

GROWING RISK OF A DOWNWARD CORRECTION TO THE HOUSING MARKET

- Between 2001 and 2003, Irish growth came out below trend and was much weaker than we have come to expect of this Celtic tiger. The slowdown would doubtless have been even sharper if the residential property sector had not continued its rapid expansion.
- All factors driving up housing demand have played in recent years. The improvement in creditworthiness has fuelled demand – potentially high due to strong demographic growth –, along with the shortage of homes from the start, triggered an even greater surge in prices than other countries in which a similar acceleration occurred (Netherlands, Australia, Spain and the United Kingdom).
- Although the market seems to be overvalued, the problem is not as old – or as easy to prove – as one might think. Several factors could possibly trigger a downward correction: higher interest rates (not before Q2 05), an exogenous shock affecting the key variables of employment, income and confidence, or an escalation in the number of homes for sale.

The building sector softened the blow in 2001/03

From an average rate of around 10% per year in the second half of the 1990s, Irish GDP growth dropped below 5% a year between 2001 and 2003. This dramatic slowdown arose when the global economy and international trade screeched to a halt, hitting one of the world's most open economies in terms of trade and investment flows¹.

The situation would have been even worse if the residential construction sector had not continued to register remarkable growth. According to the Department of the Environment², the volume of production in this sector rose by 11.4% in 2003, after a 2.3% increase in 2002. More generally, home building accounted for 13% of GDP in 2003, well above the 6% of 1990. The construction sector also helped shore up domestic demand through the number of jobs it created. Between the end of 1998 and the second quarter of 2004, nearly 84,000 people found new work in this sector, representing almost a quarter of all new positions created over the period.

Demand was underpinned by the substantial increase in purchasing power...

Formidable growth in the residential property sector came about because all factors driving up housing demand materialised at the same time: relaxation of solvency requirements, tax incentives, buy-to-let and demographic and socioeconomic factors.

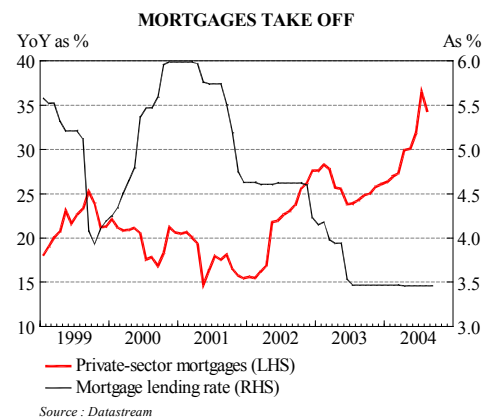
The huge rise in household purchasing power was the primary reason for improved solvency, pushing up demand for homes. Between 1995 and 2002, gross disposable income climbed at a rate of nearly 6.5% per year. Purchasing power did go through a soft patch in 2003 (+0.5%) but stronger earnings growth (the central bank is forecasting 4.25% next year) and higher employment mean we can expect a pick-up. The OECD is projecting annual increases of 4.1% in 2004 and 4% in 2005. Rising purchasing power should therefore provide fresh support to demand.

...low interest rates...

The relaxation of solvency requirements came about as a result of deregulation and financial innovation in the 1990s, more recently helped by the European Central Bank's accommodative monetary policy since 2001. Mortgage lending rates fell to 3.5% in 2004, compared with 6% at the beginning of 2001. In real terms, Irish

interest rates are now the second lowest in the world, behind Spain's.

Low interest rates encouraged mortgage borrowing with outstanding debt soaring by over 25% in 2003 to stand at nearly EUR 55bn (40.8% of GDP).



The trend in 2004 is not one of a downturn as the year-on-year rate of increase is still greater than 30%. Household debt has doubled in 10 years to reach nearly 95% of gross disposable income at the beginning of 2004, of which approximately 80% was mortgage debt.

...tax incentives...

Tax incentives have added to the benefits of lower interest rates: mortgage interest payments are tax deductible, there is no council tax or land tax, and capital gains on primary residences are no longer taxable. According to one OECD study³, these tax incentives represent the equivalent of one point in interest rates. Accordingly, Ireland is the second most generous country in terms of incentives to buy property, after the Netherlands (see p23).

...and strong demand from investors

Investors have also driven up demand with buy-to-let accounting for around 20% of new mortgages in 2003. This was also the reason for 28% of new home and 21% of old home purchases. Here again, the boom has resulted from tax incentives that the government reintroduced in 2002 after stopping them in 1998: tax deductible interest, lower land registry costs, reduction in capital gains tax.

¹ The degree of openness (sum of imports and exports of goods and services as a percentage of nominal GDP) exceeds 150% of GDP, compared with a eurozone average of around 70%.

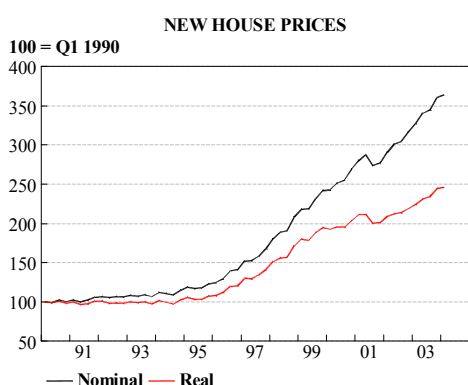
² Review of the Construction Industry 2003 and Outlook 2004–2006, August 2004.

³ Paul van den Noord, Working Papers n°356, OECD Economics Department.

Consequence: high pressure on prices

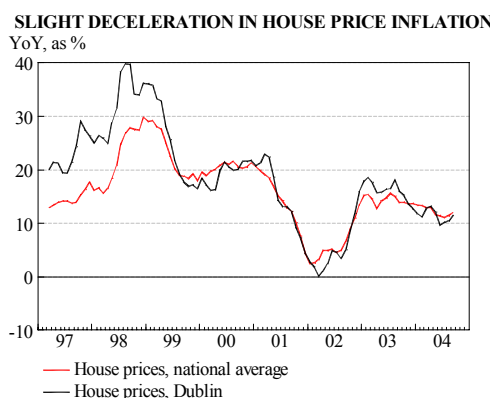
We have established that several factors contributed to improve households' solvency and to boost housing demand. These have had an even greater effect as potential demand was relatively high due to demographic considerations (high population growth, particularly among the 15-34 age group, migratory flows) and socio-economic factors (reduction in the number of occupants per household, from 3.7 in 1981 to 3.3 in 1995 and 2.9 in 2002).

Faced with this newly solvent demand, there were not enough homes to go around. At the start of the 1990s, the number of homes per 1,000 inhabitants was just 290, compared with 440 in Spain and 465 in France at the time. This completed the prerequisites for prices to soar, as happened in most countries⁴ but even more so in Ireland. The price of new homes, as measured by the Department of the Environment have duly risen by more than 250% in nominal terms and by nearly 150% in real terms since the beginning of the 1990s.



Sources: Datastream, The Department of the Environment, Heritage and Local Government (DoE)

This trend has faded a little recently. According to the permanent tsb price index (ptsb), house-price inflation on new homes came out at 7.8% for the first nine months of the year, slightly below the rate for the equivalent period of 2003 (9.4%).



Sources: Ecwin, permanent tsb

Even the year-on-year increase in house prices was down to 12% in September, compared with more than 13% at the beginning of the year. This gentle slowdown is relatively surprising given the further acceleration in credit growth (see above), but it may reflect difficulty in being able to afford property (especially first-time buyers) with existing house prices having sky-rocketed. According to Bank of Ireland, the annuity on a standard mortgage currently absorbs nearly 34% of

household income, compared with 27.4% in 1999, despite the historically low level of interest rates (which have stopped falling).

A downward correction is likely

The surge in prices obviously raises the possibility of a bubble. National and international authorities in charge of financial stability have recently contemplated this issue. Some economists prefer an approach based on an econometric model of the property market (error-correction model) combining certain supply-side factors such as the cost of construction and the cost of land⁵. By incorporating these supply variables, they have been able to show that current valuations for residential property are in line with the fundamentals: i.e. there is no bubble.

Although the IMF mentions these models in its latest report on Ireland⁶, it appears to criticise them by writing that the supply variables used are probably endogenous to the property cycle⁷. The organisation prefers a traditional asset value approach: the P/E ratio⁸. As with any asset, the price (P) of a property asset should, at any point in time (t), be equal to the asking price adjusted for future earnings flows (E), i.e. the fundamental value. This is equal to the sum of future expected rents minus maintenance and repair costs⁹. It transpires that the P/E ratio has reached record levels. Several factors may explain the rise in the P/E ratio. First, the drop in the real risk-free interest rate. This was a major reason for the exceptional P/E growth of the 1990s. However, it does not explain the recent increase as real interest rates have been relatively stable since 2000. Another possibility is that investors are expecting higher rental yields in the near future and/or are demanding less of a risk premium. In theory, medium-term rent growth is supported by income growth (4-5% in real terms). According to the Central Bank of Ireland, however, real rents rose by less than 1.5% between 1997 and 2003. Worse, rents – as measured by the subcomponent of the consumer price index – have fallen by more than 9% since their mid-2002 peak. This drop in rents may be due to the economic slowdown that has been sweeping through the country since 2001, and to the increase in the number of homes available (buy-to-let in particular). The recent economic bright spell may therefore be an encouraging sign for investors. As we await confirmation, though, the significant discrepancy between changes in house prices and in rents, as seen in the higher P/E ratio, is the most damning indictment that the Irish property market is overvalued.

Experts at the Central Bank of Ireland¹⁰ have admitted that a comparison between real estate P/E ratios and 10-year government bonds yields reveals a significant overvaluation in the first quarter. According to its own estimates, though, houses were not significantly overvalued before 2003.

⁵ See in particular: Kieran McQuinn "The Irish Housing Market: A Financial Stability Assessment", *Financial Stability Report 2004*, Section 3, September 2004.

⁶ IMF Country Report No. 04/349, November 2004.

⁷ In the IMF's opinion, the fundamentals can only explain around 80% of the price increase between 1997 and 2003 (see *World Economic Outlook*, September 2004).

⁸ Even if a P/E ratio approach is not perfect: failure to consider tax and regulatory changes, limited data, etc.

⁹ Due to a lack of available data, the IMF used a series of gross rents.

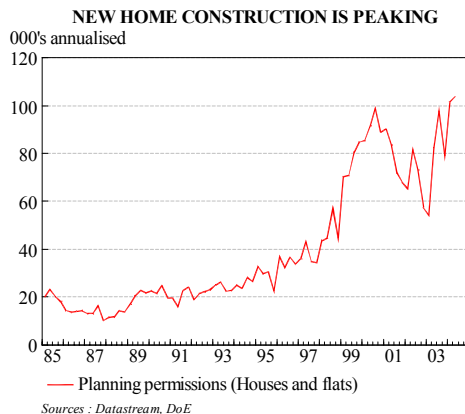
¹⁰ "The Irish Housing Market: Fundamental and Non fundamental Influences", *Financial Stability Report 2004*, Section 2, September 2004.

⁴ For an overview of the global housing market, see the *Monthly Economic Report for May 2004*.

Although there does appear to be a problem of overpricing, this is a more recent phenomenon and is therefore not as serious as we might otherwise have thought. Nevertheless, the longer current price trends continue, the worse the problem of overvaluation will become and the more painful future adjustments will be.

Against this backdrop of overpricing, the following factors could trigger a downward correction:

- as in other eurozone countries, the main risk of the bubble bursting lies in an **interest rate hike**, especially as the majority of Irish mortgages (70%) are at variable rates of interest, like in Spain and the United Kingdom. Higher interest rates would automatically increase the debt burden. The Central Bank of Ireland is now stressing that interest rates are "unusually low" and that households should be aware that they will rise. It also fears that many households underestimate the weight of future interest payments at a time when inflation is low. The ECB is unlikely to start bringing its monetary policy back to normal before the end of Q2 05 at the earliest, meaning that the credit and property bubbles may continue to expand. However, the upside is that, as in the United Kingdom, adjustments to the refi rate will no doubt be gradual, limiting the shock to household finances;
- **there may be excess supply.** Construction of new property broke all records in 2003. 68,819 houses were completed, bringing the total increase to 420,000 since 1995, i.e. nearly a third of all current homes (1,287,958 according to the 2002 CSO survey). The trend clearly remains upward for 2004. Indeed, given the number of building permits issued in the first half of the year –35,707 houses (+57.8% yoy) and 15,660 apartments (+36% yoy)– the Department of Environment's forecast of 83,000 homes (houses and apartments) completed in 2004 is likely to be surpassed.



The lack of homes at the beginning of the property boom may well justify this growth in supply, as do such factors as increasing demand for second homes, but the risk now is that supply is becoming excessive. Unless the number of people per household takes an even sharper downturn, which seems unlikely given Ireland's demographic structure, the current rate of construction will be unsustainable;

- **a sudden economic slump due to an exogenous shock.** As we saw at the beginning of this study, the Irish economy is very open and therefore vulnerable to an external shock. Potential crises are manifest: fresh surge in oil prices, sharp depreciation of the dollar, significantly slower growth in trade and investment flows in the wake of the US slowdown, hard landing in China, etc. The risk would then lie in the recessionary impact that such a shock would have on the economy in general, and on income, employment and confidence in particular.

The effects of the bubble bursting

If the property bubble were to burst, it would affect three areas: the Irish financial system, construction sector and consumer spending.

- **The effect on the Irish financial system.** 50% of banks' portfolios are concentrated on the property sector (residential and commercial). Financial institutions would therefore understandably ration credit in the event of a sharp drop in house prices, weighing on investment and consumer spending. According to one stress test carried out by the Central Bank of Ireland, the financial system has adequate capacity to absorb a modest fall in house prices;
- **The direct impact on the construction sector.** As we have seen, the construction sector has become essential to the economy and has been a major source of job creations over the recent period. It would suffer a drastic correction if prices were to fall, and will probably slow fairly sharply in the medium term anyway, given current excesses;
- **The impact on consumer spending.**
 - Indirect impact: the sudden slowdown in activity would cause prices to fall, especially in the construction sector, and this would have repercussions on employment and income, ultimately weighing on consumer spending. And, if the property bubble were to burst as a result of a hike in interest rates, households would suffer, forcing them to cut back spending and increase savings.
 - Direct impact. With property accounting for a growing percentage of household assets, lower prices would mean negative wealth effects, even if these seem to be limited in Ireland¹¹.

Abde-Razak BARKET
Tanguy SIMON- +33 1 42 14 29 72

¹¹ After financial deregulation in the 1990s, Ireland now has a large mortgage lending market. Mortgage equity withdrawal in particular has increased. In the absence of actual data, it is hard to say whether mortgage equity withdrawal has contributed to consumer spending, as it has in the United Kingdom. The rare studies available seem to suggest an absence of any strong link between house-price inflation and consumer spending in Ireland: see Pat O'Sullivan & Vincent Hogan, "Consumption and House Prices in Ireland", Bank of Ireland Private Banking.

All opinions and estimations included in the report represent the judgment of the sole Economics Department of Société Générale and do not necessarily reflect the opinion of the Société Générale itself or any of its subsidiaries and affiliates. These opinions are subject to change without notice. It does not constitute a commercial solicitation, a personal recommendation or take into account the particular investment objectives, financial situations.

Although the information in this report has been obtained from sources which are known to be reliable, we do not guarantee its accuracy or completeness. Neither Société Générale nor its subsidiaries/affiliates accept any responsibility for liability arising from the use of all or any part of this document.

Société Générale may both act as a market maker or a broker, and may trade securities issued by issuers mentioned in this report, as well as derivatives based thereon, for its own account. Société Générale, including its officers and employees may serve or have served as an officer, director or in an advisory capacity for any issuer mentioned in this report.

Additional note to readers outside France : The securities that may be discussed in this report, as well as the material itself, may not be available in every country or to every category of investors.

