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INSIGHT

Commercial Real Estate Markets and Potential Macroeconomic Stress

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The commercial real estate (CRE) industry comprises different real estate sectors, including office, industrial, and retail space, as well as multifamily housing (e.g., apartments). Recent economic trends have some economists concerned about conditions in CRE markets, although economic conditions affect each of these segments differently. This Insight discusses the impact of changes in inflation and interest rates as well as post-pandemic work patterns on CRE.

CRE and the Economy

The CRE industry relies heavily upon borrowing, so tightening credit conditions or the devaluing of commercial property used as collateral can affect the ability of builders to obtain financing for new construction. Higher borrowing costs can reduce CRE growth or increase rents for CRE occupants. In turn, losses in CRE can affect those individuals and institutions that finance CRE, potentially causing further ripple effects on the economy.

Conditions in certain CRE markets have some concerned about this sector. In the lead-up to and during the COVID-19 pandemic, interest rates throughout the economy were low, allowing for relatively inexpensive borrowing. As the pandemic and recovery progressed, supply chain constraints and other complications led to rapid inflation, ultimately leading the Federal Reserve to raise interest rates, thereby raising borrowing costs and tightening credit conditions.

The office sector in particular is now showing signs of stress. The pandemic resulted in a structural shift away from in-office work, resulting in high vacancy rates for this segment of CRE that persist today. Due to the convergence of work-from-home policies and other economic pressures, many companies that would typically rent space from the office subsector of CRE owners are not renewing their leases. This is evidenced by higher office vacancy rates, which hit all-time highs earlier this year. Consequently, office property leases have fallen, generating lower revenues from rent, potentially imperiling the ability of the property owners to pay back financing costs. To minimize losses, some CRE owners have been willing to break leases and renegotiate terms with tenants.

However, not all CRE segments are performing similarly. According to a recent October 2023 analysis from the National Association of Realtors, multifamily and retail properties are performing better than

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they were pre-pandemic, and industrial properties are back to pre-pandemic standards. Evidence cited includes:

- a 33% increase in net absorption and a 17% increase in unit deliveries compared to the previous year for multifamily properties,
- a decade-low vacancy rate for retail properties, and
- similar vacancy rates and net absorption to pre-pandemic levels for industrial properties.

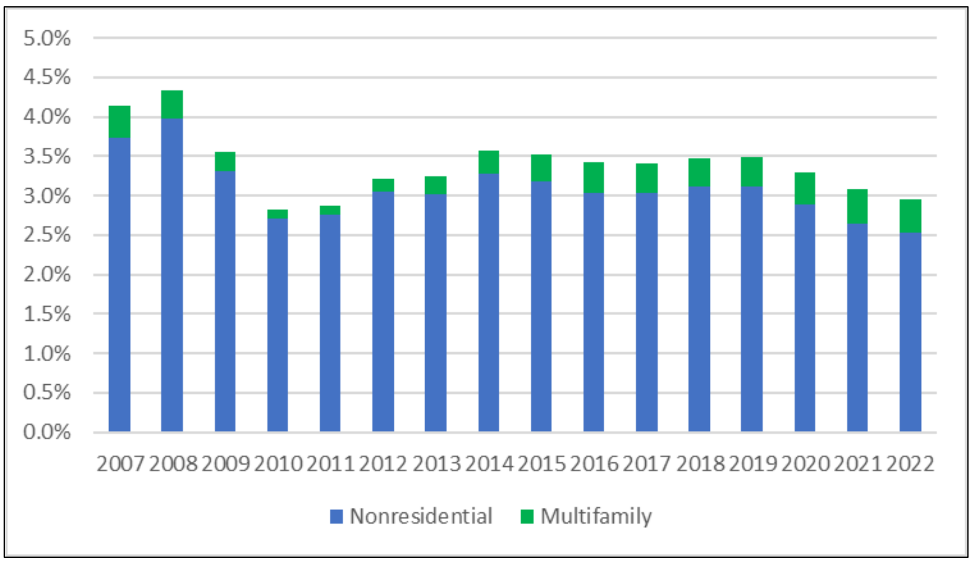
Whether some or all of these subsectors will remain resilient is yet to be seen.

Macroeconomic Implications

CRE activity is a significant contributor to overall economic activity. Therefore, a downturn in CRE markets could lead to general macroeconomic stress. As illustrated in **Figure 1** below, investment in CRE comprised nearly 3% of total economic activity in 2022, although this percentage has been falling in recent years.

Figure 1. Private Fixed Investment in CRE as a Percentage of GDP

2007-2022



Source: Bureau of Economic Analysis, National Income and Product Accounts, Table 1.1.6 and 5.4.6.

Notes: Owing to data constraints, investment in multifamily structures does not include brokers' commissions and other ownership transfers or net purchases of used structures and is therefore likely an underestimate.

CRE also likely plays a significant role in local economies. The availability and cost of CRE space can affect both local residential and business markets, and taxes from the properties themselves and the residents and businesses that occupy them can contribute revenue to local governments. Given the stress in office space specifically, it is possible that certain local economies may be disproportionately affected compared to the national economy. For example, some observers are concerned about a so-called *urban doom loop*, in which stress in office real estate leads to economic declines in downtown centers.

At a regional or even national scale, one particular policy concern is how stress in the office subsector might stress banks, which hold a significant amount of CRE debt on their books. According to the latest Federal Reserve data, banks hold around $3 trillion in CRE debt. CRE mortgages are financed on shorter terms than are residential mortgages, often with balloon payments due at maturity. Trepp, an industry analysis firm, estimates that $448 billion in CRE loans are maturing in 2023, with about $270 billion of that coming from bank loans. Further, regarding the retail subsector, many tenants are considering whether or not to renew their leases. A loss of rental income would lead to higher default rates among CRE owners. This is compounded by the coinciding maturities of many CRE mortgages, which will accelerate defaults if rental income cannot sufficiently offset the balloon payment obligations or if alternative financing cannot be procured. (For more on bank exposures to CRE, see CRS Insight IN12278, *Bank Exposure to Commercial Real Estate*, by Andrew P. Scott.)

Certain economic trends may bolster the CRE market in the near term. Economic growth has outperformed expectations, inflation has receded notably, and many other economic indicators are generally stable. However, high interest rates, supply chain constraints, and recent stress in the banking system could contribute to slower growth or stress in certain sectors, including CRE. Whether stress in CRE and banks would lead to economic or financial turmoil is highly debated. Even if the impact on the banking system is mild, CRE market stress, among other conditions, may lead to a further contraction in credit conditions.

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