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Talking point

Germany: Is housing policy heading towards the precipice?

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It will take many years to reduce the demand overhang in the housing market if there is not a huge jump in building activity. This harbours the risk that the current phase of prices returning to normal could first lead to overshooting and end in a market correction. This scenario comes with high economic costs. These could be avoided by improving depreciation conditions for newbuild housing in Germany's large cities and metropolitan regions.

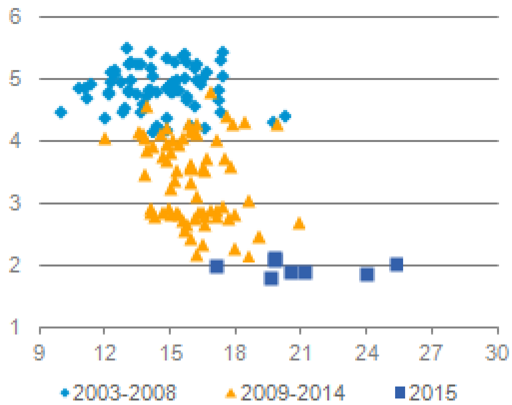
Scarce housing is the chief feature of the current house price cycle. Despite an increasing number of housing completions there has been no decrease in the demand overhang. On the contrary, it is expanding. One reason for this is the government's housing policy. The recent introduction of a rent cap (Mietpreisbremse) has presumably helped to lower rents for a short while. However, the medium-term impact contradicts the original objective of creating "affordable housing". Building activity has been sluggish particularly relative to the high price momentum and good macroeconomic environment, and anecdotal evidence shows that planned construction projects are no longer feasible and have been abandoned due to the introduction of the rent cap.

Without an expansion of supply the high demand in the major cities and conurbations will continue to drive house prices up further. This trend could in fact pick up substantially, as investors are searching frantically for safe yet relatively profitable assets. This applies not only to German institutional investors but also investors worldwide. German residential property is considered appealing thanks to solid, stable returns and sizeable spreads to financial market yields. This is not a new development, but many investors have benefited up to now from price increases in the bond market. Given the ultra-low yields on 10-year Bunds of far below 1% and a negative yield on maturities of up to five years, the risk-return ratio has deteriorated sharply in the year to date since the price upside is limited and there is a risk of having to pay for a low or even negative return with high volatility. This applies in particular against the backdrop of ultra-expansionary monetary policy. With the European Central Bank (ECB) buying up sovereign bonds since March as part of its quantitative easing (QE) programme and with recent talk of extending or expanding the programmes, bond yields are likely to remain low. Therefore, institutionals have started to focus even more heavily on property as an asset class.

However, there is also a further, perhaps even more important aspect that is likely to boost prices. For the first time in the current house price cycle we are starting to observe a phase of dynamic credit expansion. While the overall volume of residential building loans is up only slightly, new mortgage lending is showing unbridled growth. The summer months saw significant double-digit growth, with 50% jumps on the year-earlier months in some cases. Mortgage loan rates of well below 2% have unleashed a veritable boom in credit demand. Since the low-interest rate policy is likely to continue for several years, the dynamics of new mortgage lending are likely to remain high and gradually feed through to total loans. The crucial factor for price growth in the current cycle is who the borrowers are. If they create new housing, the price pressure in the housing market will decline as the credit volume expands. However, if it is only investors sensing the chance of a lifetime to buy existing buildings with full financing, no amortisation and with rental income covering interest, maintenance and other costs, then house prices will continue to increase and with them the macroprudential risks.

Rapid development of new mortgage lending

y-axis: Mortgage rate (%)
x-axis: New mortgage lending in EUR bn per month



Sources: Bundesbank, Deutsche Bank Research

How should the government and regulators handle this situation? One proposal has been to reduce lending, prohibit high loan-to-value (LTV) ratios and/or immediately attempt to lift interest rates. If, however, this results in a decline in lending to investors who create new housing, the currently high price pressure may in fact intensify, increasing the risk of prices overshooting. Therefore, the future direction should instead be to build, build, build – this is the only way to solve the demand overhang in the years ahead. The federal government's recent proposals to subsidise micro-housing and allow more federal land to be rezoned for construction purposes are steps in the right direction. However, the targeted EUR 120 million in nationwide subsidies will scarcely enable more than a few thousand additional micro-housing units to be built. The demand overhang runs to a housing shortfall of several thousand homes in each of many cities. Actually, the only conclusion that can be drawn is to forge ahead with no half measures.

We believe that the right way to remedy the situation in the current market phase is to improve the depreciation rules. If these are only granted for newbuild projects, the demand for loans will automatically climb among those who want to create new housing. At the same time, those investing in existing homes and merely betting on prices rising will receive a signal that there will soon be more housing available and that price pressures will ease in future. As a consequence, their demand for credit should tend to fall. This measure should mean a considerable increase in the number of new houses along with a decrease in macroprudential risks and price pressure. A key aspect for the implementation of our proposal is to put a time limit on the incentives. This can prevent an oversupply of houses at the end of the current price cycle.

Otherwise, if building activity remains sluggish there is a risk that the current return to normal pricing will first lead to overshooting and, in the medium term, end in a market correction. The economic costs of such a misguided development will rapidly exceed the fiscal costs of more attractive depreciation rules many times over. For this reason, the German government should urgently revisit its current strategy of treating housing policy as an instrument of social policy and create an overall package to boost residential construction in the major cities and metropolitan regions. Improved depreciation rules for newbuild housing ought to be at the core of the package.

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