Irish House Prices: Gliding into the Abyss?

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Offering no evidence except wishful thinking, estate agents and politicians assure us that we have nothing to worry about: the Irish housing market can look forward to a soft landing. If, however, we look at what has happened to other small economies where sudden prosperity and easy credit drove house prices to absurd levels, we should be very worried indeed.

If the experiences of economies like ours are anything to go by, we may be looking forward to large and prolonged falls in real house prices of the order of 40–50 per cent, and a collapse of house building activity.

Two housing booms are especially sobering for being so similar to ours: Finland in the 1980s and the Netherlands in the 1970s. Finland boomed after oil was discovered off the coast in the mid-1980s. With low interest rates and loans available for the asking, house prices soared.

Then, as the Soviet Union collapsed, unemployment rose and house prices started to fall, creating problems first for builders, then for home owners, and finally for banks. The Finnish banking system effectively disintegrated under the weight of bad housing loans, and had to be rescued, at huge expense, by the state. Unemployment rose from 5 to nearly 20 per cent. The real price of houses fell by over 40 per cent.

A Finnish discussant in an online board captures the spirit of the times. "In 1991, a friend of mine offered about $120,000 on a lovely house that had cost

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Netherlands, 1978–85	-50%
Finland, 1989–95	-46%
Japan, 1991–present	-43%
Norway, 1987–93	-39%
Switzerland, 1990–2000	-39%
New Zealand, 1980–85	-37%
Denmark, 1978–82	-36%
Sweden, 1979–85	-35%

Table 1: Falls in house prices.

$240,000 to build just three years previous. With over 20% unemployment, it was not surprising that the owner and his wife had both lost their jobs and were about $12,000 behind in their mortgage payments. Obviously, the owner refused my friend's offer, but the bank manager called back in just a few hours with a counteroffer: he'd accept the $120k if my friend also paid the delinquent $12k in mortgage payments. That's it, the other family was left without a house and still owed the bank about $70k."

The Netherlands shows how house prices can collapse even when banks are large enough to absorb large losses. In the 1970s, thanks to the discovery of natural gas, the Dutch economy was the wonder of Europe. Once again, low interest rates and relaxed lending criteria led to a housing boom. Then in 1979, the international recession bit, interest rates rose and prices tumbled. By 1985, the real price of houses had fallen by 50 percent.

Table 1 shows some of the major house price collapses in the past 30 years. Among industrialized economies, there have been 16 episodes where the real price of houses has fallen by more than 20 per cent. Unlike stock market crashes, house price crashes are typically prolonged, lasting from 4 to 8 years.

There is an iron law of house prices. The more house prices rise relative to income and rents, the more they subsequently fall.

To see the iron law in operation look at Figure 1. It shows, for every indus-

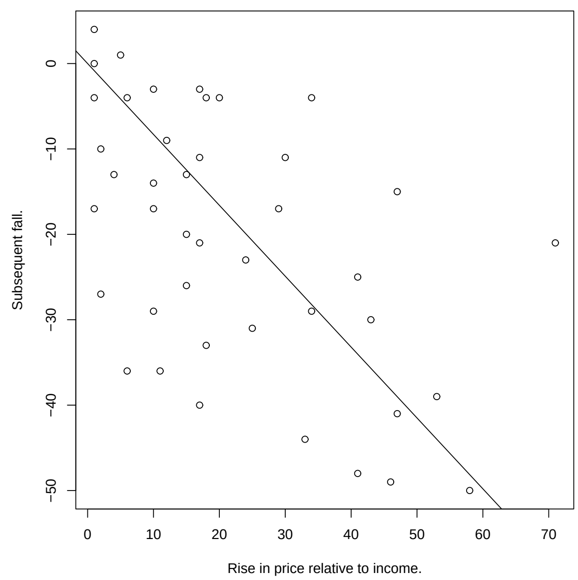

Figure 1: Rises in house prices relative to income and subsequent falls.

trialized economy between 1970 and 2000, how a rise in house prices relative to income is followed by a proportional fall. Economic theory predicts that house prices should be very volatile and prone to "rational frenzies", and that is what the data show.

But how about Ireland? Surely our house price rise is simply due to our rising income, and the shortage of houses in places where people want to live?

Neither reason is valid: while incomes have risen, house prices have risen faster. Since 2000, house prices have risen 30 per cent more than income. Similarly, were there any shortage of housing we would see rents rising as fast as house prices. In fact, compared with income, rents have actually fallen since 2000.

The importance of what has happened to rents cannot be over-emphasized. If the housing boom were due to rising incomes and more people forming households, what economists call fundamentals, rents would also have risen. The fact that rents have fallen shows conclusively that our housing boom is a bubble, pure

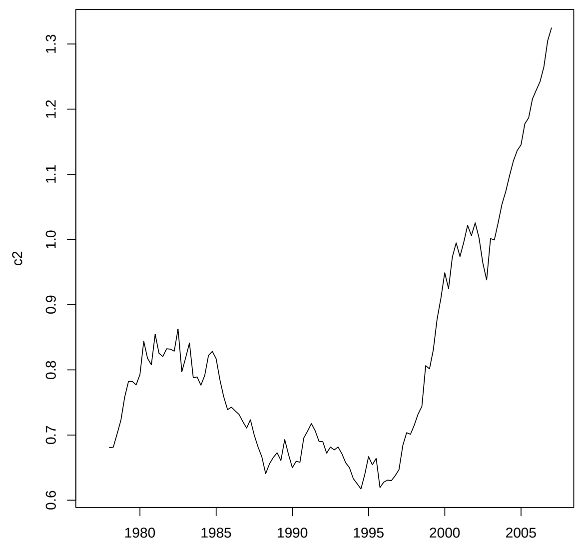

Figure 2: Ratio of Irish house prices to disposable income.

and simple.

But why can't we just have our soft landing, where prices stay fixed or rise slowly for a while? Definitely not: a soft landing is not so much unlikely as contradictory.

Suppose that house prices really were expected to level off. Then the owners of the tens of thousands of empty houses and apartments can expect no further capital gains, and should cash in their investments. Why pay a mortgage on an empty apartment that has stopped rising in value? As speculators rush for the exit, prices will crash.

Secondly, if prices stop rising, it makes no sense to buy a house. Compared with mortgages, rents are ridiculously low. For €2,000 a month you can pay a mortgage on something in a muddy field on the wrong side of Celbridge, without nearby shops or schools, and a 2 hour commute to Dublin. For the same amount you can rent a million Euro house in southeast Dublin, close to the Dart line and surrounded by good schools. Once people put off buying in favour of renting, prices will not stabilize, they will crash.

Just as rising prices generate self-fulfilling expectations—you have to buy now before prices rise further, causing prices to rise—so falling prices generate their own momentum.

Buying in a falling market is a guaranteed way to lose a fortune. Even if prices fall by only five per cent, a €500,000 house on which you paid 10% in stamp duties and fees will leave you €75,000 poorer.

It is a lot less nerve wracking to sit things out and rent for a year or two. And when everyone does that, prices fall further.

How far are prices likely to fall when the bubble bursts? If we suppose, optimistically, that prices were more or less in equilibrium with income and rents around 2000, then house prices are about 25 per cent over-valued now. Unfortunately, when house prices fall they generally overshoot and end up undervalued. It is not implausible that prices could fall, relative to income, by 40–50 per cent.

House prices can halve relative to income without huge falls in the selling price of houses. If the price of houses falls by 5 per cent each year, while prices rise by 3 per cent, and real incomes by 2 per cent, then after 5 years house prices will have fallen relative to income by 50 per cent.

This is an average: some places will have larger falls, others smaller. After the last British housing bubble, for example, when prices fell on average by 10 per cent, prices in East Anglia fell by 40 per cent.

The ratio of prices to rents is a measure of the return to investing in housing. Rossa White has shown the ridiculous levels of prices compared with rents in different parts of Dublin (his report can be downloaded from www.davydirect.ie). In Sandymount, for instance, annual rent is barely 1 per cent of purchase cost.

This is a price-earning ratio above Google's, and can only be justified if we believe that future incomes will rise forever at around 6 per cent a year. Is this possible? Well, if it is, in 25 years time we can look forward to being almost 3 times as rich as the United States.

Rossa White's estimates of rent to price ratios show that the middle of the market in Dublin is less seriously overvalued than the top and the bottom. International experience shows that the worst houses in the worst places always experience the worst falls.

We can expect the biggest falls in apartments as speculators try to sell before getting roasted alive, and in dismal outlying towns with long commutes to Dublin. And at the top of the market, where prices need to fall by perhaps two thirds to bring them back into line with rents.

House price collapses affect the wider economy in three ways. First, households lose wealth and start to repay loans instead of spending. Secondly, banks reduce lending as they lose money on bad loans.

While banks are reluctant to foreclose and try to reschedule instead of taking an immediate loss on a loan, borrowers with negative equity will walk. For many with hundred per cent mortgages on apartments that have fallen in value by €150K (the sort of falls that have occurred in Washington, DC lately), it will make sense to leave the keys in the door and relocate to London for a while.

The third, and potentially catastrophic, effect of a house price fall is on building activity: more houses get built as prices rise, and fewer as prices fall. As our exports have stalled since 2000, the Irish economy has come to be entirely driven by house building. Between building new houses and selling existing ones, housing now generates almost one fifth of our national income. In effect, the Irish economy is now based on building houses for all the people that have got jobs building houses. Economists call this a multiplier-accelerator process, and it is very unstable.

To see how rapidly a building boom can evaporate we can look at Arizona. Rising population led to a building boom that should sound familiar: people queuing overnight to buy houses in new developments; builders increasing prices by a few thousand a week; people paying a down-payment of $5,000 on a house and selling it on for a $100,000 profit a few weeks later.

A few months ago, however, rising interest rates brought it all to a halt. Despite incentives like free swimming pools and fancy kitchens, and even at prices below the cost of labour and materials, builders cannot sell, leading to vast empty developments that have been called the new ghost towns of the West.

The parts of America that had the biggest housing boom are now experiencing falls in house prices of around 15 per cent. The United States is now facing a possible recession as house building falls towards its usual bust level of around 4 per cent of national income, from a boom level of 6 per cent.

In Ireland, if and when the fall occurs, it will be from around 18 per cent of national income. We could see a collapse of government revenue, and unemployment back above 15 per cent.

We have spent the last 5 years learning to believe that exports and competitiveness do not matter, and that we can get rich by selling houses to each other. We are likely to spend a painful few years as we unlearn that lesson.

Pilots define a soft landing as one that you can walk away from. Looking at the price collapses in places like Finland and the Netherlands, and the building bust in Arizona, Ireland could be heading for something closer to what they call CDIT: controlled descent into terrain. You are happily descending through cloud, thinking yourself at a safe altitude, until suddenly you smack into a hillside.