Commercial real estate in the euro area: macroeconomic or idiosyncratic shocks?

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Commercial real estate prices are an important driver of business investment. This post quantifies the role of macroeconomic, financial and idiosyncratic factors in commercial real estate price dynamics in the euro area. Over the entire period studied, commercial real estate appears to have been a channel of transmission of macroeconomic and financial shocks, especially since 2015.

Chart 1: Commercial real estate transaction prices and interest rates in the euro area

Sources: ICE BofA, MSCI

Note: commercial real estate real prices are calculated by dividing nominal prices of transactions by the GDP deflator.

Changes in the price of commercial real estate (i.e. property owned by firms) can have macroeconomic consequences. Companies' access to external funds partly depends on the value of their capital, due to information asymmetries in the credit market: lenders will only grant loans if the value of the collateral is high enough to compensate them in the event of default. Real estate represents a significant proportion of a firm's assets. In France, at the end of 2023, land and buildings accounted for 57% of the non-financial assets of non-financial corporations (see Bonomo et al. 2024). Consequently, a drop in commercial real estate prices may limit firms' financing capacity, and hence their investment. For example, Héricourt et al.

(2024) estimate that a 1% fall in commercial real estate prices leads on average to a 0.2% fall in business investment. This “financial accelerator” plays a heterogeneous role from one firm to another, and is especially relevant for firms in the real estate sector, whose capital is essentially composed of properties.

Since the creation of the euro area, commercial real estate prices have fluctuated widely, sometimes fuelled by shocks specific to this market, such as the development of teleworking since the Covid crisis (Henricot et al. 2022, Bergeaud et al. 2023). They also appear to be strongly correlated with movements in interest rates, driven either by macroeconomic or financial developments (see Chart 1). Indeed, the increase in prices has been particularly continuous and sustained during periods of low interest rates (2005-2007, 2015-2019), and the fall has been just as marked during periods of high interest rates (2008-2012, and since 2022). The fall in real prices since 2022 has been particularly spectacular, with the sharp drop in nominal transaction prices (down 15.2% between Q2 2022 and Q2 2024) amplified by the rise in the GDP deflator (up 10.1% between Q2 2022 and Q2 2024). As with residential real estate prices, this strong correlation between interest rates and prices can be explained by the role of credit in the demand for commercial real estate. Financialisation of the commercial real estate market, whereby investors arbitrate between the yields available from different assets, also drive this correlation.

Quantifying the factors driving the commercial real estate cycle

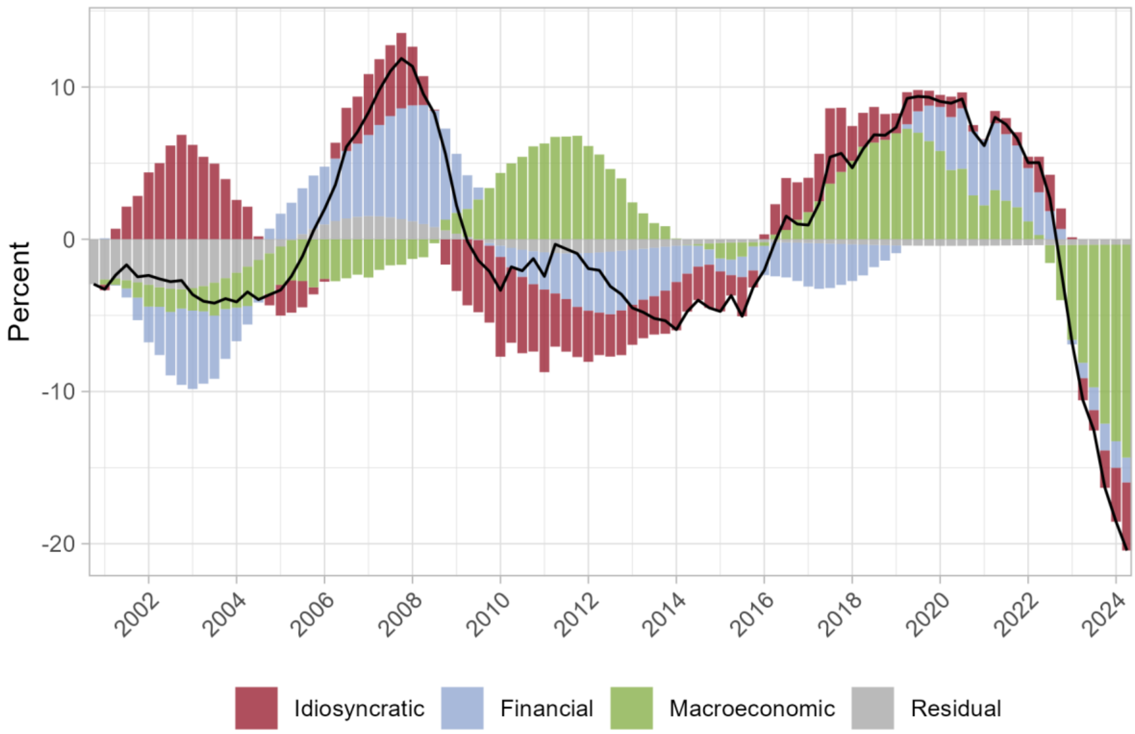
This post quantifies the role of macroeconomic, financial and idiosyncratic factors in commercial real estate price dynamics in the euro area. A quarterly vector autoregressive (VAR) model is estimated using Bayesian procedures. The model includes six variables, three of which are standard macroeconomic variables: real GDP growth, growth of the GDP deflator, and an estimate of the short-term interest rate in the presence of unconventional monetary policy (Krippner 2013). It also includes the spread on high-yield euro-denominated bonds. This variable captures the cost of debt financing as well as investors’ expected return. Lastly, the model naturally includes a commercial real estate transaction price index, divided by the GDP deflator.

Various shocks are identified based on assumptions about their short-term effects. This analysis does not seek to identify the different macroeconomic shocks (to aggregate supply, aggregate demand or monetary policy) separately. Financial shocks correspond to changes in investors’ risk appetite, and are identified by assuming they lead to a change in spreads that is disconnected from the macroeconomic situation. Lastly, idiosyncratic shocks are identified by assuming that they have no instantaneous impact on macroeconomic and financial variables. This assumption appears reasonable insofar as a shock specific to commercial real estate affects only a small part of aggregate demand (via the construction sector) and has mainly medium-term effects on capital accumulation. This commercial real estate shock combines demand and supply shocks that this analysis does not seek to identify separately.

Commercial real estate as a channel of transmission of macroeconomic and macro-financial shocks

The model indicates that idiosyncratic shocks played a major role in commercial real estate price movements around the 2008 crisis and especially in the early 2010s (see Chart 2). Since then, their contribution has been of secondary importance, although it has been growing since Q2 2023. This can be explained by the fact that the growth in teleworking has had a partly redistributive effect in the euro area, by depreciating real estate on the periphery of downtown areas in favour of more central properties (see [Financial Stability Report, December 2024, pp.18-21]). Financial shocks were a determining factor around the time of the 2008 crisis and in the early 2010s. Risk appetite also played a key role in keeping valuations high in the wake of the Covid crisis. However, over the last ten years, it is macroeconomic shocks that stand out, in particular because of movements in inflation and the resulting monetary policy decisions: low inflation and low interest rates appear to have contributed to the rise in commercial real estate prices through 2020, before the resumption of inflation in 2022 and the normalisation of monetary policy reversed this dynamic.

Chart 2: Breakdown of the deviation of commercial real estate real prices from their long-term average in the euro area



Sources: Eurostat, Krippner (2013), ICE BofA, MSCI, author's calculations

Note: In Q2 2024, real commercial real estate prices in the euro area were 20.4% below their long-term average. Idiosyncratic shocks accounted for 4.6 percentage points of this difference, and macroeconomic shocks for 13.9 percentage points.

Commercial real estate therefore appears to be a channel of transmission of macroeconomic and financial shocks, especially since 2015. Indeed, the volatility of these valuations is more the consequence of an endogenous adjustment to other shocks than the sign of idiosyncratic shocks or a commercial real estate bubble (Coffinet et al. 2018). This volatility is a standard transmission channel of monetary policy, which can however have asymmetric effects:

unconventional monetary policies have indeed favoured real estate investors, thereby amplifying the increase in commercial real estate price and putting financial stability at risk in the event of a downturn in the cycle (Berg et al. 2024). However, European macroprudential authorities have tools at their disposal to limit these risks by acting ex ante on market dynamics and ensuring the ex post resilience of financial institutions. For example, Ireland introduced leverage and liquidity limits for real estate investment funds in 2022 and in 2024, Denmark introduced a bank capital buffer for exposures to firms from the real estate- sector.