Irish Fiscal
Advisory Council

Analytical Note No. 1:

June 2014

House Price Risks

Eddie Casey

© Irish Fiscal Advisory Council 2014
This Analytical Note was originally published as part of the June 2014 Fiscal Assessment Report

This report can be downloaded at **www.fiscalcouncil.ie**

ANALYTICAL NOTE 1: HOUSE PRICE RISKS

Irish house prices have risen sharply in recent quarters. The pace of the turnaround has led some to question its sustainability and whether there is evidence of another asset price bubble in the making. Given the knock-on implications for the sustainability of both macroeconomic growth and government revenues, this note looks at house price risks. In light of recent experiences, improvements to data availability, particularly for new household numbers and available housing supply, could be made and authorities should ensure that policy responses have the correct orientation to address any emergent risks.

Having more than tripled in the period 1994 to 2007, real average property prices in Ireland underwent a dramatic correction. Real mix-adjusted residential property prices fell by 52 per cent from their 2007 peak, remaining 49 per cent lower by end-2013 (see Figure N1 summary indicators).[1] More recent price developments indicate a stabilisation: Dublin has recorded five consecutive quarters of annual increases and the first increase outside of Dublin for six years came in early 2014.

ASSET CONSIDERATIONS

Apart from fundamental factors such as incomes, supply and demographics, key factors affecting house prices relative to rents are what might be deemed “asset considerations”. These arise due to the fact that housing represents an investment asset as well as a consumer good. In this context, price expectations and interest rates are key influences with respect to the cost of home ownership. The User Cost of Capital for Housing (UCCH) attempts to compare all relevant housing costs against expected price rises. When nominal interest rates are low relative to expected house price inflation, this signals a negative cost associated with housing ownership. Significantly negative user costs are often associated with speculative bubble-type behaviour, as was the case in Ireland prior to the crash.

Measuring price expectations poses some difficulties, but one proxy is to use recent historical changes. Effectively, we assume price expectations are backward-looking (as in Browne *et al.*, 2013). Figure N1 takes annual average house price changes as a proxy, similar to Duffy (2011), implying that one-year ahead expectations for national house prices would be for a rise of almost 4 per cent in early 2014. Another way to capture expectations is through surveys. Lyons (2014) highlights survey results from Daft.ie, showing respondents’ expected change in house prices over the next twelve months. Surveys covering 2012-2014 show expectations gradually recovering. Respondent expectations for Dublin are for a 6 per cent rise for the twelve months from March 2014 while, outside the capital, expectations are for a stabilisation in prices.

---

[1] To measure the change in the average level of prices paid for residential properties sold in Ireland, the CSO use mix-adjustment to discount the effects of varying property characteristics. This approach is available for data from 2005 on.

Whichever measure of price expectations is used, user costs appear to have diminished of late. This signals a more benign housing cost environment. Housing valuation ratios comparing prices to rents or disposable incomes have also fallen sharply. These metrics point to a nascent recovery in house valuations, although both remain over 40 per cent below peak levels. Historically, real housing price declines tend to stretch out over five to six years, reversing much of their previous run-up (see Ahearne *et al*., 2005; Reinhart and Rogoff, 2009). However, Irish house prices, at their trough, had corrected to real levels last seen in 1998 – prior to what is considered the start of the bubble-period.[2]

CREDIT AVAILABILITY

Credit availability can serve a critical role in the fuelling of asset price bubbles, in that it can further promote a detachment of prices from fundamentals. Ireland's experience during the bubble-period demonstrated this behaviour. Growth rates in loans for house purchases averaged 23.4 per cent *per annum* over the period 1999-2007, compared to a Euro Area average of 10.4 per cent (ECB, 2009).

The housing market in recent years, by contrast, has witnessed a paucity of new lending. Net mortgage lending saw average annual declines of 2.4 per cent in 2013, with outstanding loans as a share of disposable incomes falling to early-2005 levels from a 2008 peak.[3] Looking at just new lending in 2013, first-time buyer and mover purchaser mortgages fell by 5.1 per cent in number and by 4 per cent in value, year-on-year. This follows a rebound in 2012 from a very low base – 2012 mortgage loans were equivalent to just 15 per cent of their 2005 number. The 2012 increase was partly spurred by the ending of mortgage interest relief for first-time buyers in December. Looking ahead, continued financial sector deleveraging and the withdrawal of a number of lenders from the Irish market may constrain new lending. Comparing Residential Property Price Register transactions and Irish Banking Federation (IBF) drawdown data might suggest a greater share of non-mortgage financed purchases were evident in 2013, including those of returning expatriates, new immigrants and non-residents, or those who held off buying in the latter stages of the bubble period.[4]

SUPPLY CONSTRAINTS

Recent price appreciations may be interpreted in a number of ways. On the basis of the data presented here, which is by no means comprehensive, a detachment from long-run fundamentals or an appreciation founded primarily on credit expansion may not provide sufficient explanation. A reversal in some over-correction may be quite likely, however, while supply constraints are also likely to be key drivers. The Housing Agency (2014) indicate that the latter may be a foremost problem in Dublin areas, which are expected to require roughly 7,500 additional houses *per annum* over 2014-2018. Completions in 2013 for Dublin as a whole, however, were less than 1,400. At a national level, the ESRI analyse a range of demographic scenarios for the next fifteen years, suggesting a need for at least 25,000 new dwellings *per annum* to meet ongoing demand, although precise estimates of the current vacant housing stock are not provided. While housing starts and Construction Purchasing Managers' Indices (PMIs) point to some supply expansion more recently, these originate from a very low base. Supply pressures could be expected to alleviate gradually as the sector recovers and provided that any constraints associated with new developments begin to ease.

---

[2] Lyons R., and J. Muellbauer, in a forthcoming paper entitled "*Explaining the bubble: House prices, user-cost and credit conditions in Ireland, 1975-2012*", provide a thorough analysis of the various phases of Irish house price dynamics over the period 1975 to 2012.

[3] These figures are net of loan repayments.

[4] Comparing these datasets to arrive at a share of cash transactions is problematic as IBF figures may include self-build mortgages with no corresponding transactions. Similarly, single transactions on the CSO's Residential Property Price Register may refer to multiple units.

NEED FOR IMPROVED DATA AVAILABILITY AND ANALYSIS

Even if supply issues are at the core of recent appreciations, the authorities should remain vigilant. Careful consideration should be given to monitoring risks of possible future bubbles, especially as trends now suggest reduced user costs. Greater awareness of risks would be well served by improving data availability with respect to regional household numbers as well as current and projected housing stocks. More detailed fundamental analysis of the housing market, if made publicly available, should also limit risks of price growth expectations becoming dislodged from fundamentals.

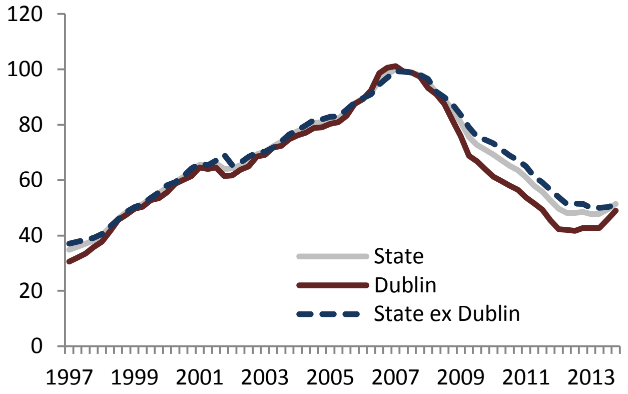
Other pre-emptive measures to limit the risk of future bubbles from forming might build on improved data and analysis by addressing barriers to supply responses, especially in areas of high demand and where suitable land may be available for development. Authorities should be cautious that, in responding to any perceived housing problems, price pressures are not fuelled even further such that these become ingrained in expectations. It is also important to ensure that the Central Bank has the necessary micro- and macro-prudential tools in place to control credit growth in the event that bubble-type dynamics take hold. Similar scope for a prudential role in fiscal policy should also be explored further (i.e., property-related tax policies could be used if risks of future bubbles were to emerge). The Council will continue to monitor various indicators to help assess whether grounds for concern exist with respect to housing market trends.

Figure N1: Ireland: Housing Developments

Real house prices remain well below their peak, having returned to 1999 price levels...

Real Residential Property Prices (HICP adjusted)

Index: Q1 2007=100

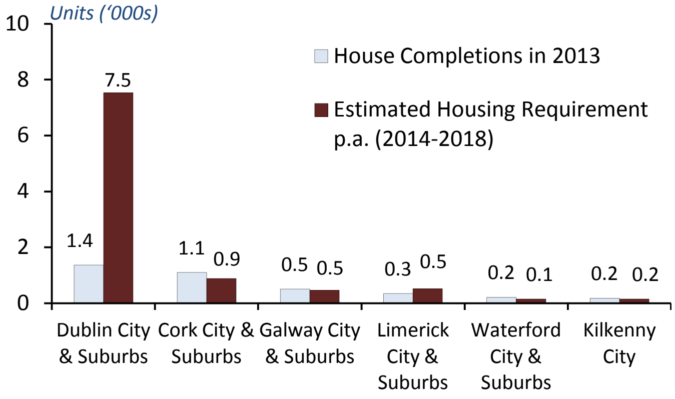


Sources: ESRI/PTSB; CSO.

...while supply pressures appear to be most prevalent in Dublin

Estimated housing requirements & completions

Units ('000s)

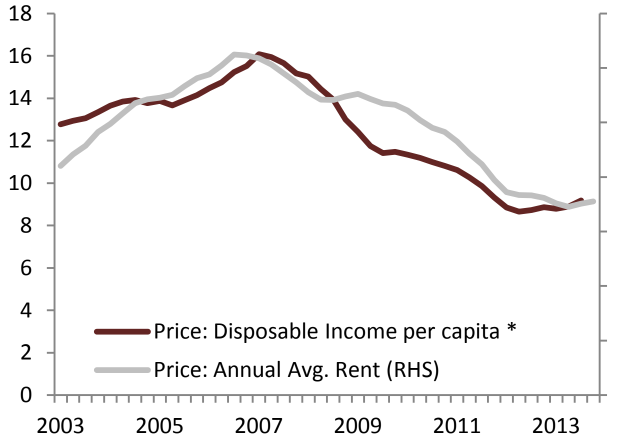


Sources: Housing Agency; DoECLG.

Note: Completions cover rural + urban settlements; requirements only cover urban settlements of 1,000 persons or more.

Typical housing valuations also remain well below peak levels...

Housing Valuation Ratios

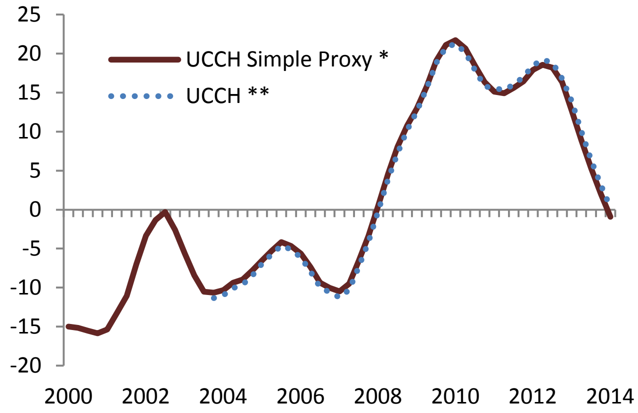


Sources: ESRI/PTSB; CSO.

*Average house prices divided by moving 4-quarter sum of adjusted personal disposable income per capita.

...but more favourable user costs have re-emerged as price expectations improve

User Cost of Capital for Housing (UCCH)



Sources: Central Bank of Ireland; CSO; ESRI/PTSB.

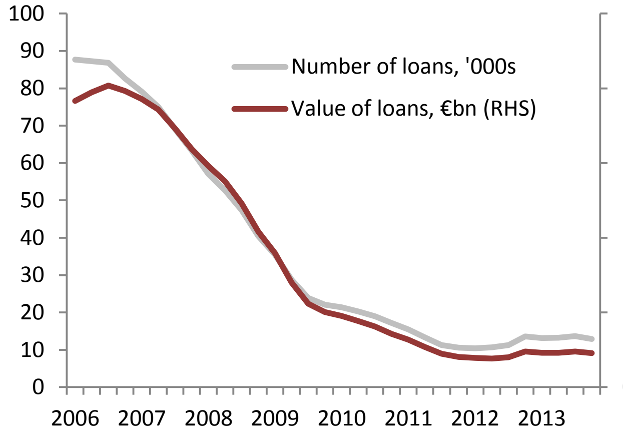
* New mortgage interest rates less annual price change for past 4Qs.

**Includes first-time buyer taxes/subsidies; down-payments; deprec / maint.

New lending remains at levels far below respective peaks...

Annualised Residential Mortgage Lending

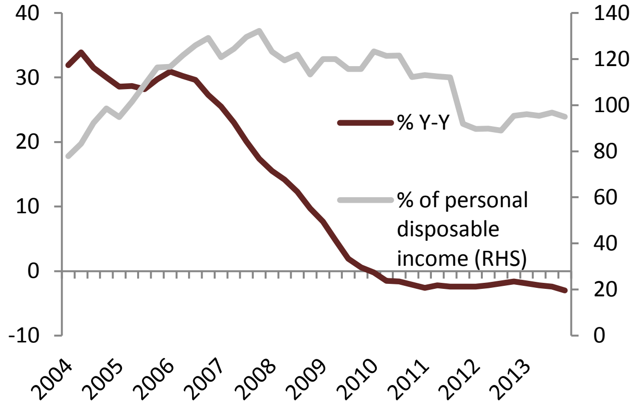
First-time buyer and mover purchaser loans



Source: IBF/PwC Mortgage Market Profile.

...and net lending is still declining. Outstanding lending as share of incomes has returned to 2005

Loans to Irish Households for House Purchase



Sources: Central Bank of Ireland; CSO.

BIBLIOGRAPHY

Ahearne, A.G., J. Ammer, B.M. Doyle, L.S. Kole and R.F. Martin (2005). "House Prices and Monetary Policy: A Cross-Country Study", Board of Governors of the Federal Reserve System, International Finance Discussion Papers No. 841. Available at: http://www.federalreserve.gov/pubs/ifdp/2005/841/ifdp841.pdf

Browne, F., T. Conefrey and G. Kennedy (2013). "Understanding Irish house price movements - a user cost of capital approach", Central Bank of Ireland, Research Technical Paper. Available at: https://www.centralbank.ie/publications/Documents/04RT13.pdf

Duffy D., (2011). "User Cost and Irish House Prices", ESRI.

ECB (2009). "Housing Finance in the Euro Area, March 2009", Structural Issues Report.

Housing Agency (2014). *Housing Supply Requirements in Ireland's Urban Settlements 2014-2018*. Available at: https://www.housing.ie/Housing/media/Media/Publications/Future-Housing-Supply-Requirements-Report.pdf .

Lyons, R. (2014). *House Price Expectations: From Bust to Boom?* Presentation at Irish Economic Policy Conference, Institute of Bankers, January.

Lyons, R. and Muellbauer, J. (2013). "Explaining the bubble: House prices, user-cost and credit conditions in Ireland, 1975-2012", draft June 2013.

Reinhart, C.M. and K.S. Rogoff (2009). "The Aftermath of Financial Crises", *American Economic Review*, vol. 99(2), pages 466-72. Available at: http://www.nber.org/papers/w14656