The London office market experienced a pronounced office cycle across the late 1980s and early 1990s, as did most other major financial centers. Rapidly increasing rents and capital values gave way to oversupply, rising vacancies, and falling prices. The consequences of the real estate crash fed back onto the broader financial system through adverse impacts on institutional investment performance, bank bad debt provisions, and asset values of the corporate sector. This paper, supported by the Real Estate Research Institute, is intended to improve understanding of the operation of office markets during this difficult period.

We have specified and estimated a model of the office market using annual data for the City of London over the 1977-95 period. The model consists of a rental adjustment equation, structural supply (completions) and demand (absorption) equations, and a series of identities that define the vacancy rate. Real effective rents respond to the gaps between equilibrium and actual rent levels and natural and actual vacancy rates. That is, rents are mean reverting. Construction responds to the rent gap when it is negative (when value exceeds replacement cost), and net space absorption is negatively related to rents and positively related to financial services employment growth. The construction and absorption relations feed back onto rents through their impacts on the vacancy rate. Capital markets affect the space market through their impact on equilibrium rents (dependent on real interest rates), which affect both actual rents and construction. In general, the model explains the behavior of the market in response to those shocks, with the exception of the exceptional level of completions in 1989 that we attribute to “developer over-enthusiasm” facilitated by excess bank lending to real estate.

The model was tested by comparing dynamic simulation values to observed data. Recall that over the period of analysis, the City market experienced a major employment cycle and a sharp rise in real interest rates. The dynamic simulation represents a very stringent test of the ability of the model to capture this cycle and rise because any discrepancies between simulated and actual values are allowed to cumulate over the simulation period. The model tracks vacancy rates reasonably well over the 1986-95 decade, which is especially supportive because no separate vacancy equation was estimated.

The model was used to generate forecasts of market behavior starting from the still overbuilt 1995 conditions under three different scenarios. In the first, rents and vacancy rates are shown to converge toward their equilibrium values. In the second, a positive employment shock is seen to generate sharper reductions in vacancy rates and increases in rental levels. These impacts will be dampened eventually by increased construction. Finally, a decline in real estate interest rates has a less dramatic impact, lowering rents and increasing demand initially, thus leading to a reduction of the vacancy level back to the natural rate.