The turnaround in the real estate market is currently less pronounced in France than in the other major western economies

In the major western economies, the main consequences of the increases in base interest rates set by the central banks more than a year ago emerge in the real estate market. These increases cause a tightening of access to credit for households and a decline in demand for real estate, leading in turn to a turnaround in the real estate market. In particular, real prices of real estate, i.e. prices adjusted for inflation, appear to be falling back to different degrees depending on the country, with France being least affected for the moment, in contrast to Germany. This turnaround in the real estate market could hamper household investment, as is already the case in the United States, and affect households' financial situation, especially in the United Kingdom, Italy or Spain, where the characteristics of the credit market are likely to cause a rapid rise in household debt.

Jules Baleyte, Mathilde Niay

The increase in base interest rates by the central banks is tightening access to credit for households

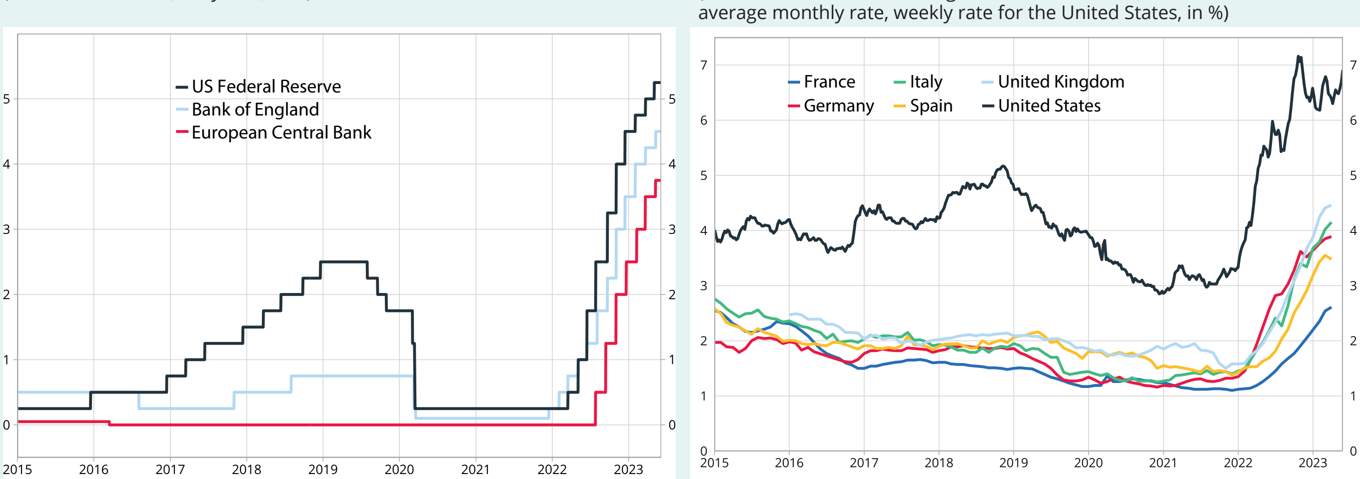
Faced with the increase in inflation in the western economies, the central banks have embarked on a rapid cycle of monetary tightening since the beginning of 2022, in order to meet the price stability objective that is part of their mandate. Thus the US Federal Reserve (Fed) raised its base interest rate by 500 basis points between March 2022 and May 2023 (►**Figure 1 left**), followed by the European Central Bank from summer 2022: the ECB introduced several consecutive increases of 75 basis points, bringing to an end the period of negative deposit rates, then went on to raise the rate on the main refinancing operations to 3.75% before the May meeting. At the same time, these central banks decided on a gradual reduction in their balance sheets, which had reached unprecedented levels following the monetary easing decided in 2020 at the height of the health crisis. Some of the first indirect consequences of this monetary tightening started to be felt in the main western economies, especially on the financial markets (►**INSEE, 2022 Focus** in the *Economic Outlook* of 24 June 2022), where tensions emerged in spring 2023 with the collapse of several regional banks in the United States.

Since the raising of key interest rates increases the rates at which commercial banks can borrow and deposit money at the central bank, this has the effect of also increasing the rates at which the banks lend to economic agents, in particular the interest rates for new loans to households for real estate purchases (►**Figure 1 right**). Thus in the United States, the interest rate surged for new 30-year loans (strongly represented in loans to households), going from about 3% to over 6% in one year. In Europe, the rates for new home loans to households, which had fluctuated on average around 2% for the last few years, then between 1% and 2% during the health crisis, increased by more than 2 points during 2022. In France, however, the rise in mortgage rates appears to be more moderate (from 1.1% at the start

►1. The rise in base interest rates is having an impact on interest rates for housing loans to households, but to a lesser extent in France

(base interest rates; daily rate, in %)

(interest rate for new housing loans to households; average monthly rate, weekly rate for the United States, in %)



Last point: left: 6 June 2023; right: April 2023 for European countries and 26 May 2023 for the United States.
Note: for European countries, the interest rate shown for new housing loans to households is the volume-weighted average of borrowing rates for households and NPISHs for the purchase of housing. For the United States, because of the large number of 30-year loans, the interest rate shown for new home loans to households is the interest rate for 30-year loans.
Source: European Central Bank, Bank of England, Federal Reserve, Mortgage Bankers Association.

of 2022 to 2.6% in April 2023) due mainly to their being capped by the usury rate, which is revised regularly based on the average effective rates implemented by the credit institutions. Since February 2023, given the rapid rise in base interest rates, the pace of revision of the usury rate has become monthly (instead of quarterly, this new measure initially being introduced for 6 months), which allowed for a faster increase in interest rates for new loans to households.

This tightening of household access to loans can also be seen in the business tendency surveys of banks carried out in the Eurozone (**▶Figure 2 left**). The conditions for granting loans for house purchases went through a highly unusual period in 2020, then hardened significantly in 2022 in all countries, although more so in Italy, Spain and Germany than in France. However, in Q1 2023, with the rise in the usury rate, the indicator for France caught up with the Spanish and Italian levels, a sign that France is realigning with its European neighbours, after a period of more abundant and cheaper credit. In Germany, on the contrary, affected for several months by a less dynamic rise in rates for new loans, and an intensification of competition between banks due to the decline in household demand, the indicator declined sharply at the beginning of 2023 after the high point reached in mid-2022.

The tightening of the credit supply affects household demand for new loans for house purchase (**▶Figure 2 right**). In surveys of banks, the balance of opinion on demand for loans from households fell sharply in 2022, reaching very degraded levels in France and Germany; in Spain it fell back significantly in Q1 2023. The rise in interest rates is the main factor to account for this fall, according to the banks surveyed, but future prospects for the real estate market are also suggested, particularly in France and Germany, while the drop in household confidence also contributed negatively in all countries. This sharp fall in demand for loans to households resulted in a significant reduction in new loans granted: in February 2023, the volume of home loans granted to households plummeted by 54% year-on-year in Germany and by 37% in France.

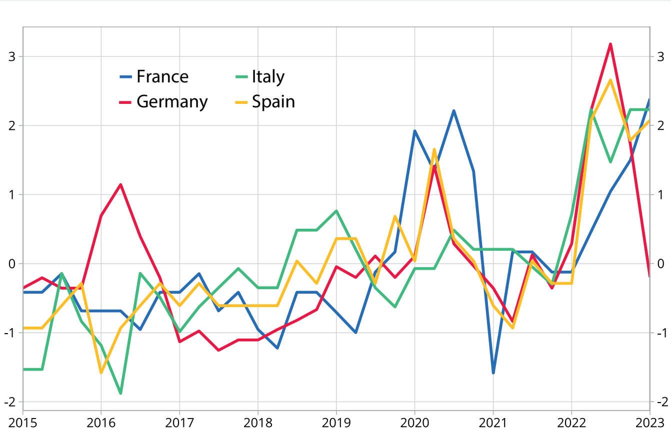
In the United States, the Federal Reserve Senior Officer Opinion Survey, published on 8 May, offers a similar diagnosis for Q1 2023 with both a tightening of conditions for granting housing loans to households and a decline in demand for these loans.

As a result, the real estate market shows signs of a turnaround

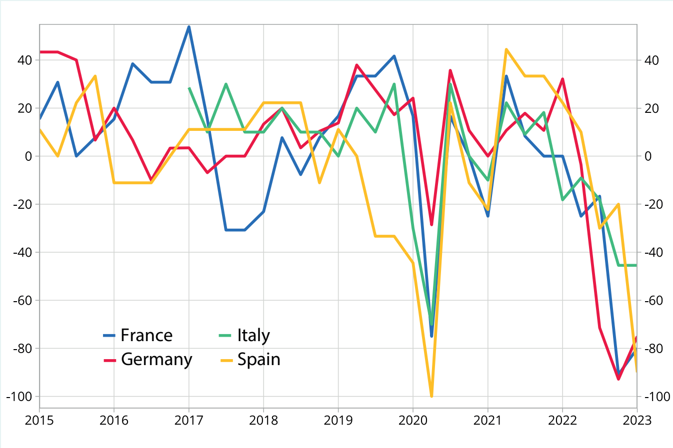
The deterioration observed in conditions of access to credit for households and the decline in the volume of new home loans, since 2022 in Europe, are passed on to the real economy *via* the residential real estate market. This market experienced a period of strong momentum at the end of spring 2020, driven by enthusiasm for residential comfort and open spaces in the countryside after the first lockdown, in a context of low interest rates,

▶2. Bank lending conditions for granting loans to households for house purchase have tightened in the Eurozone while the demand for home loans from households is in decline

(centred-reduced indicator of bank lending conditions for granting loans to households for house purchase)



(balance of opinion on demand for loans to households for house purchase; in %)



Last point: Q1 2023.
Note: for a given question in the bank lending survey, the balance of opinion is calculated as the net difference between the percentage of banks reporting an increase and the percentage reporting a decrease. On the left-hand graph, the indicator is the average of the two balances of opinion: one on credit standards applied to the approval of loans to households for house purchase (i.e. the bank's internal guidelines or loan approval criteria), the other on the terms and conditions for loans to households for house purchase (i.e. the actual conditions for a loan to which a bank is willing to agree). This indicator is then centred around 0, reduced to a standard deviation of 1. If this indicator is positive, this means that the share of banks that are tightening their conditions for granting loans to households for house purchase is greater than the share of banks that are easing their conditions. On the right-hand graph, the balance of opinion represented refers to the demand for loans to households for house purchase.
How to read it: in France, in Q1 2023, the centred reduced indicator for the bank lending conditions for granting loans to households for house purchase was 2.4; the balance of opinion on demand for loans to households for house purchase was -80%.
Source: European Central Bank, Bank Lending Survey.

making debt easy and inexpensive. This momentum has recently been reversed, for purchases of homes, the construction of new homes and real estate market prices.

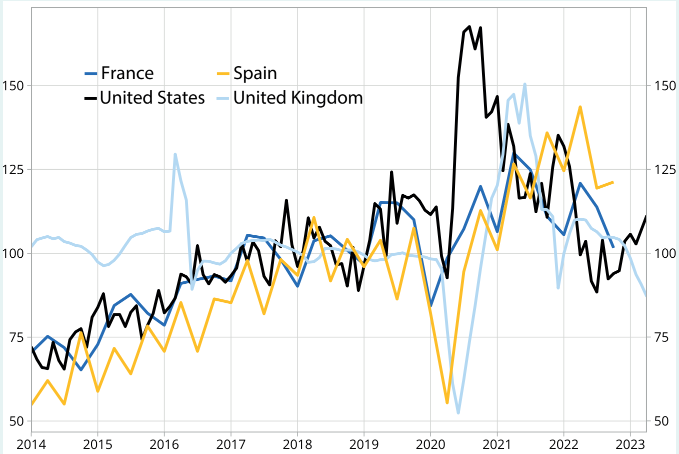
In fact, the number of real estate transactions, which had increased substantially, reaching record levels just after the health crisis in 2020, declined sharply in the United States, the United Kingdom and, to a lesser extent, France (► **Figure 3 left**). This reversal of the momentum came earlier in the United States, where the number of real estate transactions started to tumble in autumn 2020, in reaction to the peak in summer 2020, then continued to decline with the rapid introduction of monetary tightening by the Fed. At the beginning of 2023, real estate transactions in the United Kingdom returned to their pre-health crisis trend trajectory, while in the United States and France, they are now slightly below this trajectory. In Spain, the decline in transactions seems more moderate, but the real estate market has a very different momentum there from the other countries studied over the last decade. The country still bears the scars of the 2008 crisis, which means that caution is required when comparing recent dynamics between Spain and its neighbours.

In addition, the fall in demand for housing was accompanied by a decline in the granting of building permits, and hence in the construction of new homes, from Q2 2022 for the United States, France, Germany and Italy (► **Figure 3 right**). In these countries, building permits have followed a similar trend to real estate transactions in recent years, with a strong increase after spring 2020 then a sharp decline from 2022. In the United States, for example, the number of building permits was 40% higher than its 2018 average in Q1 2022, but only 7% above this level in Q4 2022.

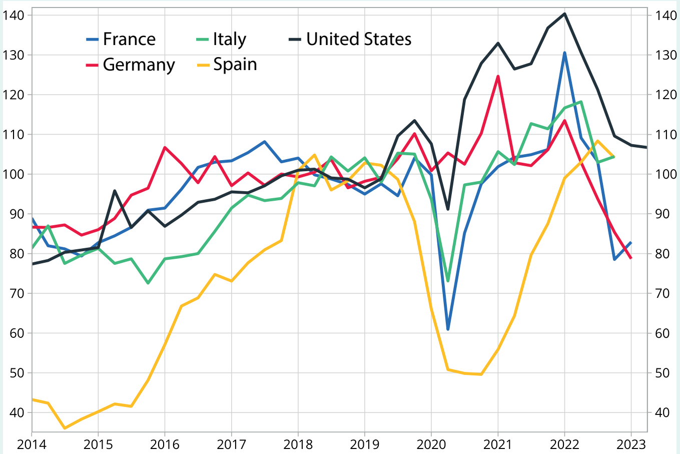
Real property prices, i.e. adjusted for the dynamics of consumer prices, are also showing signs of a reversal (► **Figure 4**). Coming out of the first lockdowns in 2020, and in line with the sharp increase in demand for housing, real property prices rose significantly, moving upwards, away from their short-term trend from Q3 2020 (except in Spain, which also demonstrated a specific dynamic, with real property prices on the contrary having slowed down in 2020). The deviation from the trend trajectory of recent years (2015-2019) can be interpreted as a form of overvaluation of the property market, resulting from conditions specific to the convergence of the health crisis and remarkably low interest rates. This deviation from the trend varied from country to country, but was particularly pronounced in the United States and Germany (deviation from the trend trajectory of 18 percentage points in Q1 2022 and 11 percentage points in Q4 2021 respectively, at their maximum), and to a lesser extent in France (9 percentage points in Q3 2021), Italy (6 percentage points in Q3 2021) and the United Kingdom (4 percentage points in Q3 2022). In Italy, unlike the other countries, the trend trajectory for prices is in decline, as has been the case since the 2008 crisis, because of the prolonged slump in demand between 2008 and 2015, the accumulation of housing stock and low household expectations for the real estate market during this period of negative spiral. As a result, like the situation in other countries, the maintaining of prices in Italy after 2020 can be seen as an upward deviation from the pre-crisis trend.

► 3. Real estate transactions and building permits are now in decline

(number of real estate transactions; base 100 in 2018)



(number of building permits; base 100 in 2018)



Last point: for real estate transactions, April 2023 for the United States and the United Kingdom, Q4 2022 for France and Spain; for building permits, Q2 2023 for the United States, Q1 2023 for France and Germany, Q4 2022 for the others.
Note: real estate transaction data (new and second-hand dwellings) are quarterly in France and Spain, and monthly in the United Kingdom and the United States. The quarterly Eurostat indicator used for building permits is the useful floor area authorised in m^2 in residential buildings, whereas in the United States, it is the monthly number of building permits for new privately owned homes expressed on a quarterly basis.
How to read it: in France, in Q4 2022, the number of real estate transactions was 1.6% higher than in 2018; in Q1 2023, the number of building permits granted was 17.1% lower than in 2018.
Source: Eurostat, HM Revenue & Customs, Census Bureau.

From the end of 2021 or the beginning of 2022, in line with the expectations of a rise in borrowing rates and a tightening of the credit supply, the dynamics of the real prices of real estate reversed and started moving downwards. Prices in Germany dropped well below their trend trajectory (-8.6 percentage points in Q4 2022), while in Italy and the United Kingdom, they more or less returned to this trajectory (-1.6 and +0.0 percentage points respectively). Real prices of real estate also slipped back in the United States and France, but remained higher than their pre-crisis trend trajectory (9.3 percentage points and 4.9 percentage points respectively). Again, the situation in Spain was unique, with real prices of real estate accentuating the downward trend that began from the end of 2020: the reason may be the context of high inflation that Spain experienced from early 2021 to mid-2022, as the momentum of consumer prices had been significantly stronger than nominal real estate prices. In the countries studied, nominal prices actually have a generally upward trend, accelerating during the health crisis before slowing down recently –Germany is nevertheless the only country where we observe a substantial drop in nominal prices from the last quarter of 2021.

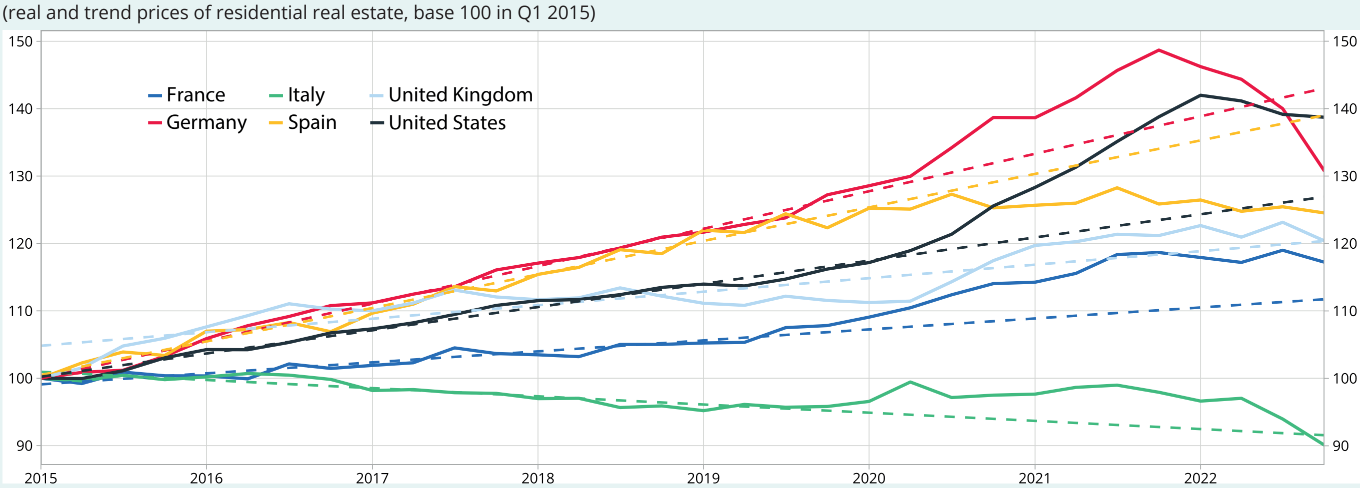
Thus it appears that in the United States and France, real prices are still above their pre-heath crisis trend trajectory. This observation could suggest a continuation in the adjustment of real prices, especially in France, due to catch-up in the rise in interest rates on new loans. Indeed, in countries where real property prices had largely exceeded their pre-crisis trend trajectory, they subsequently fell back fairly sharply (►**Box**). In Italy and the United Kingdom, the consequences of tightening monetary policies, which played a major role in moderating real estate prices observed since the start of 2022, may continue to affect real estate prices in 2023, bringing real prices below their trend trajectory, as is already the case in Germany as well as in Sweden and Canada (►**Box**). The turnaround in the real estate market could then affect economic activity.

The turnaround in the residential real estate market could affect economic activity to different degrees depending on the country

The turnaround in the momentum of real estate activities could have several types of consequence for economic activity. On the demand side, difficulties in the real estate sector could emerge through investment in housing, which represents, for example, around 4% of GDP in France or the United States. After the automatic rebound after Q2 2020, housing investment continued its recovery at a sustained pace in 2021, and this was the case for all countries (with the exception of Germany and Spain, however, ►**Figure 5**). This trend was subsequently reversed: for example, in the United States, investment in housing declined for eight consecutive quarters, and more strongly towards the end of 2022 (-7.6% in Q3, which represents -0.4 points of quarterly GDP, and -7.0%, in Q4). In Italy, the turnaround in 2022 was less pronounced, with investment in housing still largely above its pre-health crisis trend trajectory, in particular thanks to large subsidies for households for energy efficiency work in their homes. In Germany, where the post-Covid recovery was not accompanied by much of a rebound in household investment in construction, it declined throughout 2022, whereas in Spain, it has fallen back since mid-2022.

►4. After a sharp acceleration in 2020, real estate prices, adjusted for inflation, changed momentum in 2022 and are now on a downward trend

(real and trend prices of residential real estate, base 100 in Q1 2015)



Last point: Q4 2022.
Note: for each country, the solid line represents real prices, while the dashed line represents the linear trend calculated for the period between Q1 2015 and Q4 2019. Real prices have been deflated by the consumer price index.
How to read it: in France, in Q4 2022, real estate prices were 17.2% above their Q1 2015 level and 5.5% above their trend level.
Source: Bank for International Settlements.

The continuing downturn in the real estate market could be accompanied by a downturn in activity in the construction sector, thus holding back GDP in the western economies. For example, in France and Germany, the value added of construction has already fallen back in every quarter since Q2 2022 (cumulated, -2.4% in France between Q2 2022 and Q1 2023 and -4.6% in Germany).

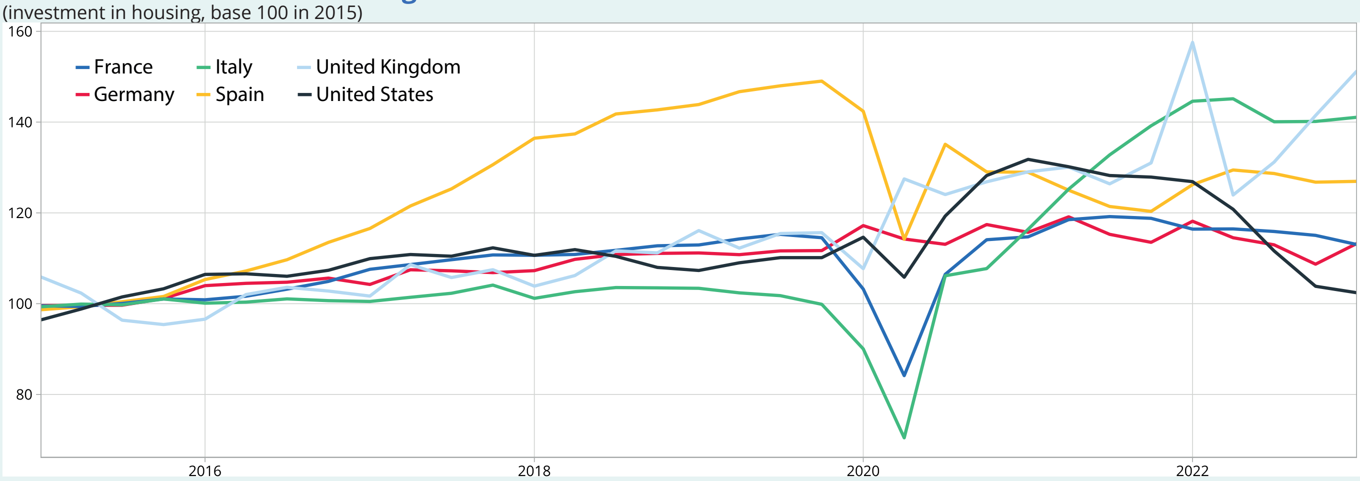
In addition, the rise in the cost of credit could have an effect on households' gross disposable income, by increasing the cost of old loans when they have been contracted at a variable rate or when they have to be renegotiated due to their short maturity. The countries studied are not all exposed to this risk to the same extent because the proportion of loans contracted at variable rates varies considerably from one country to another, and has even changed in recent years (►**Figure 6 left**). In France, the share of variable rate loans is structurally extremely low, including in 2022, thus protecting households that had taken out home loans. Similarly, in Germany and the United States since the 2008 real estate crisis, the share of variable rate loans appears to be quite modest (despite an increase during 2022). In Spain and Italy, the proportion of these loans has fallen sharply since 2010, but a sizeable share of existing loans have been taken out with this variable rate and could therefore see their monthly repayments increase substantially in the coming months. Also in Italy, and to a lesser extent in Spain and Germany, banks have increased the use of variable rate loans in the context of rising rates in 2022. In the United Kingdom, in addition to a relatively high proportion of variable rate loans in recent years, the vast majority of loans are for 2 or 5 years; their rate is then renegotiated when they mature. Households in the UK, Spain and Italy therefore appear to be the most exposed to the rise in the cost of old loans, when these are at variable rates or short-term maturity. This increase in the cost of old loans could result in an increase in the cost of repaying households' debt, as can already be observed in Australia (►**Box**).

An increase in monthly repayments, especially if households had not anticipated it, may possibly hamper financial and real estate stability. Certainly, the risk that these households may default is increased, putting extra risk onto the credit institutions: to compensate for this, these institutions may then increase the rates on loans, thus leading to a negative spiral. Default on payment may also force buyers to sell their home, lowering its price, and thereby increasing the supply of housing in the face of falling demand. The risk of households defaulting on their loan is mainly linked to their level of debt. In relation to gross disposable income, the level of household debt appears particularly high in the United Kingdom, thus exposing them all the more to the risk of a turnaround in the real estate market (►**Figure 6 right**). In France, household debt is higher than in the other Eurozone countries, and it is the only country to have experienced a regular and continuous upward trend for more than forty years. Spanish household debt has fallen sharply since 2010 but, at nearly 80% of gross disposable income, it could rise again following the rise in interest rates.

In addition, the turnaround in the real estate market could reduce the value of owner households' assets, and a "wealth effect" could then encourage them to reduce their consumption in anticipation of a reduced income in the future. However, this effect appears to be happening mainly in the United States or the United Kingdom, and much less in France (► **Chauvin, V. & Muellbauer, J., 2018**). ●

►5. The momentum in housing investment reversed in 2022

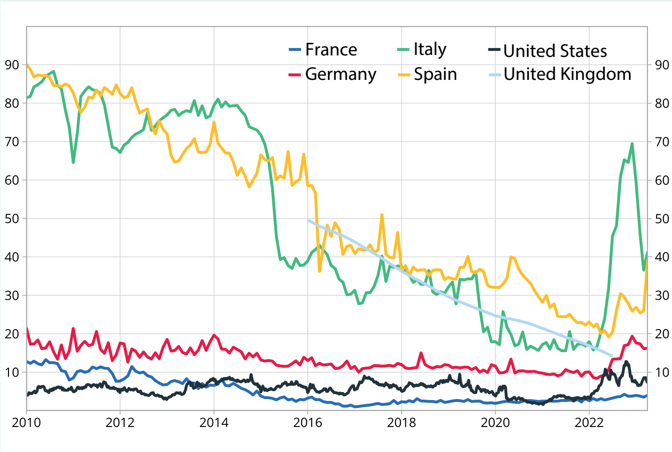
(investment in housing, base 100 in 2015)



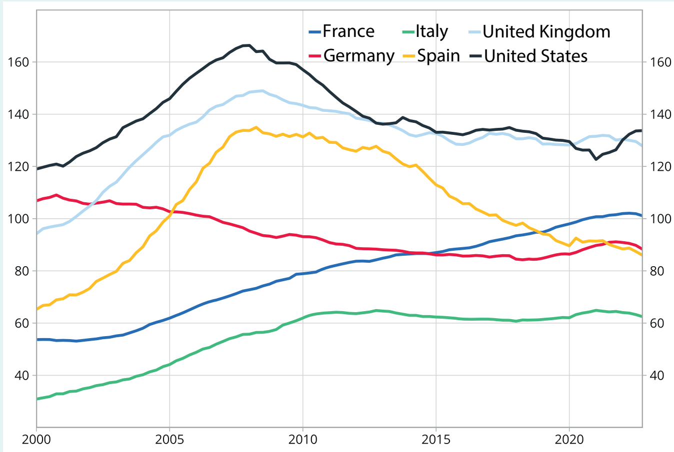
Note: for Eurozone countries, the investment considered is investment in housing, whereas for the United Kingdom and the United States, it is specifically household residential investment.
How to read it: in France, in Q4 2022, investment in housing was 14% higher than its average level throughout 2015.
Source: Eurostat, BEA, ONS, Insee calculations.

►6. UK and Spanish households seem more exposed to the turnaround in the real estate market

(share of new variable rate loans, in %)



(household debt, in % of GDI)



Last point: for the share of new loans (on the left), Q3 2022 for the United Kingdom, April 2023 for all other countries; on the right, for household debt (in % of GDI), Q4 2022.
How to read it: in April 2023 in France, the share of new variable rate loans was 4.0%. In Q4 2022, in the same country, household debt was 101.1% of their gross disposable income.
Source: European Central Bank, Mortgage Bankers Association, ONS, Banque de France.

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What lessons can be drawn from real estate market trajectories observed in other advanced economies?

The movements in the real estate market analysed in this Focus study can also be found in other advanced economies, at a higher intensity in some cases, or perhaps an earlier timeframe. This is particularly the case in several northern European countries (Sweden, Netherlands, Denmark) and English-speaking countries (Australia, New Zealand, Canada).

In these six countries, the real estate market was very dynamic coming out of the worst part of the health crisis, with notably a sharp rise in real prices of real estate (▶**Figure 7 left**), especially in New Zealand, where they increased by 34% between Q2 2020 and Q4 2021. However, the rise in prices in these economies was followed by a sharp decline from the end of 2021 or the beginning of 2022. The downturn in real property prices was -18% in Canada, -17% in New Zealand, -15% in Sweden, -11% in Denmark and Australia and -7% in the Netherlands between the end of 2021 and the end of 2022.

This recent decline in real prices of real estate could be interpreted, depending on the case, as a backlash from the specific period 2020-2021, marking a return to more traditional real estate market conditions. At the end of 2022, real prices of real estate in New Zealand or in the Netherlands seemed to have returned to the pre-health crisis trend trajectory.

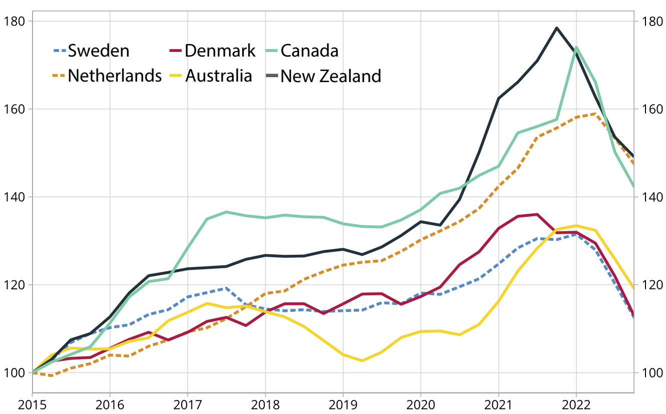
The consequences of this turnaround in the real estate market for households were already beginning to appear. The Debt Service Ratio, calculated by the Bank for International Settlements, measures the weight in household income of their loan repayments; it started to rise sharply again in Australia and Canada (▶**Figure 7 right**). In these countries, debt service was already structurally high, above 12% in the years preceding the health crisis, while in comparison, it is between 6 and 8% in France, Germany or the United States. In the six countries monitored in the body of the Focus, debt service appeared stable in 2022, except in the United States, where it was rising again.

The speed at which the real estate market was passed through to household income in Australia could be explained by the large number of variable rate loans, as the increase in their rates was passed on almost immediately to households' monthly payments, with the share of these loans rising to 60% in Australia.

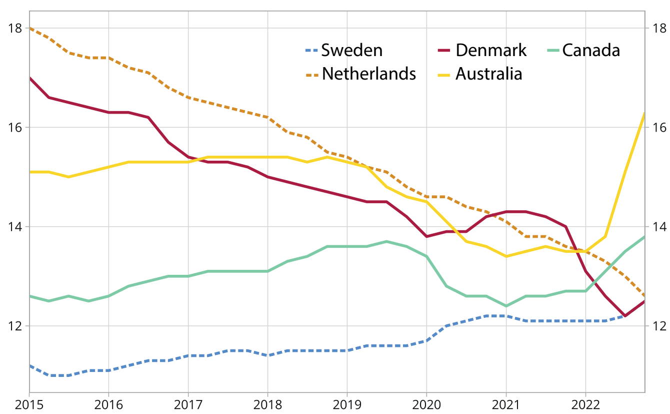
In the countries of northern Europe, the turnaround in the real estate market could also have consequences for the sustainability of household debt. This amounts to almost 200% of GDI in Denmark and the Netherlands, despite a reduction over several years, like the reduction in debt service in these countries since 2015. If household investment and consumption capacities were to deteriorate in these countries, demand for the products of Germany, and to a lesser extent those of France, could be affected.

▶7. The real estate market reacted more briskly in other advanced economies

(real prices of real estate, base 100 in Q1 2015)



(Debt Service Ratio, in % of GDI)



Last point: Q4 2022.
Note: the Debt Service Ratio (DSR) is constructed as the sum of interest paid by households and loan repayments, divided by the average disposable income to which is added interest paid, giving the following formula (▶ **Drehmann and al., 2015**):

$$DSR_{j,t} = \frac{i_{j,t}}{\left(1-\left(1+i_{j,t}\right)^{-s_{j,t}}\right)} * \frac{D_{j,t}}{Y_{j,t}} \quad (1)$$

where $i_{j,t}$ is the average interest rate for the stock of existing debt, $D_{j,t}$ is the stock of debt, $Y_{j,t}$ is the household disposable income increased by interest paid, and $s_{j,t}$ is the residual maturity remaining on outstanding loans. The debt service series is not available for New Zealand.
Source: Bank for International Settlements.