

The Irish Property Bubble: Causes and Consequences.

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While house price booms and collapses are common internationally, they are rarely catastrophic.

Ireland is unusual because its entire economy after 2000 came to be driven by a property bubble.

By 2006 construction accounted for 20% of GNP, banks had dangerous exposures to building and commercial property loans, and domestic wages had been driven to uncompetitive levels.

The rapid collapse of the bubble leaves us facing the prospect of cumulative falls in GNP of over 25%, unemployment above 15% by the end of the year, and no prospect of national recovery until wages fall to internationally competitive levels.

A simple model of Ireland since 1990.

During the 1990s Ireland experienced the Celtic Tiger: rapid employment growth driven by competitive labour costs.

As employment and income rose, house prices were driven up.

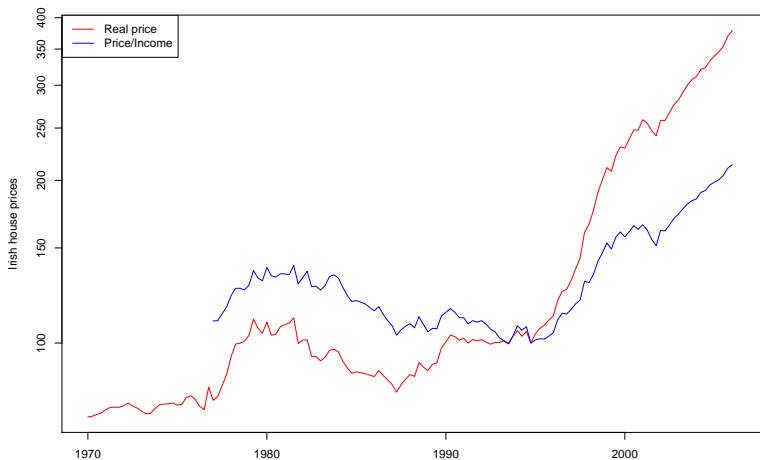
Construction rose and this increased employment, leading to further construction: multiplier accelerator.

As property prices rose, value of collateral increased and perceived risk of property lending fell: financial accelerator.

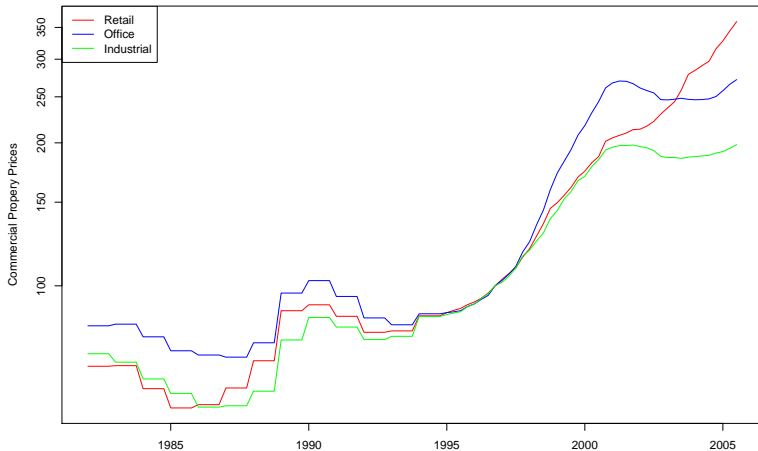
Effect of bank lending exacerbated by narrowness of Irish market: by increasing lending by 20% a handful of banks could drive up property prices by 20%: elements of pyramid scheme.

Market came to be driven by expectations of capital gains: rental yields below 4%.

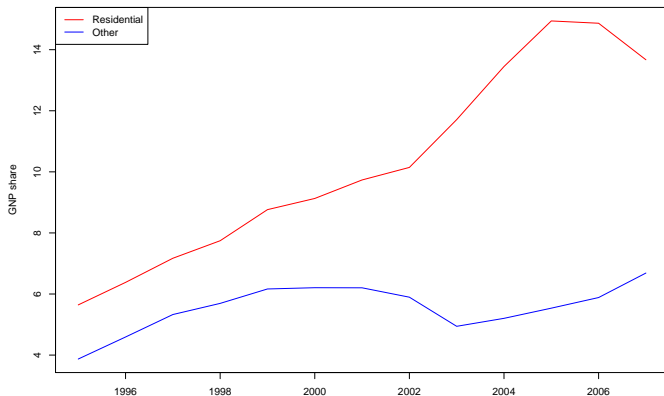
Irish House Prices.



Irish Commercial Prices.

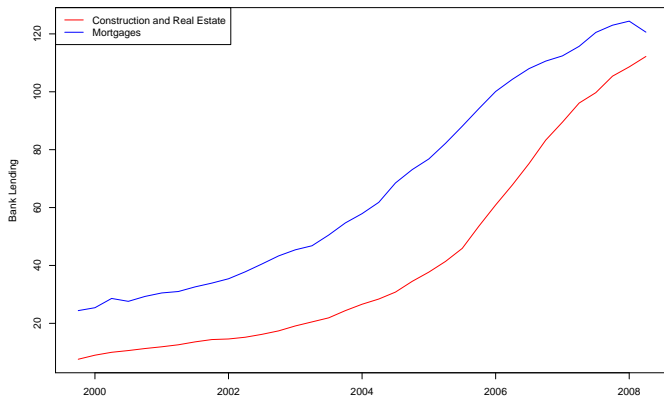


As prices rose, so did construction.



Construction: rise in employment from 165,000 in 2000 to 280,000 in 2008 (10% of employment to 13%). 85% Irish.

and Bank Lending.



- Rising employment drove wages up despite stagnant productivity.
Since 2000 Euro zone wages have risen by 10%, Irish wages by 30%.
- Government revenue heavily reliant on expenditure taxes: rising revenue allowed increased expenditure commitments.
- General property mania: why did Irish economics profession not see it coming?

Decline and Fall

Collapse long preceded international financial crisis: fall in sales of new and secondhand houses starting mid-2007.

Falls in prices so far.

Housing 30%.

Commercial 40%.

Final extent and duration of falls is macroeconomically immaterial, beyond the fact that the fall will be large and protracted.

Construction Collapse

Large supply of empty and unsold property, falling income and employment, and falling population.

Construction, but not demolition, of residential and commercial property will fall to zero for foreseeable future.

Collapse in construction employment, and manufacture of building materials. Also transport, wholesale and retail.

Low level of formal education of workers in these sectors makes retraining problematic.

Traditional safety valve of emigration closed because of international recession: possibility of social unrest from mass unemployment.

Banking Collapse.

€110 Bn lent to builders and developers.

Typical US regional collapse: 20% loss.

Narrowness of Irish market increases risk of substantially larger losses.

Guarantees of Anglo and Nationwide liabilities have strong chance of being called in next 21 months.

Extent of house price falls.

Rental yield at peak of bubble 4%.

Equilibrium around 8%, but rents have fallen by 25% so far: implies price falls of around 60% from peak.

Prices often overshoot: fall of 70% to bring 10% yield.

However, this assumes rest of economy continues to function normally.

- Collapsing employment implies many will be unable to meet mortgages, leading to forced sales at all levels of market. Many heavily indebted households will disappear abroad.
- Liquidation sales of unsold stock by bankrupt builders.
- Many households, including the very wealthy, that invested in apartments and commercial property will be forced to sell all assets to cover debts.

Internationally unprecedented falls of 80% or more are therefore a real possibility.

Do not seek to maintain prices or output above equilibrium levels

Abolish stamp duty, and introduce local government tax.

Compile proper price and quantity statistics.

Bankruptcy law.

Only way to restore competitiveness is by substantial nominal wage cuts.

Public sector needs minimum of 10% cut for all workers, up to 20% for the highest paid.

Send signal that Ireland is serious about recognising its mistakes and dealing with them.