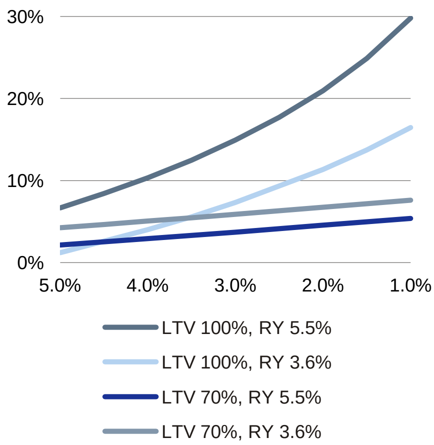
Sources: Deutsche Bundesbank, Detusche Bank Research

Credit market: Real vs risk-tol. investors 11

Source: Deutsche Bank Research

Return on equity skyrockets if mortgage rates decline and loan-to-value ratios go up 12

y axis: Return on equity
x axis: Mortgage rate



LTV=loan-to-value, RY=rental yield, standard credit for buy-to-let=2%, repayment rate, price increases and rent increases 2% p.a.

Source: Deutsche Bank Research

Recommendation to macroprudential supervisory authorities

The numerous real estate bubbles that burst in other countries provide extensive illustrative material for analysis. Therefore, Germany's most important macroprudential body, the "Ausschuss für Finanzstabilität" (AFS, or Committee for Financial Stability, consisting of representatives of the finance ministry, BaFin and the Bundesbank), considers three factors to be mainly responsible for the risk of a bubble: rising house prices, dynamic credit expansion and the relaxation of lending standards. In the current German cycle neither credit expansion nor lending standards have changed noticeably (chart 10), and for this reason the AFS maintained its observer status last year.

However, there is a risk of the AFS prescribing the wrong medicine going forward. In its 2014 report it states that the share of investment in residential construction in gross domestic product indicates a supply overhang. This is an important indicator, but one which is of only limited significance in the current market phase given a demand overhang. Furthermore, the regional differentiation of risk weightings for mortgage loans brought into play by the AFS is also out of place. This is true at least if the intention is to dampen mortgage growth in conurbations, where the demand overhang is particularly large. In order to run down the current demand overhang and reduce the price pressure the point is not to restrain mortgage loan volumes in the major cities and conurbations but to expand them. Otherwise, the current market phase of a return to normal risks turning into a phase of overheating.

Concurrently, the situation has changed significantly owing to the extremely low interest environment. The possibility looms that credit growth could pick up sharply due to additional demand from risk-tolerant investors (to distinguish risk-tolerant from real investors see chart 11). These invest in existing dwellings and as a consequence do not help to reduce the demand overhang and already today plan to resell the property in a few years. For these investors property purchases are particularly attractive if there is a further steep drop in 5 to 10-year mortgage rates (from 1.9% p.a. at present). Then the annual return on equity in standard valuation models could skyrocket (chart 12). This would heighten the appeal of risky financing options with little equity, low or zero repayment of capital and high loan-to-value ratios. Since rental income would far outstrip the interest and maintenance costs investors would recoup their capital in only a few short years. The investment success of these risky financing models would then depend on resale values. But, as discussed above, many signs point to further rising prices, so investors could probably attach low significance to resale risk for the time being. To channel new credit volume towards real investors, tax incentives could increase the attractiveness of new buildings relative to investments into existing dwellings.

Conclusion

Politicians should focus on an expansion of building activity in the major cities and conurbations in order to reduce the upside pressure on house prices. In the past few months there have been indications of easing activity in the construction sector. If this trend materialises, the pressure on house prices will intensify further. One possible cause of this development is capacity restrictions, and a lack of suitable skilled labour in the finishing trades in particular. An immigration law that specifically focuses on bottlenecks in the labour market could help to bring about some relief. If it becomes obvious over the next few months that construction growth is going to remain sluggish long term, rent control should not be implemented in the regions. Since this is probably not going to happen, the federal government ought to improve depreciation rules at the regional level on a temporary basis. It is vital to limit this measure to a few years in order to ensure low risk of a supply overhang at the end of the cycle.

It is up to the macroprudential supervisory authorities to support building activity via the lending channel. If the AFS decides to revisit the idea of regionally different risk weightings for mortgage loans, as indicated in its 2014 report, it could possibly exacerbate the price growth it is actually trying to tackle. At the same time, though, efforts should be made to prevent a further decline in mortgage rates, since otherwise the return on equity will skyrocket in cases of standard mortgage loans, risk-tolerant investors will stampede into the market and the risk of a bubble will grow as a consequence. Therefore, the supervisory authorities should support the necessary expansion of supply via dynamic, healthy growth of mortgage loans, yet seek to prevent the financing of risky investment projects that only pay off on ultra-low interest rates. The differentiation of real and risk-tolerant investors should be implemented by tax regulations which set incentives to invest into new buildings. Furthermore, the Bundesbank should enhance its communication policy and clearly point to the problems that go hand in hand with lending to risk-tolerant investors.

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