Rays of hope for German house prices

Prices for residential property in Germany have already fallen significantly and the correction is likely to continue in the coming months. However, there are initial glimmers of hope. Although the number of property transactions has only increased slightly so far, according to an ECB survey of banks, demand for property loans has at least picked up somewhat.

Dr. Marco Wagner

Price correction in full swing

Prices for German residential property have fallen significantly since mid-2022 (title chart). This was triggered by the massive rise in interest rates in the wake of central banks ramping up their key rates to fight inflation. According to data from the Federal Statistical Office, prices for existing residential property in particular have fallen. At the end of last year, these were 14% lower on average than at their peak in spring 2022. New builds recorded a much smaller drop of 5%.

Low turnover points to further downside potential

The price correction is unlikely to be over yet. Despite the fall in house prices, the number of transactions is still significantly lower than before the rise in interest rates. There is clearly still a large gap between the price expectations of buyers and sellers, which has arisen due to the fact that many potential buyers are unable to finance a property purchase at current prices under the current financing conditions.

However, many potential sellers of existing properties are apparently not prepared to make any noticeable price concessions, even if they bought their properties a long time ago and at significantly lower prices than they could currently achieve, i.e. they are ‘only’ foregoing some of their profits. Many, on the other hand, continue to orientate themselves on the prices achievable three years ago. This is all the more true as, according to a recent **Bundesbank survey**, 40% of private individuals still expect property prices to rise in the next twelve months. For this reason, prices for existing properties are likely to have fallen in the last two years primarily because some owners have had to sell their properties for various reasons (e.g. relocation, divorce, death). In the long term, however, other owners are also likely to realize that they will not be able to achieve the prices from 2021 for the time being and will have to make price concessions.

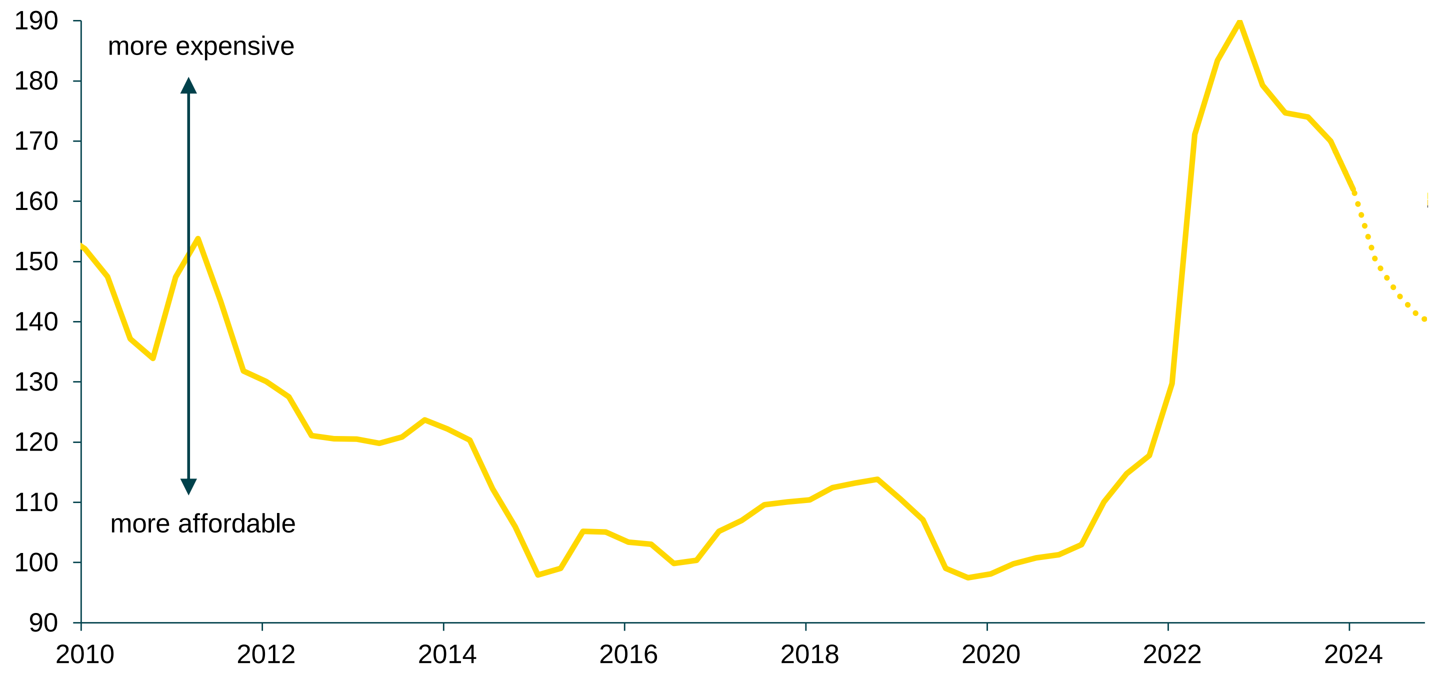
How much further will prices fall?

The **Bundesbank's** estimates in its monthly report for February show that prices would still have to fall in order to be back in line with their long-term determinants such as interest rates and income. Compared to the first quarter of 2024, it estimates that there is still potential for a further correction of 5% to 10%.[1]

Our affordability index, which compares the debt service when purchasing a property (interest and repayments) to income, tends to favor the lower end of this range. This is because rising incomes and the fall in house prices in the meantime have already made them somewhat more affordable again (Chart 1). If incomes continue to rise substantially and interest rates for 10-year mortgage loans remain at the current level of around 3.5%, a further 5% fall in house prices would be enough to push the affordability index to a similar level by the end of the year as in 2010, when the property boom began.

Chart 1 - Real estate a bit more affordable lately

Affordability index: Debt service (interest&amortisation) in relation to disposable income, 2020=100; from 2024Q2 Commerzbank forecast assuming that incomes rise by 4% per year, interest rates stay at 3.5%, house prices fall by 5% until the end of 2024



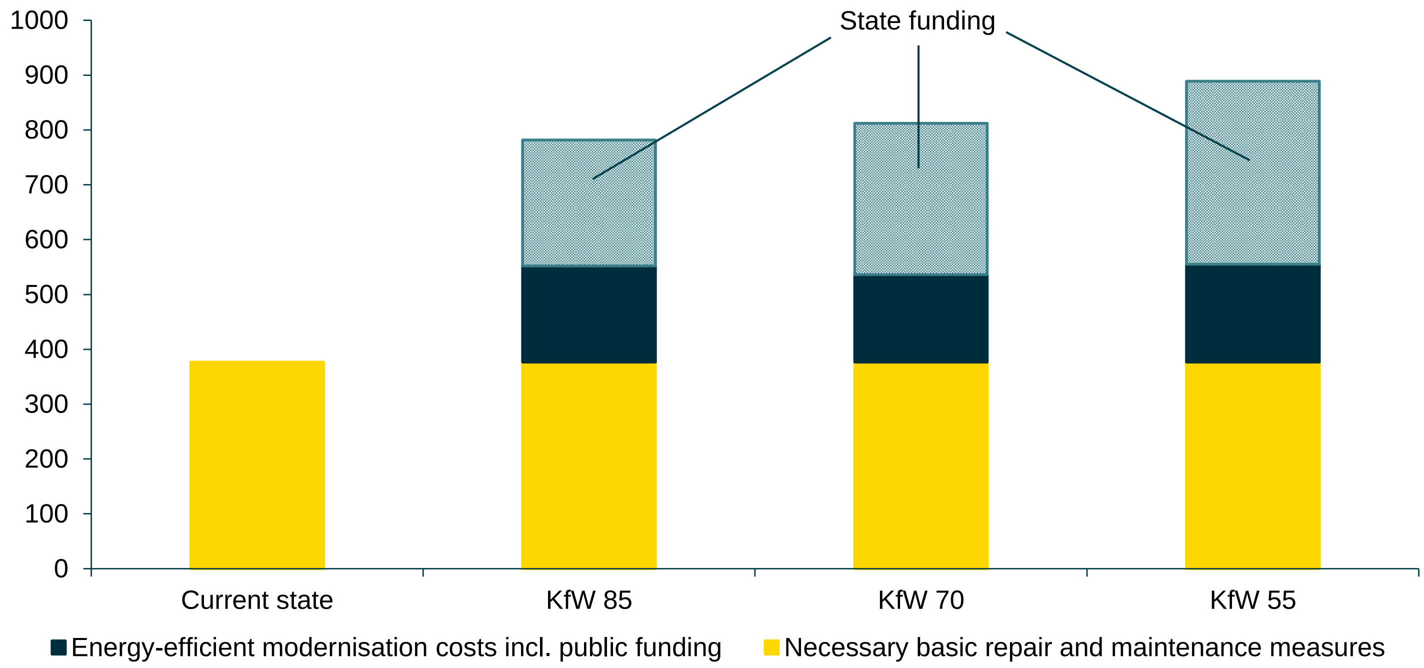
Source: Bundesbank, Federal Statistical Office, Commerzbank Research

Uncertainty factor: refurbishment costs

However, additional downward potential for the prices of existing properties could result from the fact that in the past two years, potential buyers have become more aware of the costs of energy-efficient renovation that will be necessary in the medium term. These are not insignificant, as a **report** (German only) for the consumer advice centre confirms (Bundesverbraucherzentrale) (Chart 2). The study calculates the refurbishment costs required to bring these properties up to current standards for buildings built between 1919 and 1978. Necessary basic repair and maintenance measures are likely to have always played a role in pricing, while energy-efficient refurbishment was often probably of secondary importance. According to the study, the latter amount to between 400 and 510 euros per square meter, depending on the desired level of efficiency. As the study was written in 2021, the costs are likely to be a good 20% higher today, based on the general trend in construction costs. This would result in costs of between 70 thousand and 90 thousand euros for a house with a living space of 150 square meters. Around half of these costs could be financed by subsidies, at least at the time the study was prepared, so that the costs to be borne by the owner would correspond to around 6% of the purchase price for a purchase price of EUR 500 thousand. However, the resulting further downward potential for the average purchase price of an existing property in Germany is likely to be smaller. This is because these costs are likely to have played a role in pricing in the past, albeit a less prominent one. In addition, the study only looks at houses built before 1978. In the case of more recent houses, the cost of energy-efficient refurbishment – if this is necessary at all – is likely to be significantly lower.

Chart 2 - Substantial refurbishment costs

Measures required for repair/maintenance and energy-related additional costs to achieve certain energy standards (sso-called KfW 85/70/55), average costs for buildings built in different years, in euros per square metre of living space



Source: Verbraucherzentrale Bundesverband, Commerzbank Research

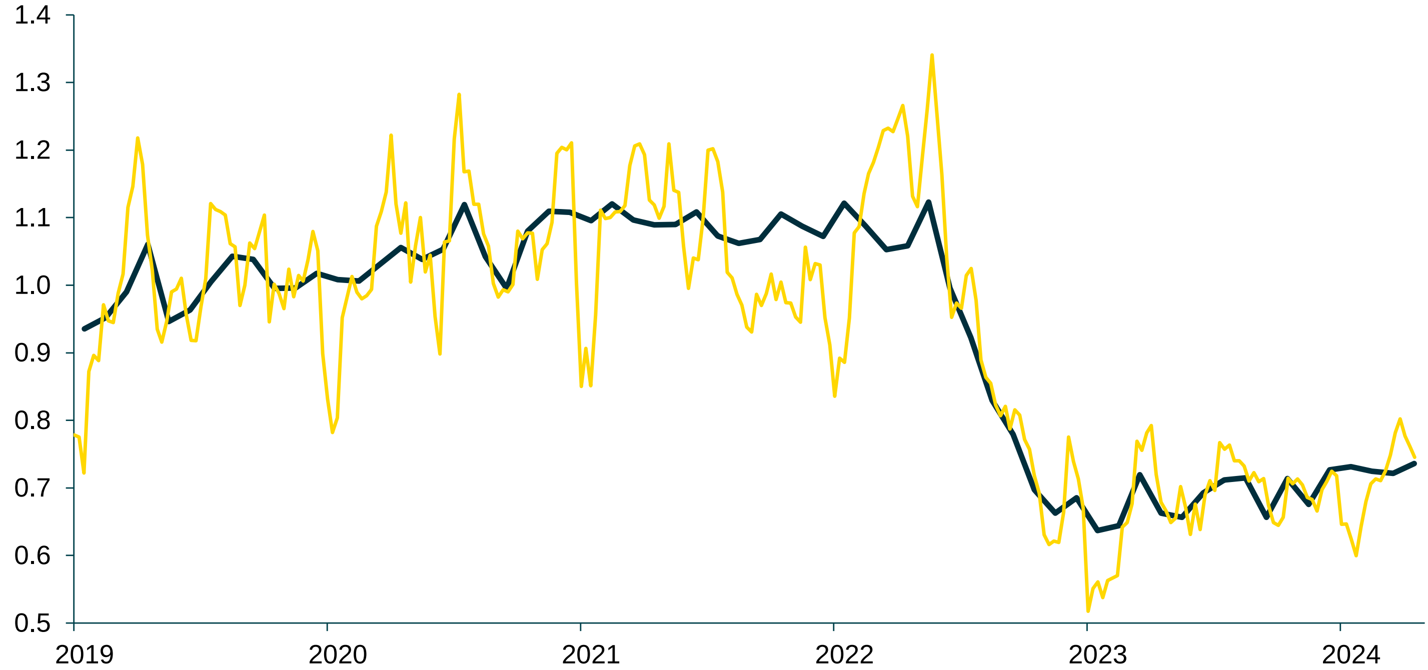
Number of property transactions barely increased, ...

The fact that the number of property transactions has hardly increased again so far after its significant decline in 2022 speaks against a rapid end to the price decline. The number of new mortgage agreements concluded, which is a good approximation and which we have seasonally adjusted on a monthly basis, is still a third below its level before the interest rate turnaround, and there has recently been a slight increase at best (Chart 3). Obviously, the price expectations of potential sellers and buyers are still far apart in many cases.

In view of the fall in prices and the resulting lower supply, the number of transactions is unlikely to return to 2021 levels. However, a noticeable increase can be expected if residential property were to become as affordable again as it was before the interest rate turnaround, taking into account interest rate levels and income trends.

Chart 3 - One third less transactions

Number of newly concluded mortgage contracts, index 2019=1; weekly data and seasonally adjusted monthly data



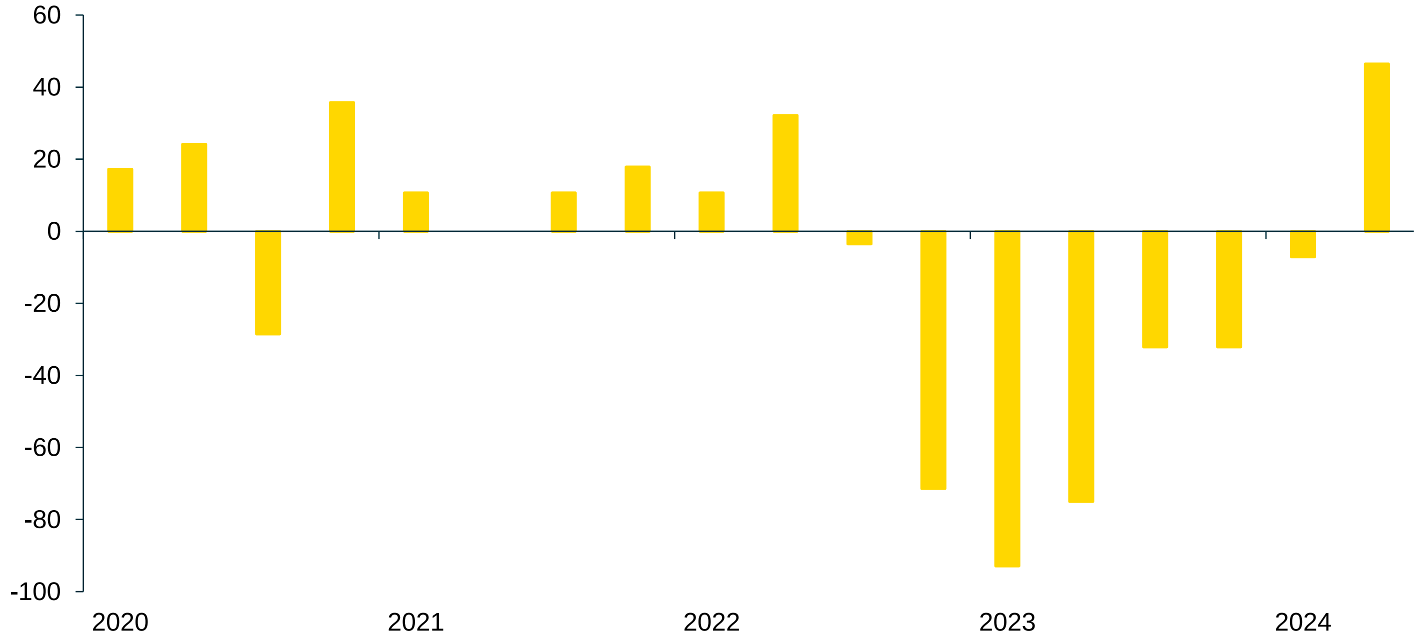
Source: Federal Statistical Office, Schufa, Commerzbank Research

... but somewhat stronger demand for credit

The ECB's recently published **Bank Lending Survey (BLS)**, in which banks report a recent increase in demand for property loans (Chart 4), provides more hope. The survey asks how demand for property loans to private households has changed over the past three months, which on balance around 46% of banks assess as positive, after the majority of banks had reported a decline in demand in the previous seven quarters.

Chart 4 - Demand for property loans on the rise again

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



Source: ECB, Commerzbank Research

Prices likely to fall until the end of the year

Despite these initial signs of hope, the prices of existing properties are likely to continue to fall. The further downward potential is likely to be between 5% and 10%, even taking into account the costs of energy-efficient refurbishments. If there is no further significant rise in interest rates, prices are likely to stabilize around the turn of the year.

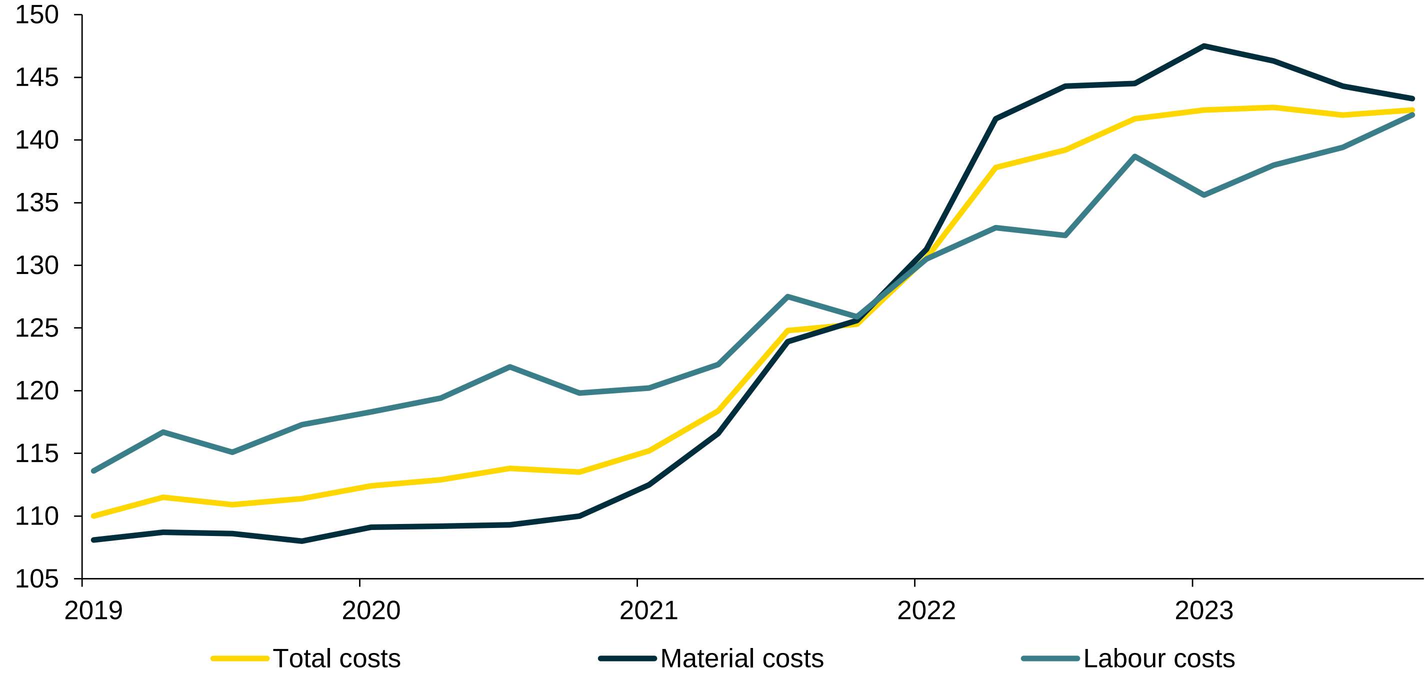
New buildings still struggling with high construction costs

However, sellers are unlikely to be prepared to make major price concessions for new builds, as this would quickly push them into the red. In recent years, not only sales prices have risen dramatically, but also construction costs, particularly in 2021 and 2022. Although this increase has largely come to a halt, construction costs have not fallen, at least not until the end of 2023. This is because slightly lower material costs were offset by a further increase in labor costs (Chart 5).

Labor costs are also likely to continue to rise in the foreseeable future. Following the emerging conclusion of this year's collective bargaining round, wages will be increased by EUR 250 on 1 May, which we estimate corresponds to an average increase of around 6%. On 1 April next year, they will probably rise by a further 4%. This means that at least the labor costs for workers covered by the collective agreement will increase significantly. As a result, sellers of new buildings are unlikely to grant price reductions in the coming quarters to the extent that would be necessary to quickly find a new market equilibrium. For this reason, the adjustment here is likely to continue to be based primarily not on price but on volume, i.e. the number of new homes built.

Chart 5 - Construction costs have not yet fallen

Construction costs for residential buildings, index 2015=100



Source: Federal Statistical Office, Commerzbank Research

[1] Based on the average for 2023, the Bundesbank estimates an overvaluation of 10% to 15%. However, prices have fallen over the course of 2023 and, according to our estimates, they are likely to have fallen further at the start of the year, meaning that property prices in the first quarter are likely to be around 5% below the average for 2023. This leaves a downside potential of 5% to 10%. (back to text)

Fed preview: Not confident enough for rate cuts

Bernd Weidensteiner

The surprisingly sharp rise in prices in recent months has put a Fed rate cut on the back burner for the time being. At the press conference after next week's FOMC meeting, Powell is likely to reiterate his recent statements that the Fed wants to regain more confidence about a slowdown in inflation before considering lower interest rates, and that will probably take some time.

Fed to remain at rate peak for quite some time...

In the first months of 2024, prices in the US rose significantly more than expected. Consumer prices excluding food and energy were an annualized 4.3% higher in Q1 than in Q4. Even though the Fed's preferred deflator of private consumption shows slightly lower rates, the data has thrown a spanner in the works for plans to cut interest rates in the near future. This is because the Fed had always made any rate cut dependent on the data giving the central bank the necessary confidence that inflation would move sustainably towards its 2% target. This is not the case according to recent figures, Fed Chairman Powell said in a recent appearance. It will probably now take longer to be sure enough about this.

The Fed will therefore leave interest rates unchanged at next week's meeting and confirm the target corridor for the fed funds at 5.25% to 5.50%. However, Powell also indicated that the Fed is not currently considering raising interest rates. Instead, interest rates will probably be left at the current level “for as long as necessary”. We now assume that the Fed will not make its first rate hike until December. The Fed would then have kept interest rates at the level reached in July 2023 for 17 months. This would be longer than in previous cycles: In the last 30 years, the Fed has only stayed at the peak for between 5 and 15 months (chart).

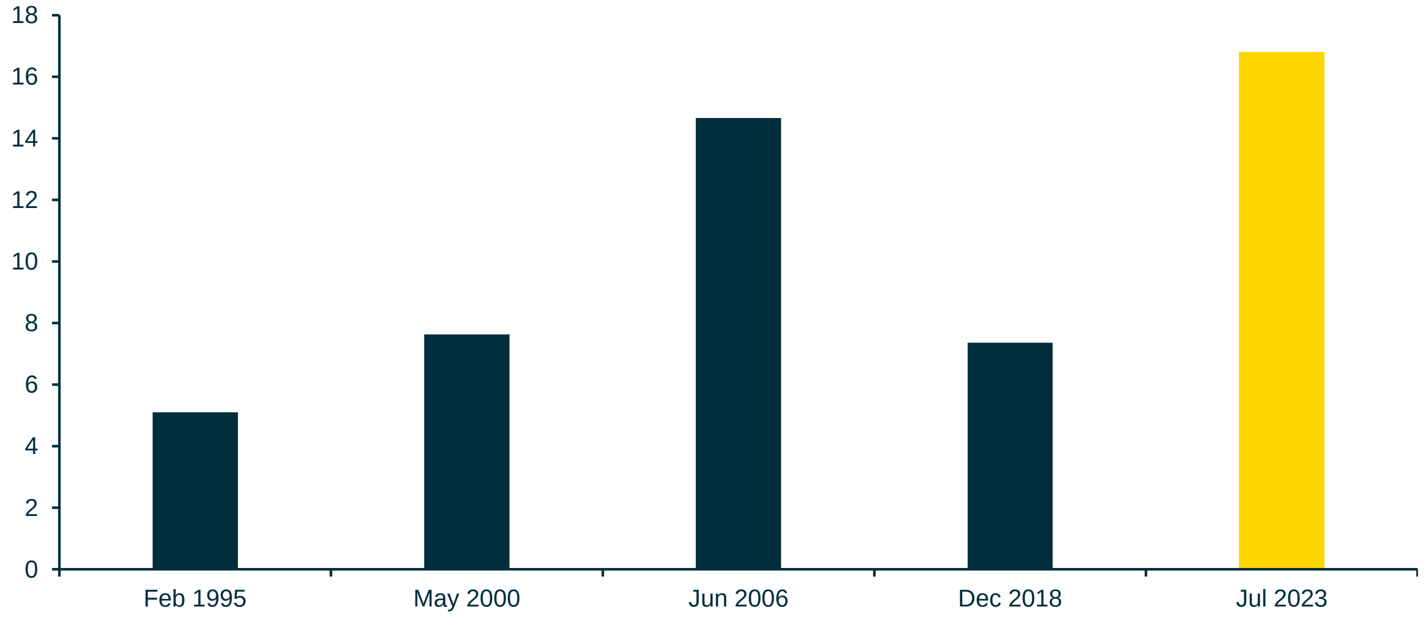
... but will soon scale back QT

However, there could be news with regard to the Fed's securities portfolio. After the central bank massively expanded its securities portfolio in the course of combating various crises, it has now been reducing it again since June 2022 (this process is known as “quantitative tightening”, QT). Since then, the central bank has reduced its bond holdings by a total of almost 1.6 trillion dollars, a drop of a good 18%. The Fed wants to reduce the pace of reduction in order to avoid any tensions on the markets. The experience of September 2019 plays an important role here. At that time, the Fed had already started to reduce its balance sheet, which had reduced banks' deposits at the Fed (bank reserves). Due to a number of special effects, reserves fell significantly once again in September, apparently falling below the level desired by the banks. As a result, money market rates rose sharply. The Fed now apparently wants to avoid a similar development by stopping the balance sheet reduction in good time in order to give the banks a larger reserve cushion.

According to the minutes of the Fed meeting in March, the reduction is to be slowed down “fairly soon”. In the long term, the Fed wants to return to a portfolio consisting solely of US Treasury securities. It currently still holds 2.4 trillion dollars in mortgage-backed bonds (MBS), which are only being phased out of the Fed's portfolio very slowly due to their long maturity. No adjustment is expected here. In contrast, the Fed will reduce the upper limit for the monthly reduction of its Treasury securities holdings (currently 60 billion dollars). The Fed may announce a decision on quantitative tightening as early as next week.

Chart 1 - The Fed is to keep rates on peak level rather long

Time elapsed between last rate hike (designation of columns) and first rate cut in respective cycle, in months. Current cylce: first cut expected in December 2024.



Source: Fed, Commerzbank Research

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