Size and Impact of Real Estate Sector and Its Role for Business Cycles and Growth

Chapter · January 2012

DOI: 10.1007/978-3-642-23611-2_2

1 author:

Wolfgang Maennig
University of Hamburg

Size and Impact of Real Estate Sector and Its Role for Business Cycles and Growth

Wolfgang Maennig

Abstract The real estate industry is one of the most important industrial sectors of Germany. Its development and the development of real estate values are most important to Germany's economic business cycle and the country's long-term growth path. Germany's real estate price trend stagnated for at least a decade and a half and thus deviated from the international pattern. The underlying structural differences include, amongst others, the demographic development, the characteristics of the German real estate finance system, the fiscal policy and a decade-long low and stable general inflation. In return, the real estate sector in Germany – particularly when compared to other countries – serves rather a stabilising function in periods of weaker economic conditions.

Keywords Construction • inflation • market size

1 Housing Markets and the Economy

More than 700,000 German companies are active in the real estate industry and employ around 3.8 million people, which is the equivalent of a 22% share of all businesses and 10% of Germany's workforce. The gross value added of the real estate economy totalled 406 billion € in 2007, which equals a share of 18.7% of Germany's gross value added (Gutachter-Gemeinschaft 2009). This makes it safe to say that the real estate industry is one of the most important industrial sectors, second only to the manufacturing business. The value of real estate assets in the Federal Republic of Germany is estimated to total approx. nine trillion euro, which is triple the German gross domestic product. Around half of all assets held by private households represent real estate. For banks, too, real estate plays a key role, as real estate financings account for 55% of all loans (Gutachtergemeinschaft 2009). Nearly eight in ten Germans consider owner-occupied homes the optimal type of investment, while 54% believe that real estate has an excellent inflation-hedging

T. Just and W. Maennig (eds.), *Understanding German Real Estate Markets*, Management for Professionals, DOI 10.1007/978-3-642-23611-2_2,

capacity. In fact, 87% assume that homeownership will continue to play an important or indeed a more prominent role as retirement scheme.

With these figures in mind, the development of real estate values and of the real estate sector as a whole is as important to Germany as it is to other countries,[1] including for Germany's economic business cycle and the country's long-term growth path: Given its central significance in the capital formation (and retirement schemes) of private households, not just current, but also anticipatory changes in real estate values clearly impact consumers' willingness to spend.

During the global economic crisis of 2007/2008, the real estate sector in Germany – particularly when compared to other countries – served rather a stabilising function. Accordingly, residential rents rose by about 1%, as in previous years, and because of the decline in commodity prices they even slightly outpaced the inflation rate.[2] Real estate prices stagnated or decreased (only) slightly, the situation being comparable to the time before the economic crisis.[3] Nearly all important countries, such as e.g. the United States, Spain, Ireland, the United Kingdom, the Scandinavian as well as many Eastern European and Asian countries[4] initially reported brisk capital growth during the 1990s and price dips by 2008 at the latest, which triggered or exacerbated the economic dip (cf. Cieleback, in this book).

The deviation of Germany's real estate price trend from the international pattern is explained by the average available real per-capita income – which has stagnated for at least a decade and a half, the relatively high nominal interest rate, and the demographic development.[5] It is also explained by the characteristics of the German real estate finance system (including relatively long interest fixings of 5–10 years instead of a variable interest rate, relatively low LTVs for first-time buyers, virtually no secondary mortgages during a boom market, among other things) and the fiscal policy (non-deductibility of interest expenditures for owner-occupied homes, high transaction costs, for instance in the form of real estate transfer taxes).[6] Another price-retardant effect can be traced back to the subsidised construction boom following the country's reunification in 1990, especially in East Germany. The downscaling of many subsidy programs (homeownership subsidy,

[1] On the considerable influence of the real estate economy on the economic situation in general, see Leamer (2008).

[2] See Wiegand (2010). In 2009, the situation actually resembled a general deflation. The rent increase of previous years always undercut the general inflation rate.

[3] Cf. Wiegand (2010), p. 42 and Gutachtergemeinschaft (2009), p. 123. The prices of commercial real estate, however, suffered steeper losses than prices for residential real estate.

[4] Canada manifested a stagnating price trend that more or less matches the German curve. Japan has been subject to a recessive price trend for some time now.

[5] See Kholodilin et al. (2008). For the German situation in regard to economy and inflation, the interest rates targeted by the ECB, which had to take fast growing countries like Spain, Ireland, etc. into account, were too high. A higher degree of urbanisation has principally a positive effect on prices. Since it has been on a high level in Germany for an extended period of time, though, it has practically ceased to be the source of positive developments.

[6] For individual points, see Gutachtergemeinschaft, 2009, p. 152 and Wiegand 2010, p. 42.

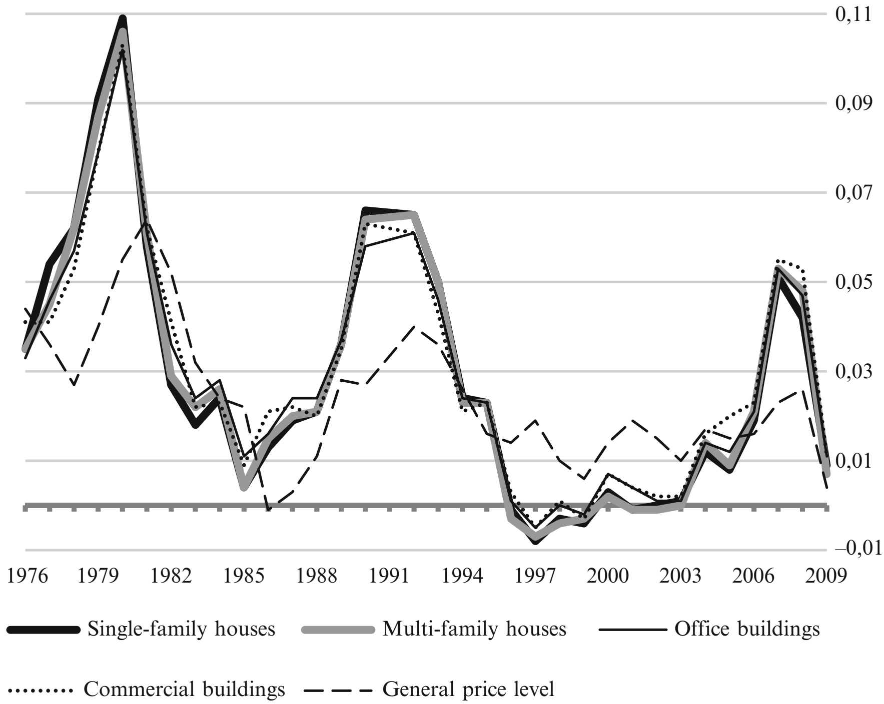

Fig. 1 General inflation rate, price increases for construction services for various building types, 1976–2009 (Source: Destatis)

degressive deduction for depreciation, special deduction for depreciation) since the mid-1990s has put an additional damper on the price trend.

Another reason for the stable price trend of German real estate is the fact that Germany's inflation rate has, on the whole, been modest over the past decades (Figs. 1 and 2), which was not exactly conducive to getting people to "seek refuge in tangibles." In the years 1991 through 2009, the general annual inflation rate in Germany averaged around 1.8%. Largely on the same level were the inflation rates for building work in the construction of single- and multi-family homes, operational office and business buildings, where it ranged between 1.6% and 1.9% in the annual mean, thus ensuring a slow growth in replacement costs. The average price increases for the maintenance of multi-family homes equalled 2.2%. Only the mean annual rate of price increases for zoned land was markedly higher at 6.5%, suggesting a bottleneck tendency for building land.[7]

[7] The stats for the time between 1976 through 2009 (with the year 1990 omitted because of the interruption of the data series during that year) reflect a similar situation: the mean general inflation rate for Germany approximated 2.4%, while the inflation rates for building services in construction for single- and multi-family homes, operational office and business buildings averaged a rate between 2.8% and 2.9%. The average price increase for the maintenance of apartment blocks equalled 3.1%, and the increase for zoned land was 6.9%.

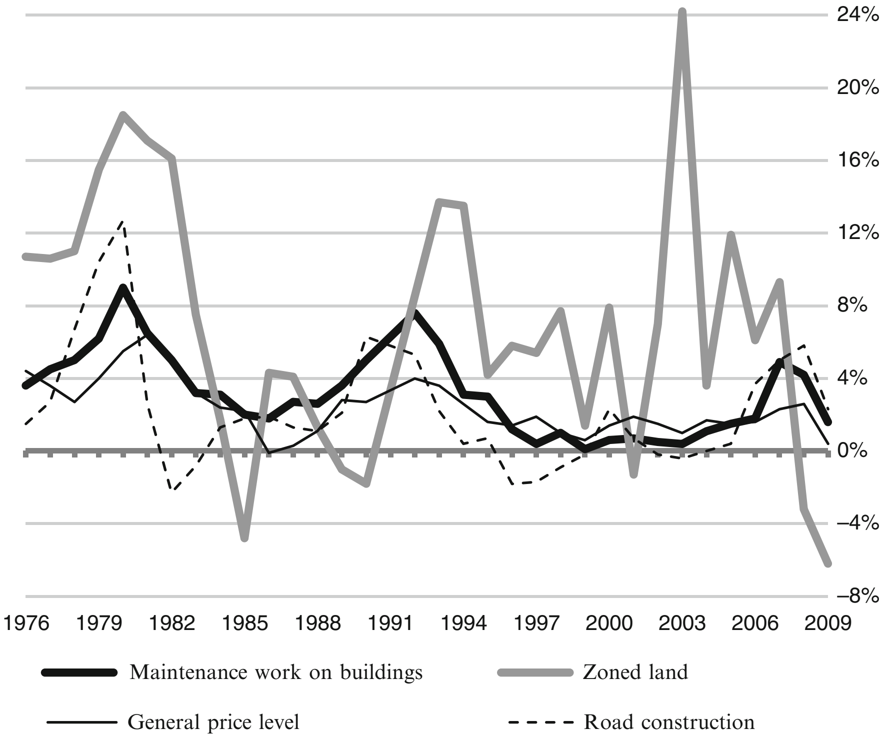

Fig. 2 General inflation rate, price increases for zoned land, maintenance work on apartment buildings and road construction, 1976–2009 (Source: Destatis)

2 Construction Activity in Germany

Before the background of the low price volatility of the real estate, it comes as no surprise that the German investment activity in the real estate area has been relatively stable in turn. Figure 3 illustrates that building investments – not including the historically unique time of the German reunification, which was defined by particularly voluminous investments – have developed at a relatively stable rate. During the period between 1991 and 2001, the housing investment average exceeded the 1970–1988 period by an average of 47%. Since 2002, the investment activity in housing construction flattened out again on, but it did so on a level around 31% above the period of 1970–1988. The average index value for non-residential building investment approximated a score of 90 for the years 1970 through 1988, with 1991 serving as reference year. In the period between 1991 and 2001, the average non-residential building investments rose by around 12% before dropping back to around 8% below the level of 1970–1988 (!) in the years since 2002.

The change in investments activity in housing construction between the 1980s and the time since 2002 compares well to the population increase caused by the

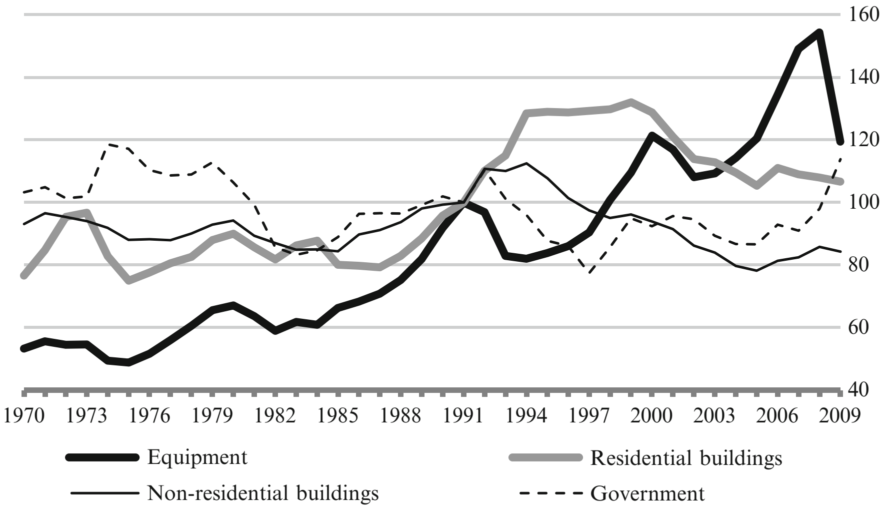

Fig. 3 Investment activity in Germany 1972–2009 (price basis: 1991) (Source: Sachverständigenrat, long-term series, Table 35: gross investments)

country's reunification (territory of the former Federal Republic until 1990, and expanded to include the East German states since 1991) by around 25%; yet investments in non-residential construction have lagged behind. There are no signs suggesting an exaggerated building boom that would trigger supply-driven pressure in Germany (excepting the tax-induced misallocations in the East German States in the 1990s).

The construction-business turnover of the construction industry, having peaked at approx. 111 billion € in 1996, dropped back to approx. 82 billion € by 2009 (Fig. 3). The German labour market does not fully reflect these relative stable developments. Rather, the number of jobs sank from the high-water mark of around 1.3 million construction industry jobs in 1996 down to just over 700,000 jobs today. This should be blamed less on business cycle impacts, though, but rather on structural ones: One factor that needs mentioning here is the substitution of domestic construction workers by foreign ones. Moreover, labour-intense housing construction lost in significance while capital-intense civil engineering regained in importance. Statistically speaking, this has caused the construction industry to seem more productive (Fig. 4).

3 Future Prospects

According to the expectations of some market participants players, positive future effects for German real estate might result because the performance of a given asset type, such as real estate, is at the same time subject to the (anticipated) performance

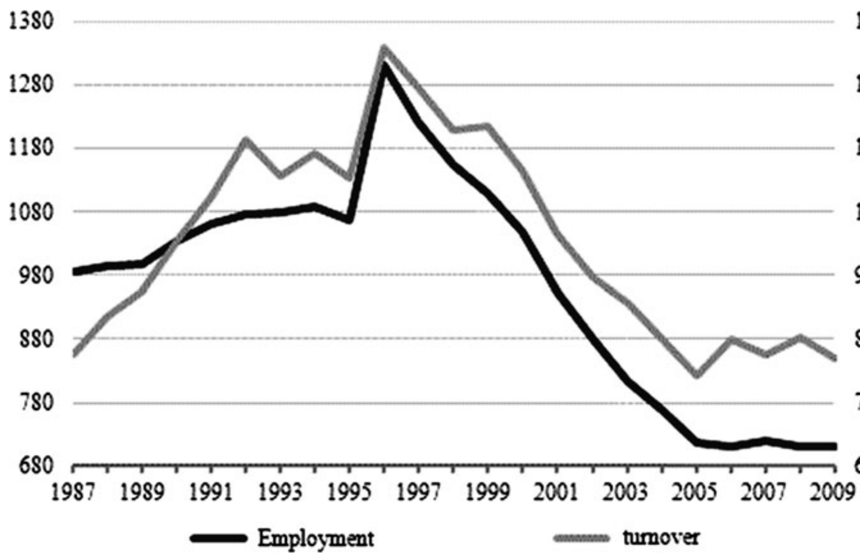

Fig. 4 Jobs (in 1,000, left scale) and turnover (in billion €, price basis: 2005, right scale) in the construction business, 1987–2009 (Sources: Deutsche Bundesbank and Destatis)

of alternative investment options. Government bonds from countries with a good credit rating only offer modest rates of return anymore. And historic precedent has led some market participants to associate the prospectively surging sovereign debt of countries (Standard and Poor's 2010) with the incentives that political decision makers might have for fanning inflationary tendencies.[8] On the basis of the assumption – to some extent confirmed for the United States[9] – that real estate has an inflation-hedging effect, this will set off another run on tangible assets. The corresponding price hikes will, at least to some extent and for the early investors, make this assumption a self-fulfilling prophecy, though hardly for all investors (Just 2010).

(Life) insurance companies and international (real estate) investors appear to contemplate reshuffling their portfolios in favour of stable German real estate (Gutachtergemeinschaft 2009, p. 152).[10] This could turn out to be an efficient strategy, if investments succeeded in prospering regions that are less likely to be impacted by demographic contraction processes.

[8] On the doubts concerning inflationary tendencies in Germany, see Maennig (2010).

[9] See Huang and Hudson-Wilson (2007) and the literature cited there. On doubts concerning the inflation-hedging capacity of German real estate, see Maennig (2010).

[10] That being said, it should be added here that another solution for debt-ridden public households is to raise taxes. For the sakes of efficiency, it is preferred to levy taxes on goods of inelastic demand and/or supply.

References

Dust, L., & Maennig, W. (2008). Shrinking and growing metropolitan areas – asymmetric real estate price reactions? The case of German single-family houses. *Regional Science and Urban Economics, 38*, 63–69.

Gutachter-Gemeinschaft (2009). *Wirtschaftsfaktor Immobilien. Die Immobilienmärkte aus gesamtwirtschaftlicher Perspektive*. Zeitschrift für Immobilienökonomie (special edition 2009). Germany: University of Mannheim.

Huang, H., & Hudson-Wilson, S. (2007). Private commercial real estate equity returns and inflation. *Journal of Portfolio Management, 33*(5), 63–73.

Jannsen, N. (2009). *National and International Business Cycle Effects of the housing crisis*. Kiel Institute for World Economics Working Paper 1510, April.

Just, T. (2010). *Immobilien können manchmal (sic!) vor Inflation schützen*. In immoebs newsletter, vol 19, pp. 14–17.

Kholodilin, K. A., Menz, J.-O., & Siliverstovs, B. (2008). Immobilienkrise? Warum in Deutschland die Preise seit Jahrzehnten stagnieren. *DIW-Wochenbericht, 17*, 214–220.

Leamer, E. (2008). *Housing IS the Business Cycle*. In Proceedings, Federal Reserve Bank of Kansas City (pp. 149–233). (Ed.). Housing, housing finance, and monetary policy.

Maennig, W. (2010). *Zukünftige allgemeine Inflationsentwicklung und Immobilienpreise* (pp. 18–23). Immoebs Newsletter 1/2010.

Standard & Poor's (2010). *Global Aging 2010: An Irreversible Truth*. http://www.standardandpoors.com/products-services/articles/en/us/?assetID=1245229586712. Accessed 25.01.2011.

Wiegand, W. (2010). *Gesamtwirtschaftliche Entwicklung*, in: Rat der Immobilienweisen (ed), Frühjahrsgutachten Immobilienwirtschaft 2010, 11–44.

http://www.springer.com/978-3-642-23610-5

Understanding German Real Estate Markets
Just, T.; Maennig, W. (Eds.)
2012, XXII, 406 p., Hardcover
ISBN: 978-3-642-23610-5