



### Prospects for growth in 2004

In its autumn report, the government's Council of Economic Experts forecast an end of the economic slump in 2004. GDP is expected to grow by approx. 1.6 %. The main motors fuelling this recovery will be exports (+4.8 %) and capital investment (+3 %). Private consumption is also predicted to rise by 0.8 % and make a small contribution to growth.

On the other hand, the situation on the labour market will hardly improve. The unemployment rate is forecast to stay well above 10 %.

### Threat of subsidy cuts boosts housing construction segment

The decline in housing construction activity did not continue in all segments in 2003. From the end of 2002, the ongoing debate about the cutting or phasing-out of subsidies for first-time home-buyers produced an unexpected boom in the number of building permits granted for one and two-family houses (+16 % and +10 %, respectively). These figures are, however, likely to fall again. Furthermore, it remains to be seen how many of the permits will actually lead to new housing construction projects.

The multi-family segment was unaffected by the political debate and the related rush to buy a property before tax laws changed. The downward trend persisted, only slowing a little in western Germany, with the number of building permits for rented accommodation falling disproportionately by 5 %. By contrast, the owner-occupied apartment segment remained stable.

### Greater interest in used housing

The used housing sector is becoming increasingly important in relation to the new housing construction segment, which is set to shrink in the medium term:

■ In western Germany, nearly two thirds of the total building volume in the residential sector (new and used buildings) is for the repair and modernisation of existing residential properties – and the trend is rising.

The markets for used owner-occupied apartments and houses with rented accommodation are showing similar developments. For example, in North Rhine-Westphalia more used owner-occupied apartments were sold in the last few years although the number of newly built owner-occupied apartments fell. Following a slump in 2000, overall annual sales run at around € 6 billion. The idea of purchasing a used property is becoming more popular and gaining importance as a way of acquiring assets and providing for retirement – not least because the number of new properties being built is decreasing sharply.

■ Whilst the market for newly built rented accommodation is still declining sharply, the market for older multi-family houses with rented accommodation is stable. The number of houses sold is steady according to current statistics. In North Rhine-Westphalia alone, multi-family houses worth € 3 to 4 billion change hands every year despite the difficult tax situation. Obviously the multi-family house is still considered to be attractive for people with a moderate sum to invest.

### Great regional differences in the development of rents

The persistent economic crisis is also hitting regional markets for rented accommodation. In view of the current situation, many tenants delayed their decision to move to a new apartment. Only when the economy picks up will demand start to catch up, especially in the growth regions, and trigger a shortage of suitable properties.

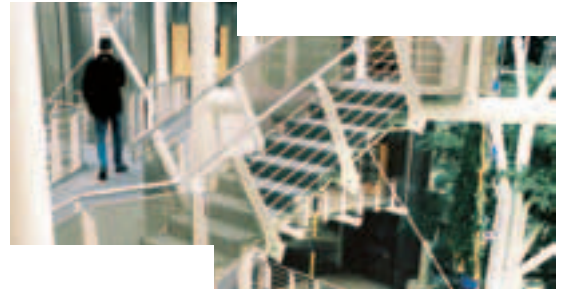
At the moment weak demand makes it almost impossible to raise rents despite the small amount of new accommodation being built. On an annual average, rents for existing housing stock rose by a mere 1 %. In the German states with growth regions such as Hesse and Bavaria, they developed slightly better, increasing by approx. 1.5 %.

Despite the weak phase, some high-price regions are showing an above-average development of rents. In Hamburg, for example, the latest list of representative rents, which is particularly significant for contracts with existing tenants, shows an increase of over 5 %. Rents in Frankfurt and Munich are also climbing steadily: Since the end of the 1990s, they have risen by up to 4 % a year according to the rent indices. However, in the Ruhr area there is little movement: In cities like Essen and Gelsenkirchen, rents have only risen by 1 %.

By contrast, rents for new leases, which are very sensitive to the economic barometer, more or less stagnated in 2003. In some cities, above all in the Ruhr area, they even fell. In Munich, rents for new leases also stabilised but at a very high level.

### Announced reforms cause uncertainty on the real estate market

Some of the changes related to the taxation of real estate activities announced by the government after the elections in 2002, above all in connection with subsidies for first-time home-buyers and the cutting of other tax deductibles, were implemented. At the same time, plans to increase inheritance and property tax were constantly being discussed. As a result, investments which would have promoted growth were delayed. It is very difficult to make long-term calculations with such an uncertain climate. On the other hand, politicians meanwhile all agree that it is necessary to encourage the individual to make provision for retirement himself and not rely on the state. The examples from our European neighbours where the state welfare system is far less generous than in Germany show how eminently important home ownership is as a safety net and particularly a provision for retirement. This is one of the main reasons why these countries are well above Germany in the home ownership league tables.



### Same subsidies for buyers of newly built and used houses

At the end of 2003, the government decided to give buyers of used and newly built houses the same subsidies while reducing the maximum income and assessment ceilings for entitlement to such concessions. The subsidies for home-buyers reduce the financial burden more when a used residential property is bought as the price of such a property is lower, comparatively speaking. The cutting of the maximum annual subsidy to 1 % of the purchase costs has made the conditions worse for a broad section of buyers. Many people can no longer afford to buy their own home as they now have to find an increasing amount of their own capital.

However, particularly in regions with low to medium prices, the restructuring of subsidies for home-buyers may mean that existing accommodation will become more attractive to buy than new properties. In the past, the difference in prices between new and older properties was largely offset by the higher subsidies granted on new properties.

The picture is different for the new housing segment in high-price regions like Munich and Frankfurt: Here, the effects of the changes in the subsidies for home-buyers is relatively small as the tax concession is not so significant in relation to the high purchase prices.

### Residential real estate will remain an important asset

In recent years, in the public discussion on the chances and risks associated with residential real estate, the problems resulting from demographic developments were often mentioned. This subject is also relevant for the German housing market. In the next ten years, the living area per home is expected to increase. However, the regions will show different patterns of development. The main losers will be the states in eastern Germany. However, vacancy problems will also arise in the structurally weak regions of western Germany – above all in large residential estates where the buildings and apartments no longer meet market requirements. The winners will include the growth regions such as Rhine-Main, the big cities in southern Germany, as well as the cities on the Rhine and Hamburg. Here, the demand for accommodation will rise and with it the attractiveness of apartments as an investment.

However, in the statistical studies too little attention is paid to the future reaction of the market players. Particularly in western Germany, property owners have enough time in the next few years to meet these challenges by improving the quality of their residential real estate, selling it or optimising their portfolios.



A residential property in an average to good location will still find a buyer as an asset with a good return and low volatility. Thanks to the broad scatter, earnings are safe from lost rental income. Another significant indication of the attractiveness of German residential real estate is the increasing appearance of foreign investors on the German market.

An important precondition for the renaissance of the apartment as an investment for the small investor is that such an acquisition must receive the same government subsidy as money put into pension funds. Then people will be able to choose how they want to invest their money and decide according to their own preferences.

### Office real estate market bottoms out

The economic crisis also had a strong impact on the office real estate market. In the five largest office real estate markets in Germany, sales fell overall by 40 % compared with the record year 2000. Following the sharp slumps in the two previous years, the rate of decline slowed to 3 % in 2003. The regional differences are very great: Frankfurt even recorded a slight growth in sales in 2003. Demand also remained relatively stable in Hamburg and Munich while the markets in Berlin and Düsseldorf weakened considerably.

The demand for office space came mainly from companies who seized the opportunity to rent modern, well-designed offices at a reasonable price. Momentum also came from company mergers and site optimisation measures. Here the new construction segment benefited most.

Despite this trend, the market players have to be prepared for relatively high vacancy rates after the record sales revenues around the turn of the millennium. The amount of office space on offer will continue to rise for the following main reasons:

■|| The offices which companies are now leasing to take advantage of reasonable rents are generally smaller than the office space previously rented. This means the amount of unlet office space will increase.

■|| As many companies are cutting staff and postponing expansion plans, a large amount of low-priced office space for sub-letting will come on the market. This concealed empty office space will lead to an increase in vacancy rates and exert pressure on rents.

■|| The amount of newly built office space to come on the market has risen sharply in the last two years.

As a result of this development, the amount of unlet office space in the five big German office real estate markets has virtually tripled since hitting its low at the beginning of 2001. The high vacancy rate is naturally having an effect on rents. They fell across the board in 2003 and landlords were increasingly prepared to negotiate special conditions.

However, in contrast to the housing market, here there will soon be a market correction: Old, inefficient locations will disappear from the market. Tenants are virtually impossible to find for these offices, even at dumping prices.

The difficult market situation and investors' growing caution has meant that very few construction projects are currently being started. And those which are, already have a certain percentage of the office space pre-let; speculative developments are now the exception. Therefore, little new office space can be expected to come on the market from 2005.