Will rising interest rates stop the recovery in German house prices?

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Residential property prices in Germany have been rising for 20 months, and the number of real estate transactions is recovering noticeably. However, mortgage interest rates have risen again and are likely to continue to do so, which could stifle the recovery of the real estate market. We analyze this risk against the backdrop of rising incomes and the fact that there is still too little construction.

Real estate prices are rising ...

Residential property prices in Germany have been rising for 20 months (title chart). According to data from Europace—which closely matches the official figures from the Federal Statistical Office—this trend applies to both existing properties and new builds. The latter have recently become somewhat cheaper, but this is probably due to a seasonal effect. In the last two years, prices have also fallen in the summer and then risen again in the fall. This is also to be expected for the coming months.

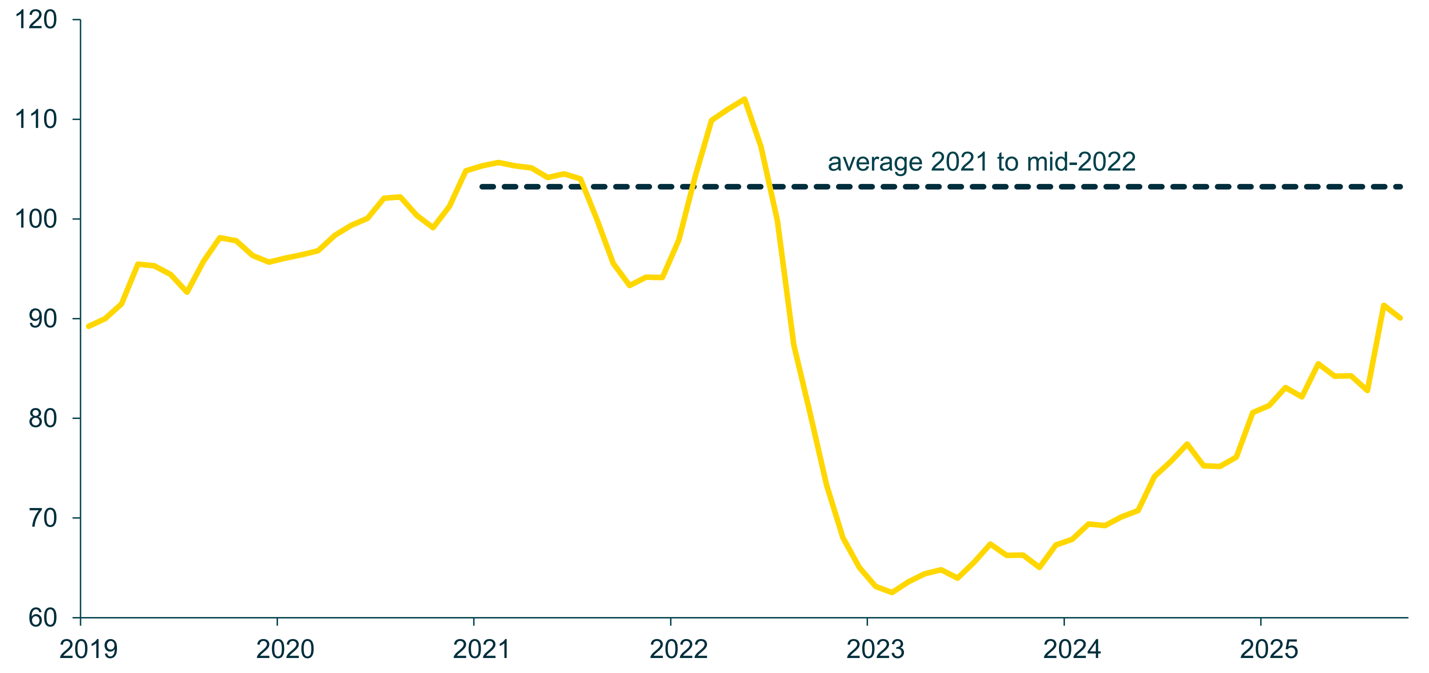
... the real estate market is also recovering

Another factor pointing to further price increases is that sales in the residential real estate market have now largely recovered from their slump in 2022. At the very least, the number of new mortgage contracts – which we use to approximate real estate transactions – has been on an upward trend until recently (Chart 1). Admittedly, this trend has been significantly more volatile than usual in the last two months. However, taken together, these two months show that the recovery of the residential real estate market has continued.

In our analyses, we have always emphasized that the occasionally very low sales figures are an indication that the price expectations of sellers and buyers are often far apart, and that a further downward correction is therefore possible. The fact that the number of new mortgage contracts is now close to its pre-crisis level again indicates that price expectations have largely converged, greatly reducing the risk of another significant correction.

Chart 1 - The residential real estate market is recovering noticeably

Residential real estate transactions approximated by the number of newly concluded mortgage contracts, index 2021=100, three-month average



Source: Federal Statistical Office, Schufa, Commerzbank Research

Will rising interest rates put an end to the recovery?

The slump in sales and thus also in prices in 2022 was triggered by the looming ECB interest rate hikes and the resulting sharp rise in mortgage rates. Accordingly, the subsequent recovery in prices and sales was supported by the ECB's interest rate cuts and the resulting somewhat more favorable financing conditions.

However, this factor is likely to cause headwinds in the coming quarters. Many investors are concerned about rising government debt, the dwindling independence of the US Federal Reserve, and inflation risks. We expect capital market interest rates to continue to rise. In this environment, interest rates of 4% for 10-year mortgage loans are entirely possible by the end of next year. Mortgage interest rates have already risen this year. According to Bundesbank statistics, the average effective mortgage interest rate for 10-year loans was at its lowest point of 3.3% at the end of 2024, but has since risen again to 3.7%.

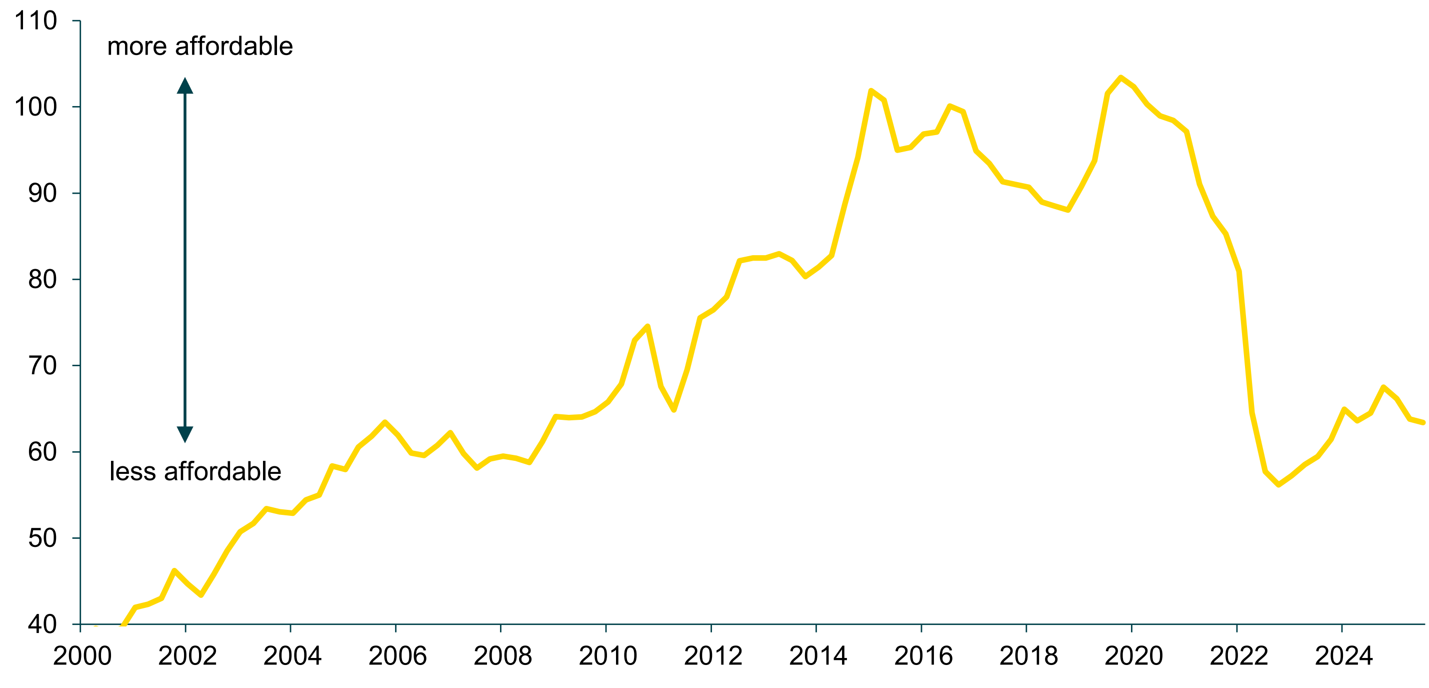
Rising incomes could offset the increase in interest rates

On the other hand, however, steadily rising incomes are making it easier to finance a home. Since the beginning of 2024 – when the real estate sector began to recover – disposable income per capita has risen by an average of 3⅓%, while net wages per employee have risen by 4½%. We expect incomes and wages to continue to grow at a solid pace in the coming months, albeit at a slightly slower rate of around 3%.

On balance, rising interest rates and rising incomes are likely to largely cancel each other out, meaning that our affordability index – which relates disposable income to debt service (interest payments and principal repayments) [1] – will hardly change in the coming year, meaning that residential real estate would be similarly affordable as in 2010, when real estate prices rose by an average of one and a half percent (Chart 2).

Chart 2 - Affordability: Homes remain relatively expensive

Affordability Index: disposable income per capita in relation to the debt service (interest payments and repayment)



Source: Bundesbank, Federal Statistical Office, Commerzbank Research

Real estate prices are likely to continue rising, ...

We expect the gradual recovery of the real estate market to continue and residential property prices to rise moderately in the coming months. According to a **Bundesbank survey**, more than 60% of households expect real estate prices to continue rising, and under the current circumstances, 30% of respondents to a recently published **Commerzbank mortgage financing study** can currently envisage purchasing residential property in the near future.

... also because housing remains scarce

Another factor supporting higher prices is that housing remains scarce, with no relief in sight. After a temporary increase in 2024, price-adjusted orders from residential construction companies have fallen again in recent months and were most recently 30% lower than at the turn of 2021/22 (Chart 3).

The number of hours worked in residential construction has also declined steadily since the beginning of 2022, and there are no signs of a sustained turnaround for the better. Against this backdrop, the European **research network Euroconstruct**, of which the Munich-based Ifo Institute is a member, expects that only 185,000 apartments will be completed in Germany in 2026, down from an estimated 205,000 in the current year. The research network anticipates a slight increase to 195,000 units only in 2027.

Chart 3 - Construction lull

Main construction sector, residential construction: order intake, seasonally and working day adjusted, volume index 2021=100; hours worked, seasonally adjusted, in thousands

Source: Federal Statistical Office, Commerzbank Research

[1] For the affordability index, we relate per capita disposable income with debt service (interest and principal), assuming an annual repayment rate of 2% of house prices. We use the effective average interest rate for a ten-year mortgage loan according to Bundesbank statistics as the basis for the interest rate. (Back to the text.)

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