

Do we have a Housing Bubble in Berlin (Germany)?

Arguments and Indicators for and against this Statement

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Key words: housing bubble, purchase prices, interest level, rent, Berlin

SUMMARY

Different research institutes and analysts announce the increase of the risk of a collapse of the housing bubble in Germany. Especially in the “big seven” cities (e.g. Munich, Hamburg or Frankfurt) real estate prices literally exploded.

The objectives of the article are to analyze which indicators can be used to evaluate the existence of a housing bubble in Berlin. For example, the demand on the housing market is increasing in Berlin as a result of the sharp rise in population figures in the past and a disproportionate increase in single-person households. This is contrasted by a low level of residential construction activity that leads to a decline in vacancy rates, rent increases and an increase in purchase prices in the sale of property. Effects of current political interventions in the residential property market (rent brake and rent cap) are also considered.

Results show that in Berlin, the biggest city of Germany, the situation is quite different than in other cities. The real estate market has been undervalued on an international scale in recent years. At least for Berlin there is probably nothing to worry about at the moment. For investors, with or without political intervention in the market, the capital continues to be extremely attractive. The reasons for this are the city's economic dynamism and cultural appeal. In international comparison Berlin is still affordable or even cheap. The work demonstrates the benefits of using several indicators to estimate if there is a housing bubble on the local market with the risk to collapse

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1. INTRODUCTION

A decade after the great financial crisis, residential property prices have recovered. In 2018 more than EUR 56 billion flowed into the European residential investment market (JLL 2019). During the recent boom, house prices in the German metropolitan areas have risen significantly higher than those in the provinces. The city of Munich, for example, is the world's most overheated metropolis. Prices have exploded in the last 10 years. The purchase prices for single-family homes have risen by 240 percent during this time (PMR München 2019). In the view of economists, such price increases are no longer healthy. The European Systemic Risk Board (ESRB 2019) warns of an overheating of the European real estate market, it could become a risk for the financial system.

But what about Berlin, the capital of Germany? In 2018 no other metropolis received as much money as Berlin with over EUR 3 billion. Prices for residential real estate have doubled. But are these rates of increase based on solid foundations or on speculation? To be able to assess this, the development of house prices was compared with various factors:

- development of purchase prices for residential real estate,
- population development,
- new residential construction,
- household income,
- interest rate level,
- rents for residential space,
- current political developments.

Before we take a closer look at the various factors, let us first briefly define the term "housing bubble". In addition, a few special features of the city of Berlin will be introduced.

2. DEFINITION „HOUSING BUBBLE“

On the real estate market, one speaks of a speculative bubble when the purchase prices are clearly excessive and far above a price that can be objectively justified. If people who cannot afford it buy overpriced real estate and put the financing on an unreasonable structure, a housing bubble develops.

If such features are present, the market threatens to overheat, so that only a small trigger can cause the bubble to burst. A bubble only becomes dangerous when it bursts. If this happens assets are destroyed. Demand collapses and this can lead to massive burdens on the financial system, which in such a case often results in massive credit defaults.

Prospective buyers should also be cautious in an overheated real estate market. Because they risk investing overpriced and not achieving any increase in value in a later sale. Furthermore, it may be difficult to obtain follow-up financing for a small repayment. Economists can forecast the probability of price bubbles using statistical models and indicators. But speculative exaggerations could not be predicted with certainty.

3. BERLIN SPECIFICS

Berlin occupies a special position among the major German cities due to the division of the city from 1961 to 1990. In the period after the unification of Germany in 1990, the situation in Berlin changed rapidly. The dividing line between the political blocs of the eastern and western world is no longer visible in many places. Until unification, the western part of Berlin was cut off from the surrounding area for decades. It was only in the following years that the natural connections were able to develop again and traffic routes were merged.

In general, the more central within the city, the more expensive it is (polycentricity). In Berlin, the districts and correspondingly the prices have developed differently. The population structure is therefore also very heterogeneous. Today Berlin is the fastest growing city in Germany. The city benefits from stronger GDP and employment growth as well as an improved level of prosperity. Population and employment have grown hand in hand here, but housing construction has not been able to keep up.

4. CONSIDERATION OF THE VARIOUS FACTORS

4.1 Development of purchase prices for residential real estate

Residential property prices in Germany have risen sharply over the past decade. Real estate prices have risen particularly sharply in the major cities, including Berlin. For example, the purchase prices for single-family homes have risen in the last 10 years to over 300 percent in some cases (Destatis 2019).

In 2018 one could speak of a Berlin-wide trend of plus 20 percent for residential real estate. The trend of rising property prices continued in 2019, certainly to a lesser expression (plus 5-10 percent). However, in international comparison Berlin is still very inexpensive. Figure 1 shows the price development since 1990 using the example of the sub-market for condominiums.



Figure 1: Average price development for condominiums for mid-level residential areas (Source: PMR Berlin 2019)

A general housing bubble is characterized by the fact that housing in all parts of the city and in all segments is overvalued. Berlin is far from this. Instead, the city is characterized by extreme heterogeneity in terms of purchase prices. Thus, even in good residential areas you can still find inexpensive apartments, while the new building next door is already twice as expensive. This is a price difference that cannot be found anywhere else in Germany. The reason for this is that, particularly in the case of many older tenants, rent increases have not been implemented continuously over the past decades. Under German tenancy law, rent increases may only be made step by step and it takes a relative long time (10-15 years) before rents would reach a level of corresponding new rental level.

4.2 Population development (demand side)

The successful economic development of the German capital was reflected in the strong population growth since 2005. This trend now appears to have been broken since the period 2016-2017 (as seen in Figure 2). During this period, only about 25,000 new inhabitants came to Berlin. This was the smallest increase in population since 2011 (Office for Statistics Berlin-Brandenburg 2019). The greatest increase in migration is from other EU countries. The decline in the German population is rather due to the persistently high level of migration to the surrounding area of Berlin. The decline in the German population continues to be more than offset by the growth in the foreign population

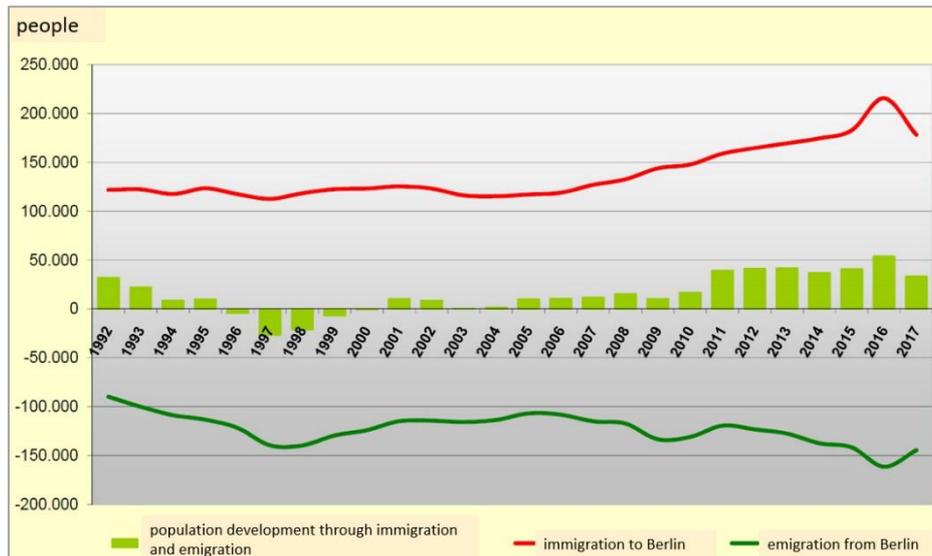


Figure 2: Population development due to relocation to and from Berlin (Source: Office for Statistics Berlin-Brandenburg 2019)

4.3 New residential construction (supply side)

German cities are characterized by a serious housing shortage (German economic institute, 2019). In 2018 around 290.000 apartments were completed in Germany but the demand was 360.000. In Berlin the demand is also higher than supply. After intensive efforts the number of residential constructions has only increased very slowly. Thus, only around 17.000 residential units were completed in 2018. New construction activity thus continues to lie behind the annual demand.

However, at the same time the number of building permits continues to decline (Office for Statistics Berlin-Brandenburg, 2019). Reasons for the sluggish new construction and the decline are also the sharp rise in prices for building land in recent years as well as the fundamental lack of open spaces. Furthermore, current political developments in the city (see point 4.6) are leading to uncertainty on the part of investors.

4.4 Household income

The private household income is the sum of all household members from different sources of income. In a study presented by the OECD in 2011, it was found that disposable household incomes in Germany rose by an average of 0.9 percent annually between 1990 and 2010. The income level in Berlin lies behind that of other major German cities. According to the latest figures Berlin ranks eleventh among the 15 largest cities (WSI 2019). Even in a comparison of cities and counties in Germany employees in Berlin are far behind the country's top earners. Here, the capital city just manages to reach rank 248 out of 402 (Destatis 2019).

4.5 Interest rate level

Generally, in Germany a loan is used for real estate financing. Here a fixed interest rate and a fixed monthly instalment are agreed for a contractually defined period. The mortgage interest rate level is decisive for what is actually payable for the home. Currently, mortgage interest rates are at an all-time low (as seen in Figure 3). Mortgage loans with an interest rate of 1.5 percent and a 30-year fixed interest rate are currently the norm. However, if interest rate level would start to increase again the risk of non-payment of principal would also increase. Properties would have to be sold again. The number of real estate offers would rise, prices would fall and the housing bubble could burst.

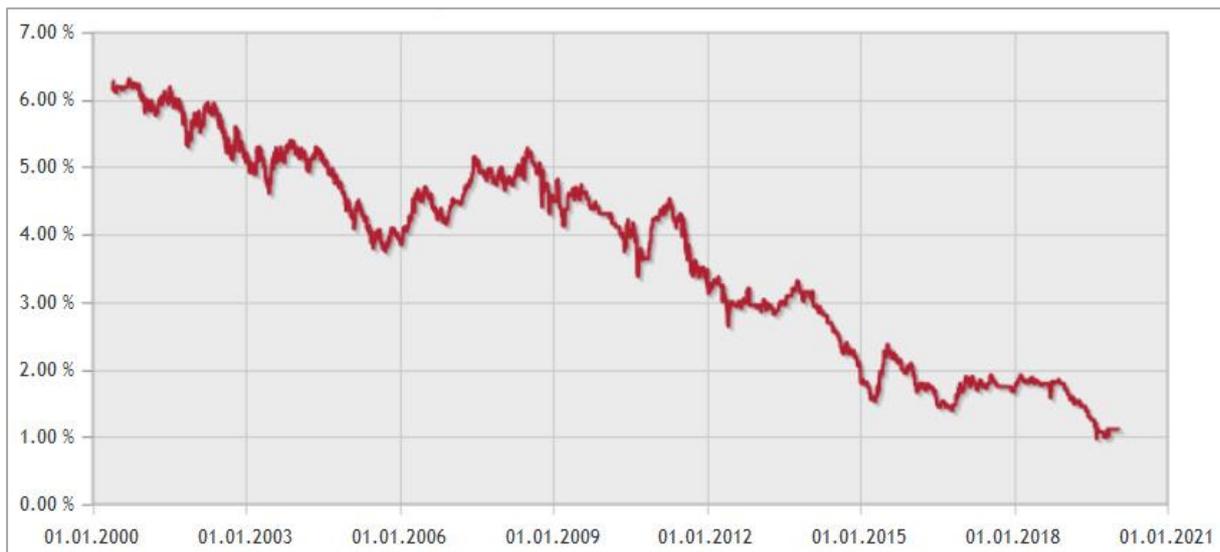


Figure 3: Mortgage interest rates in Germany since 2000 (Source: Office for Statistics Berlin-Brandenburg 2019)

4.6 Rents for residential space

Rents in Berlin have risen steadily since 2005. But since the end of 2018 this trend seems to have come to a halt (as seen in Figure 4). Since then new contract rents in Berlin have fallen by 1.5 percent within one year (Empirica 2019). Newly contracted rents signal the direction on the real estate market but only represent a small part. However, in existing contracts rents continue to rise.

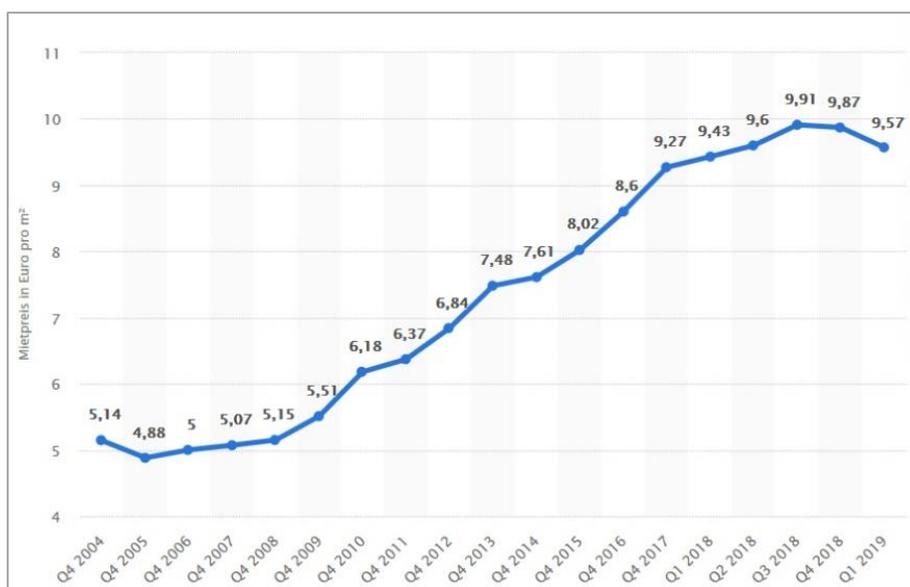


Figure 4: Development of new contract rents in Berlin (Source: Statista 2019)

4.7 Current political developments in Berlin

The recent increase in rents and prices in many major German cities has resulted in various politically initiated interventions on the residential property market. An important step towards stabilizing rents is the so-called "rent brake". Such an intervention is unprecedented in the history of German housing policy and many economists fear devastating consequences for the German housing market. Nevertheless, the rent brake was introduced in 2015 and new rentals in designated regions have since been limited to 10 percent above the local reference rent. In addition, the Berlin Senate passed the so-called "rent cap" in November 2019. This applies to around 1.5 million rental apartments in Berlin. The main points are:

- rent cap for 5 years,
- determination of rent limits,
- if re-renting an apartment the rent cannot be raised at all,
- if the rent is more than 20 percent above the permitted rent limit, the tenant can apply for a reduction of the rent,
- costs for modernization measures can only be passed on to the rent to a limited extent,
- violations of the law can be punished with a fine of up to EUR 500.000.

The political opposition has stated that the measures introduced are not in conformity with the constitution. Courts will have to clarify whether or not the instruments presented are in conformity with the law. However, both political measures are already causing increasing uncertainty among investors due to the regulatory measures that have already been adopted and are still pending (there is even an open discussion about the expropriation of private housing companies). Large international investors are already withdrawing from Germany in some cases according to major brokers.

5. DISCUSSION

A strong demand on the residential property market and a dwindling availability of building land have led to rising property prices in recent years. Low interest rates have also further supported the rise in prices. If purchase prices of residential real estate rise significantly higher in relation to rents and income, this indicates an overvaluation/overheating. Especially in Berlin this process has been observed in recent years. There has been a decoupling of purchase prices from the property income (rental income) with the result that yields are approaching zero (DIW 2019).

The low interest rate may justify this at present but a short-term increase, even if not currently foreseeable, could destroy this fragile balance. On the other hand, negative interest rates and their consequences are currently being discussed. Even an impending economic downturn could shake the current stable construct. The supply of housing is slowly increasing due to the rise in new construction activity. A slight decline in demand in Berlin can be expected due to the lower population growth. In the medium term a noticeable oversupply even seems possible.

The political market interventions (rent brake and rent cap), the slightly increasing number of completions of apartments as well as the decline in demand or shifting of demand to the surrounding area of the city do not lead to expectations of a further increase in rents as things stand at present. This would further increase the discrepancy between purchase prices and the incomes that can be generated from the property. On the other hand, the momentum in the price increase of residential real estate has weakened Berlin wide in 2019. Prices might have reached their zenith.

Despite the uncertainty created by the current political market interventions the political stable framework conditions in Germany and Berlin continue to provide a certain degree of security for investors. Other aspects for assessing the market situation which were not examined more closely in the context of the evaluations carried out could be: the development of the gross domestic product and unemployment figures, the availability of credit, the development of house prices in relation to inflation as well as the proportion of loan agreements for properties intended for rental in relation to the total number of loan applications.

6. POTENTIAL FOR CORRECTION

Currently there are no signs of "excessive" lending policy and construction activity in Berlin as in the run-up to the 2007 financial crisis in the USA. This would limit the economic damage of a "price correction". The absolute level of house prices and the gap between purchase prices and rents lead us to expect losses in property values, especially if interest rates rise (interest rate risk). The required high equity ratio and the in generally high and

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recently even stricter criteria applied by banks when assessing the creditworthiness of real estate financing would also ensure that the consequences of a bursting housing bubble for the real estate and financial markets would not be as dramatic as in the USA in 2007. Even if the existence or bursting of a housing bubble is currently not foreseeable, there is still a certain potential for setbacks and corrections. The relative price gap between purchase prices and rents in Berlin is currently 37 percent (Empirica 2019). At the moment this percentage value should therefore be regarded as the maximum upper limit of a correction but it can also be much lower.

7. CONCLUSION

At least in Berlin there seems to be currently no threat by a housing bubble. For investors, with or without political intervention in the market, the capital continues to be extremely attractive. The reasons for this are the city's economic dynamism and cultural appeal. In international comparison Berlin is still affordable or even cheap.

Even though some of the indicators under consideration point out an existence of a housing bubble the signs of a housing bubble with the possibility of bursting are currently not in sight. The existing risk should continue to decline as the price trend for residential property has slowed considerably especially within 2019. In addition, the financing of real estate investments in Berlin and in Germany as a whole appears to be relatively solid and the fixed interest period is also relatively long.

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BIOGRAPHICAL NOTES

Dr.-Ing. Sebastian Kropp graduated in Geodesy at the Dresden University of Technology (Germany) with a focus in land and real estate management. He worked as a research assistant at the Department for Urban Planning and Real Estate Management at University of Bonn. His main research interest focused on real estate management and valuation. Since 2016 he is head of Surveying in the Urban development office in the district of Friedrichshain-Kreuzberg in Berlin.

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