

In One Page : Home Prices in France in the Long Run, Past and Prospects.

Salient points of the working paper « Le prix des logements sur le long terme » (March 2010) and of the presentation to CDIF (October 2010). (These documents may be downloaded on http://www.cgedd.developpement-durable.gouv.fr/rubrique.php?id_rubrique=137).

The surge in home prices since 2000

From 1965 to 2000, the existing-home price index had been rising in parallel with income per household, subject to a fluctuation margin of $\pm 10\%$ (the « tunnel »). An exception, limited to one third of the territory (mostly the urban areas of Paris and of a few other cities such as Nice and Lyons), was the upsurge in home prices in the late 1980's, then their reversion to the « tunnel » during the 1990's.

From 2000 to 2010, home prices outgrew income per household, as well as rents, by 70%.

To purchase the same dwelling, a first-time buyer must borrow over 25 years in 2010 against 15 years in 1965 or 2000. Households' mortgage debt doubled in 10 years, from 30% of their income in the late 1990's to 58% in 2010. It would reach 85% of their income in 2030 were home prices to stay at their current level with respect to income per household.

These evolutions had at most a marginal counterpart in terms of « quality of housing service ».

Why ?

Changes in supply and demand can explain only a minimal part of the rise.

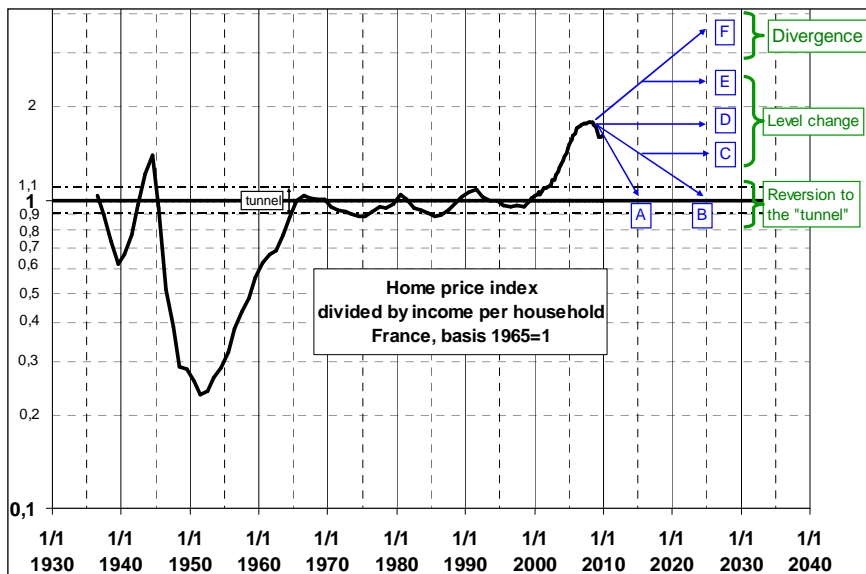
- *Supply.* The elasticity of home prices with respect to the number of dwellings being around -1 to -2, the construction of 300 000 additional dwellings would have decreased home prices by only 1% to 2%. Moreover, had changes in supply and demand impacted home prices, they would have also impacted rents – but the fact is that the latter grew in line with income per household.
- *Aging.* The low rental return accepted by investors is sometimes explained by a newly acquired apprehension of the fragility of their future pensions. Nevertheless, aging increases the proportion of households over 56 years old, threshold below which households are net buyers and beyond which they are net sellers; this should rather contribute to lower prices.
- *Foreigners and other explanations.* Purchases, net of sales, by foreigners have remained marginal at the national level (despite local exceptions), and the decrease in the number of persons per household, having begun in the 1960's, is nothing new.

Changes in mortgage conditions since 2000 explain only part of the surge in home prices: whereas a 1% decrease in interest rates allows a 6% home price increase, and a 5 year increase in mortgage duration allows a 12% home price increase everything else being equal, since 2000 the $\sim 2\%$ decrease in interest rates and ~ 7 year increase in mortgage duration explains at most half of the increase in home prices relative to income per household.

The surge in home prices relative to rents sharply decreased rental returns and consequently the expected total return of an investment in housing. It might be justified by **investors' arbitrage** against *bonds* (whose expected returns have been reduced by lower interest rates). Nevertheless, this is not true of arbitrage against *stocks* (whose expected returns are presently high *in the long term*, even though a price drop remains possible *in the short term*), except if one considers (which seems likely) that many investors, by "myopia", remember only the poor performance of stock markets over the past ten years, impacted by two crashes, and expect its repeat.

Which home price prospects in the long run ?

A growth in home prices durably higher than that of income per household (scenario F) seems excluded, since it would increase the share of housing in households' expenses to unsustainable levels.



Interest rates will eventually return to their long run level (say 3% per inflation). The impact of longer mortgage durations will be dampened by the additional monthly payments which households will have to disburse and which will lower their ability to purchase another dwelling.

For housing to keep its position in the risk/return hierarchy of the various investments, rental return (i.e. rent divided by price) will have to revert to its initial level. Since a sharp rise in rents with respect to income per household seems unlikely, home prices will have to revert towards their initial level with respect to income.

Thus, a « level change » (scenarios C, D and E), if it happened, would be very limited.

« Reversion to the "tunnel" » scenarios, such as A and B (as well as intermediate scenarios) are finally the only remaining ones. The A -"fast"- scenario assumes a 35% fall in home prices in nominal currency over 5 to 8 years. The B -"slow"- scenario assumes that home prices remain constant in nominal currency over 15 to 20 years, the reversion to the "tunnel" being slowly provided by the growth in income per household. Based on past patterns, the fast scenario seems more likely

than the slow one, which nevertheless should not be neglected. The adjustment might be delayed by the current low interest rates, until investors' myopia inverts its impact.