Ireland's Property Market – How did it come to this? And where to next?

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Challenges Facing the Irish Economy

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By way of introduction…

- Today's theme: importance of internet and social media to modern commentators (and academics?)

- My own benefit
  - ronanlyons.com
  - @ronanlyons on twitter
  - LinkedIn even got me a job!

Today is based around four “stylised facts”

- Real estate is a bad investment
- The property market is imperfect
- Accommodation is a service
- Governments can manage the property market

Context: We've seen it all before…

- Price of Mountjoy Square townhouse after construction in 1791:
  - £8,000

- Price of Mountjoy Square townhouse in 1849:
  - £500
- Fall: 94%

Outline

- **Real estate is a bad investment**
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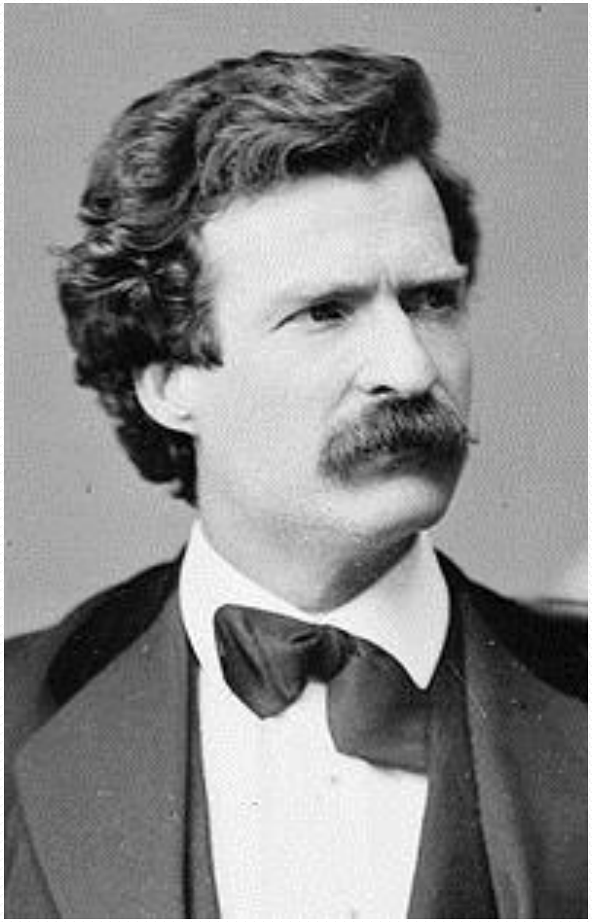
But surely…

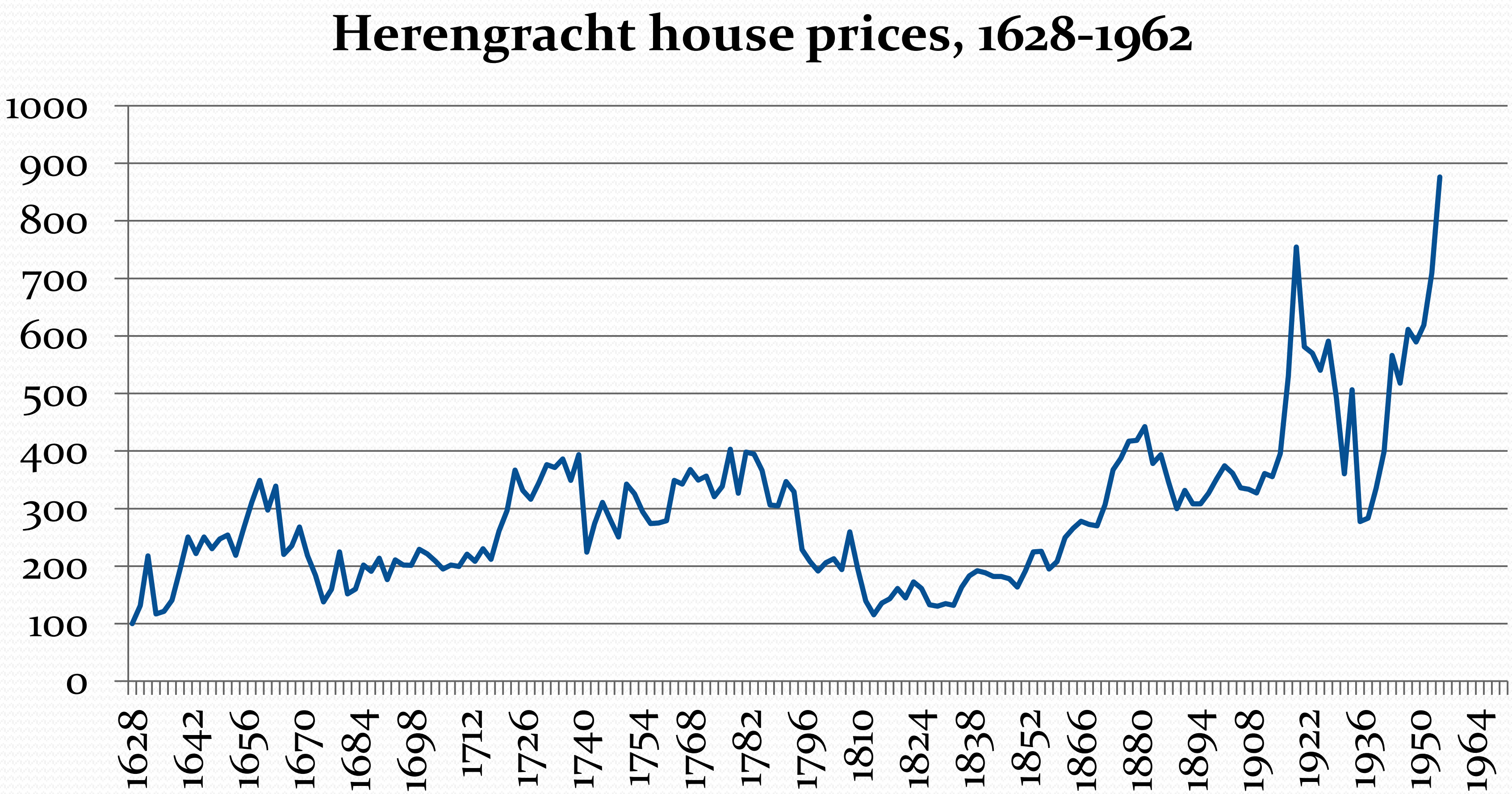
“Buy land – they’re not making it anymore!”

Mark Twain



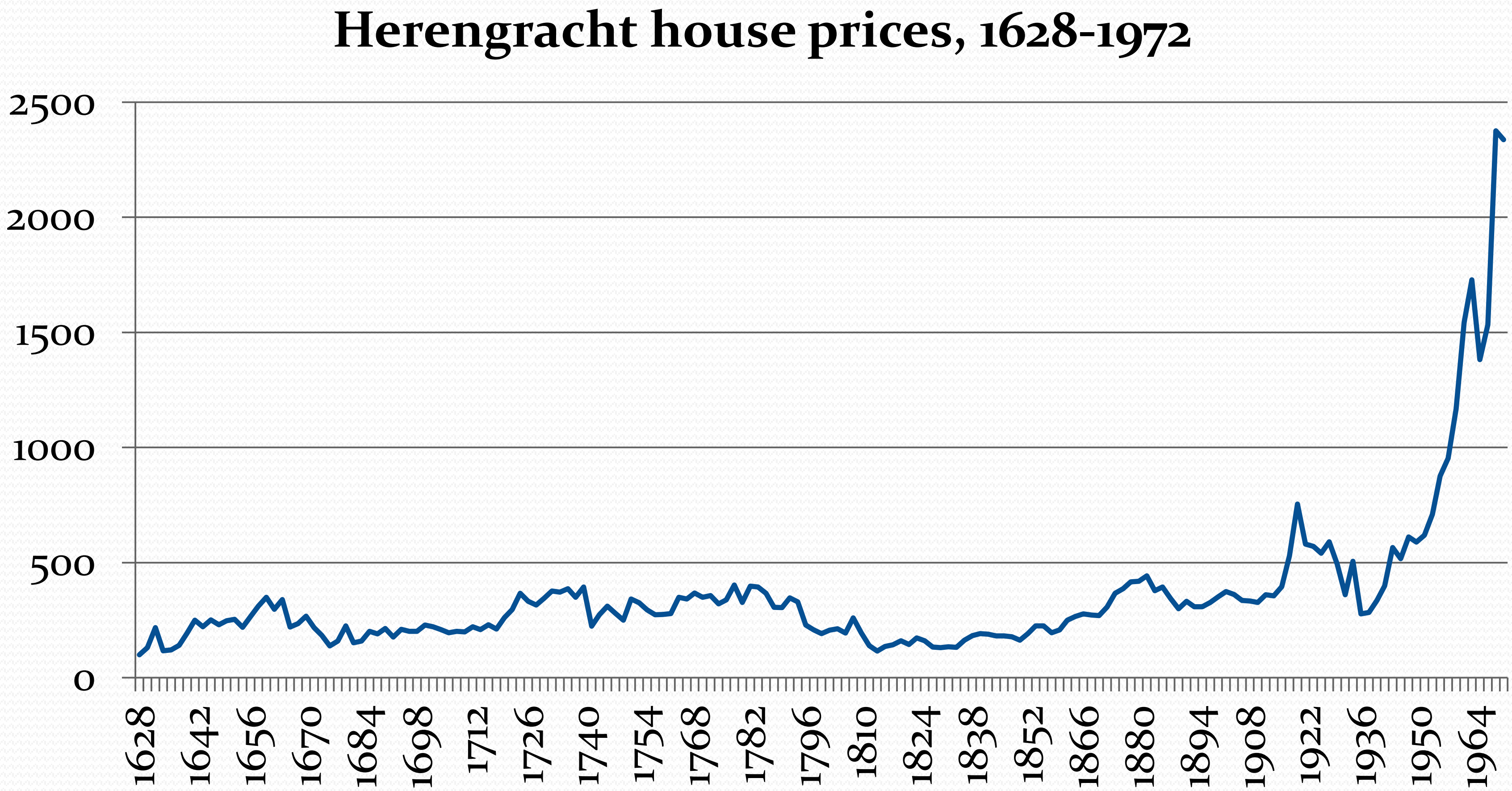
This is Amsterdam's Herengracht…

On the face of it, house prices do seem to rise at least some of the time



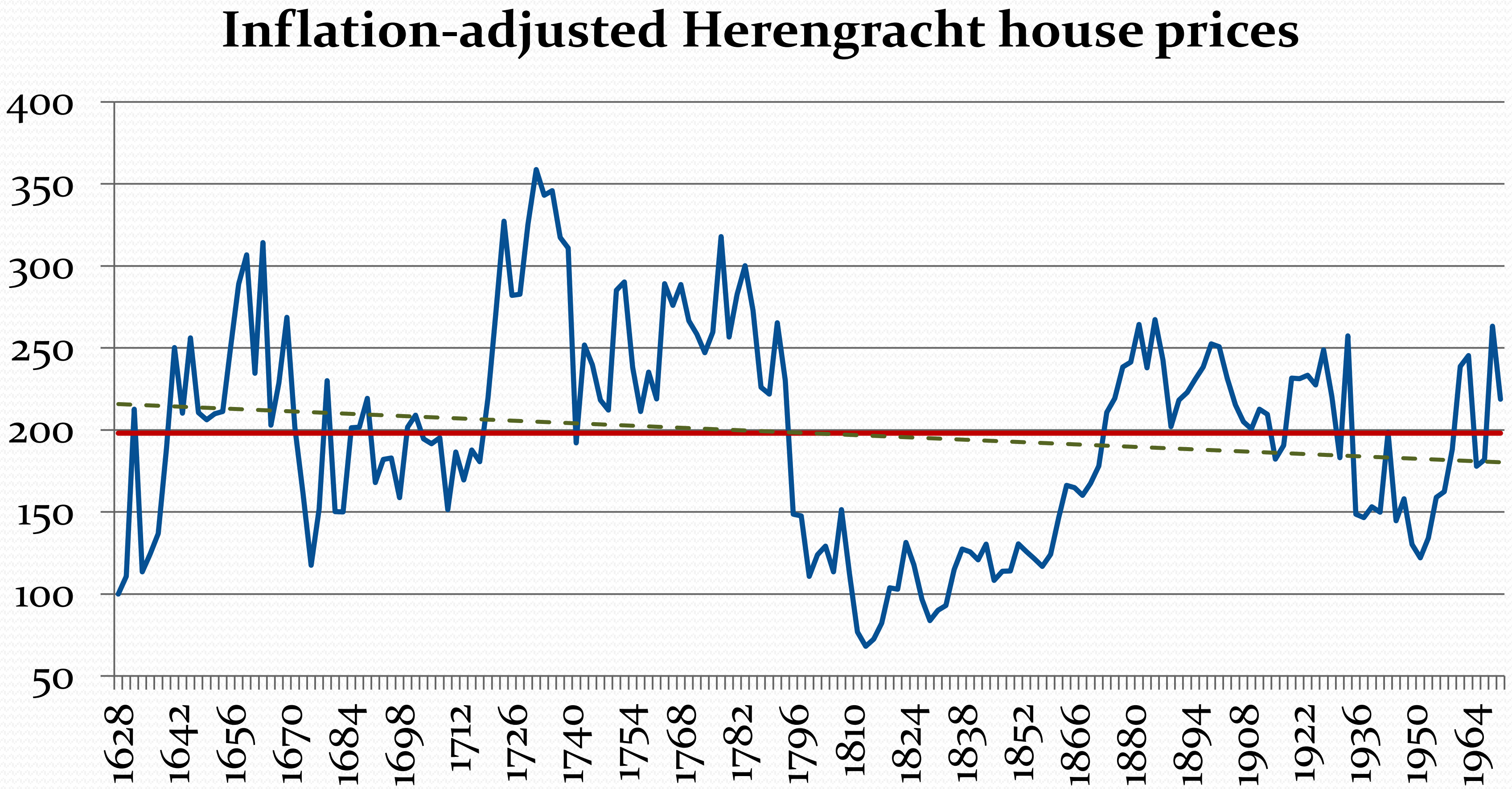
1628 = 100 – Source: Piet Eichholtz

…and rose dramatically 1950-1970



1628 = 100 – Source: Piet Eichholtz

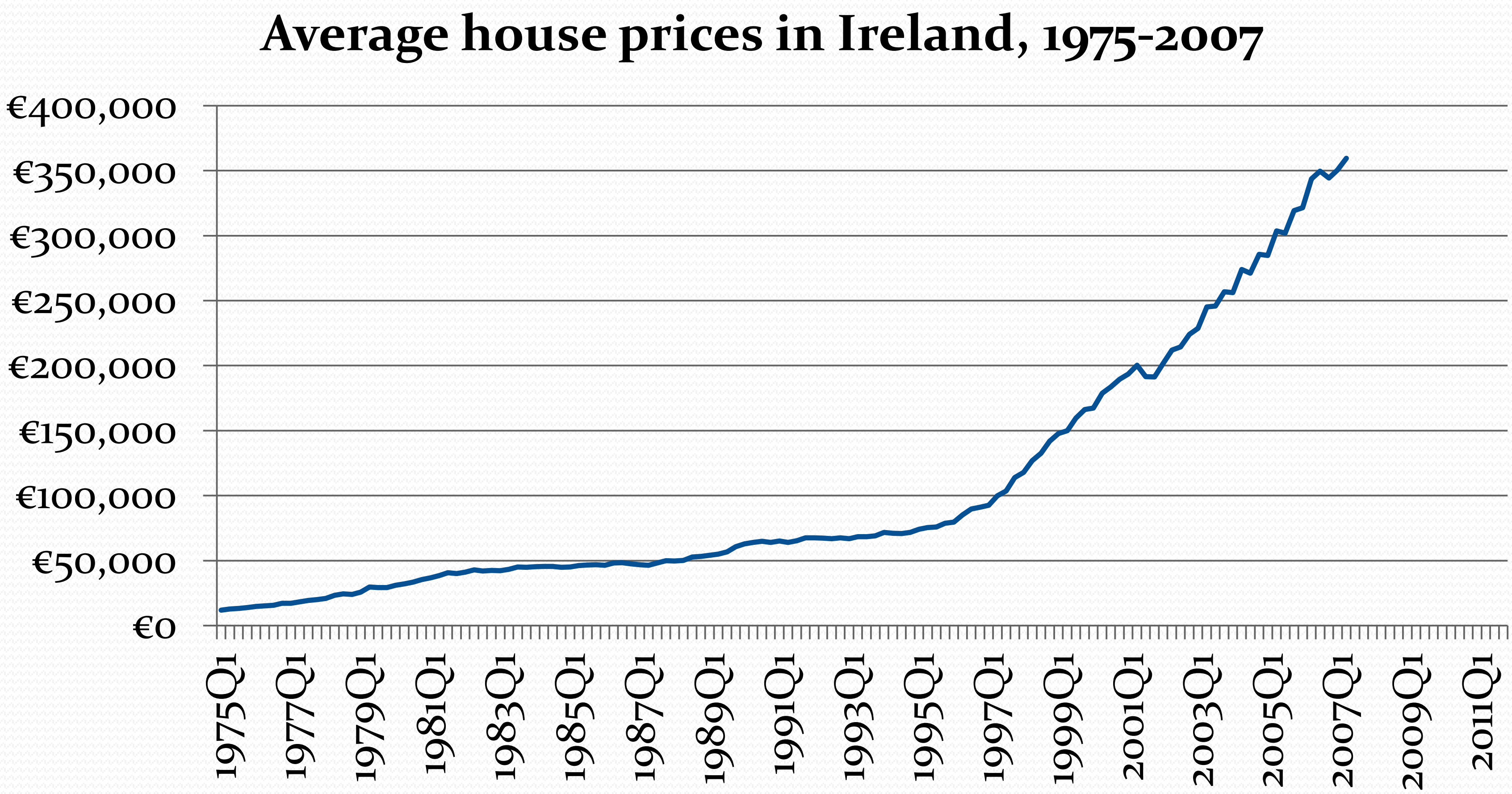
Correcting for inflation, though, substantially alters the picture



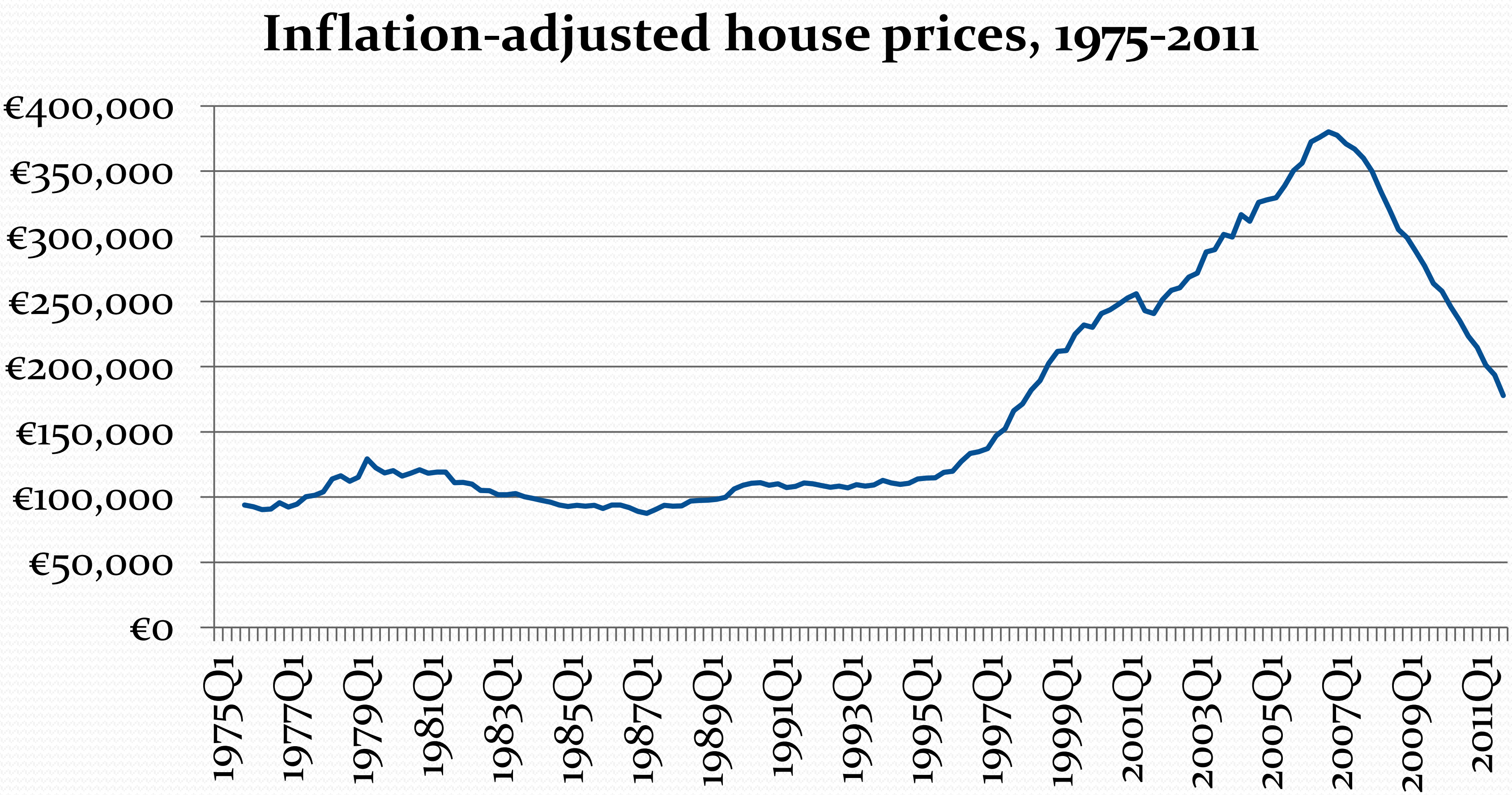
Property stores value – but little more

- Relative to the cost of living, prices in Central Amsterdam were no higher in 1975 than in 1875 or 1640
- "Stylised fact" (1): over time, house price increases on average match inflation – but don't beat it
- This can be investigated worldwide
  - The literature on long-run house prices around the world is small but pretty clear on this point – e.g. New York commercial real estate or Boston house prices
- "Bad investment" in the sense of capital gains – need to look at the "dividend" instead – rents

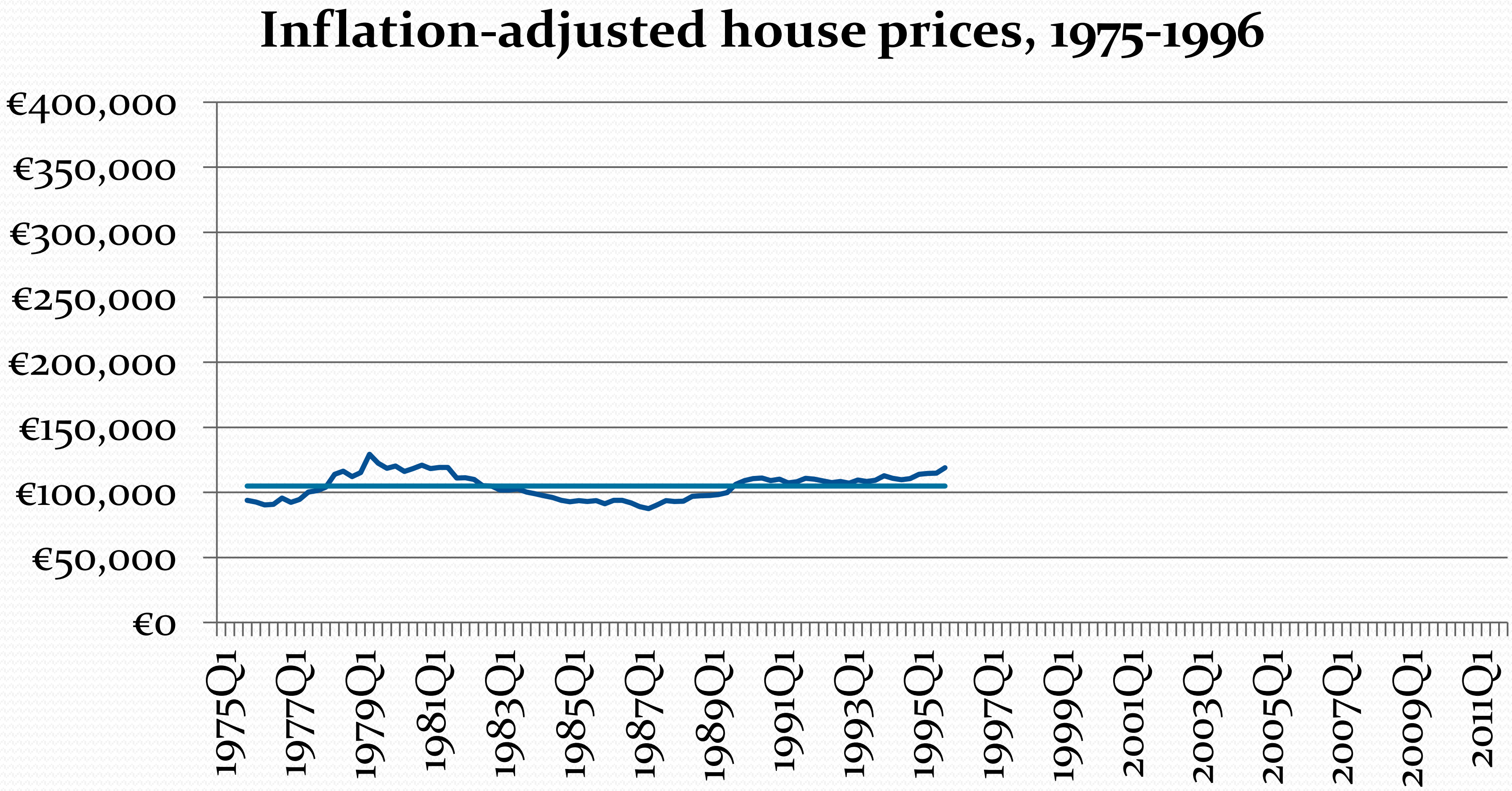
But surely Ireland is different?



Again, we need to correct for inflation (and add in the post-2007 period!)



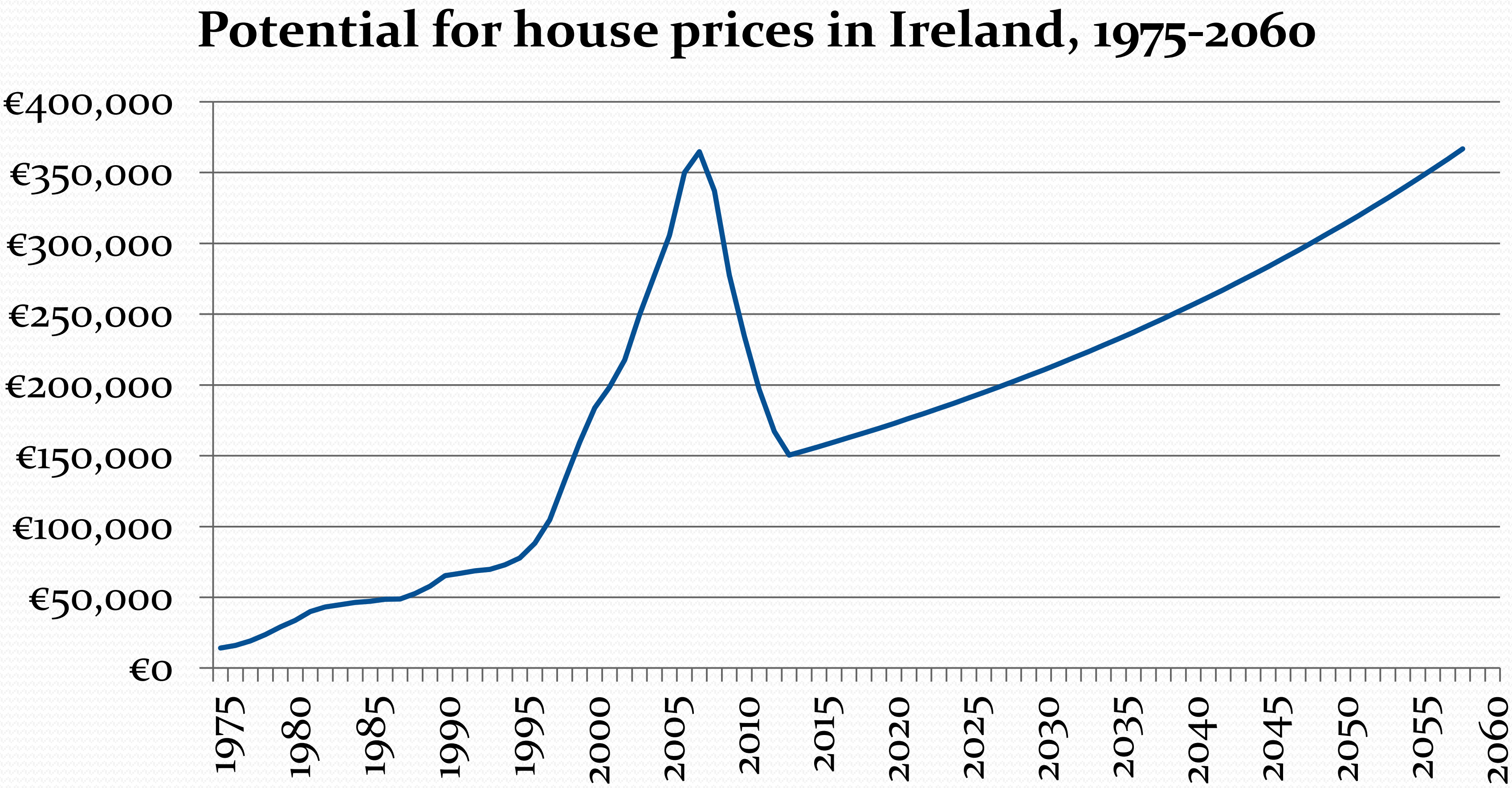
The period to 1996 looks familiar!



Our expectations about the future should reflect this

- **We should only expect house prices to increase the same rate as inflation**
- This has big implications for those who bought during the bubble (or those who bailed out bubble-era lending)
  - They can't expect inflation to eat away their problem – they will have to wait until the principal is paid off to sell their property

It may be the 2050s before prices reach levels seen at the peak



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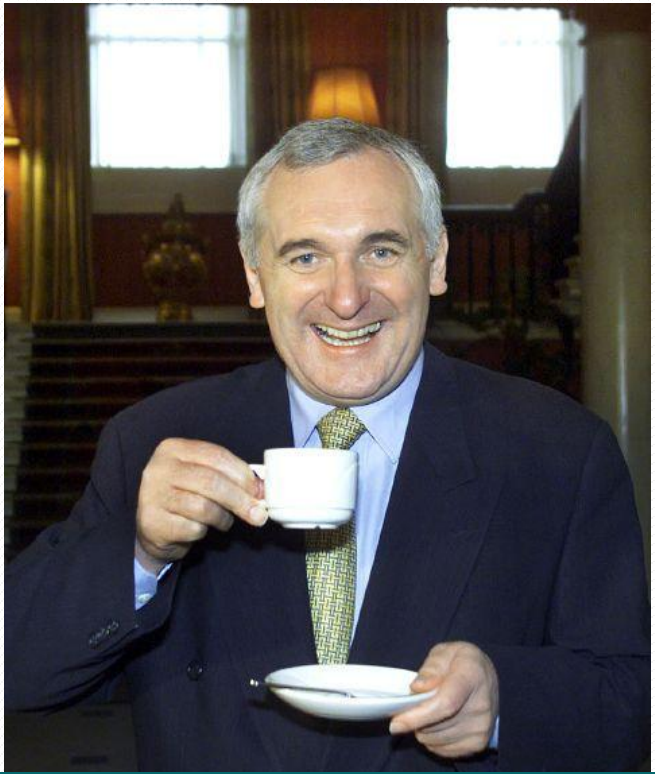
How did prices reach 2007 highs?

- The short answer:
  - Ticking all the boxes of a textbook bubble-and-crash…
  - …in a market with "adaptive expectations", where momentum is key



"Bad advice given by so many resulted in some people making mistakes when they should have bought property last year."
Bertie Ahern, April 2006

Economics likes assumptions

- Assumptions are needed to come up with any sort of model of the world
- Assumptions typically either…
  1. Strip away unnecessary detail
  2. Simplify a process we don’t understand yet
- The danger is when economists mistake a type (2) assumption for a type (1) assumption

“Rational expectations” is one contested assumption

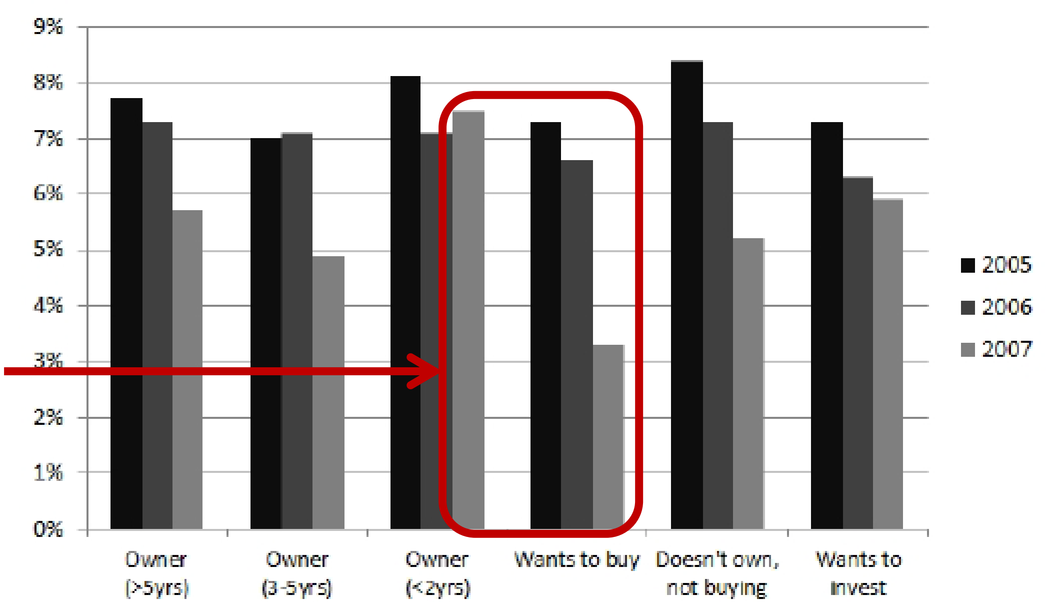
- “Rational expectations” means that consumers know all information and can process it
- An alternative is “adaptive expectations”
  - i.e. people do not process every last bit of information – instead they look at the past and extrapolate into the future
  - This has very different implications for policy
- Property markets exhibit strong tendencies of “adaptive expectations”
  - We can see this in Ireland over the last ten years

Bubbles occur when a favourable change is amplified by easy credit

1. A bubble starts out with an initial **change in conditions**, often a desirable one
   - In Ireland, this was moving from 1980s stagnation to 1990s export-led growth
2. Boom becomes bubble when prices detach from fundamentals – this needs a generous **supply of credit**
   - Entering the Eurozone gave Irish banks access to German savings to lend – a failing at EU level
3. For the bubble to suck in large numbers of people, generous **supply of the asset** itself is needed
   - Tax breaks for both builders (Section 23) and borrowers (mortgage interest relief) were domestic policy errors

Despite all this, people did not see the end of the bubble

Figure 6.2: *Expected price change over coming 12 months, by group*



Cognitive dissonance? People seeing what they want to see…

Source: Analysis of ESRI-IIB Consumer Sentiment Surveys

People also find it hard to see the end of the crash

- The typical respondent to a survey on the property market in January 2012 expected house prices to fall a further 10% this year

- Just one in six sees house prices being higher in 2017 than they are now
  - This is only slightly above the number who believe house prices will fall by a further 35% or more during the same period

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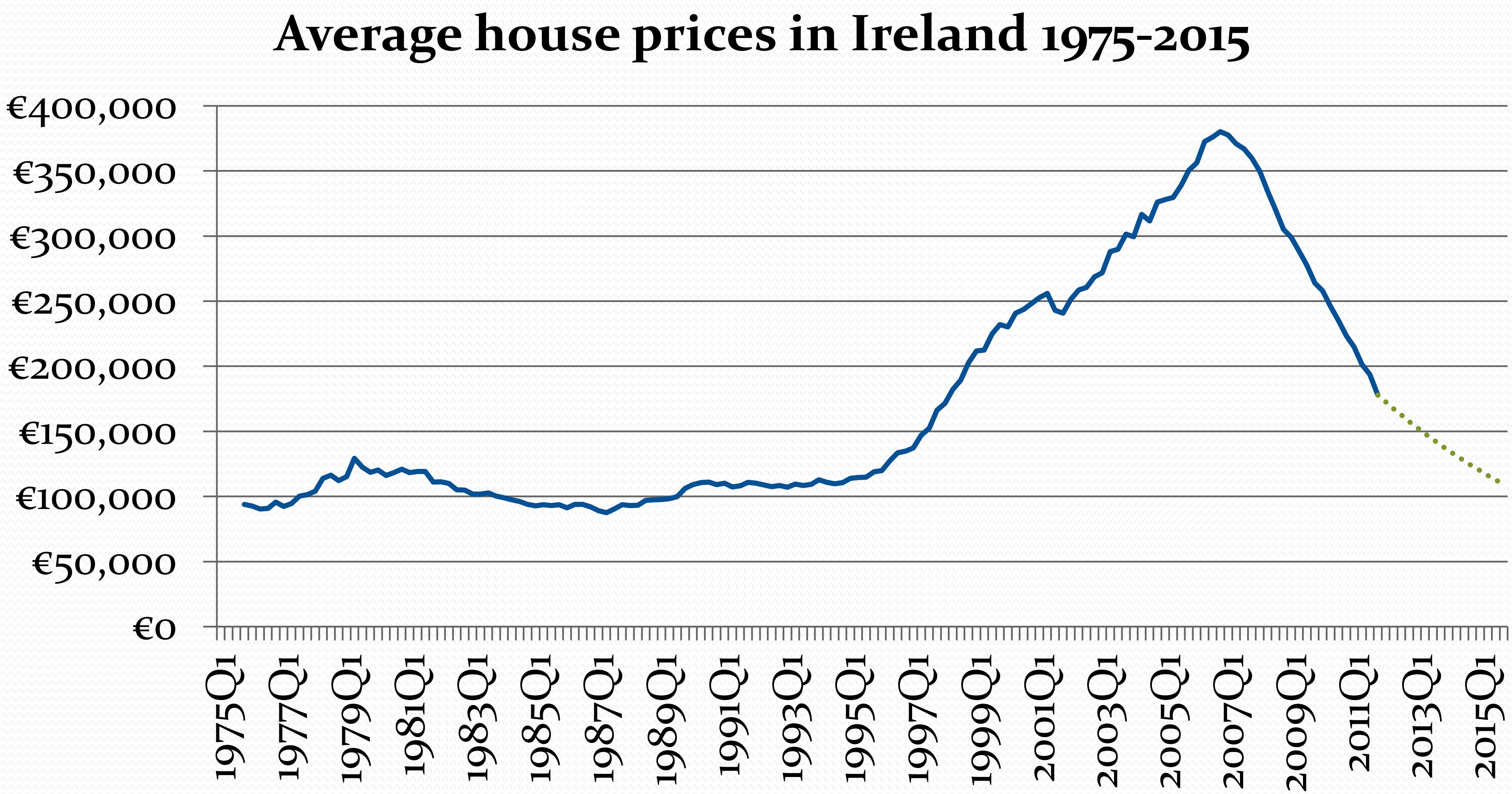
Economics is not: "what goes up must come down"



Economics *is* about: supply and demand

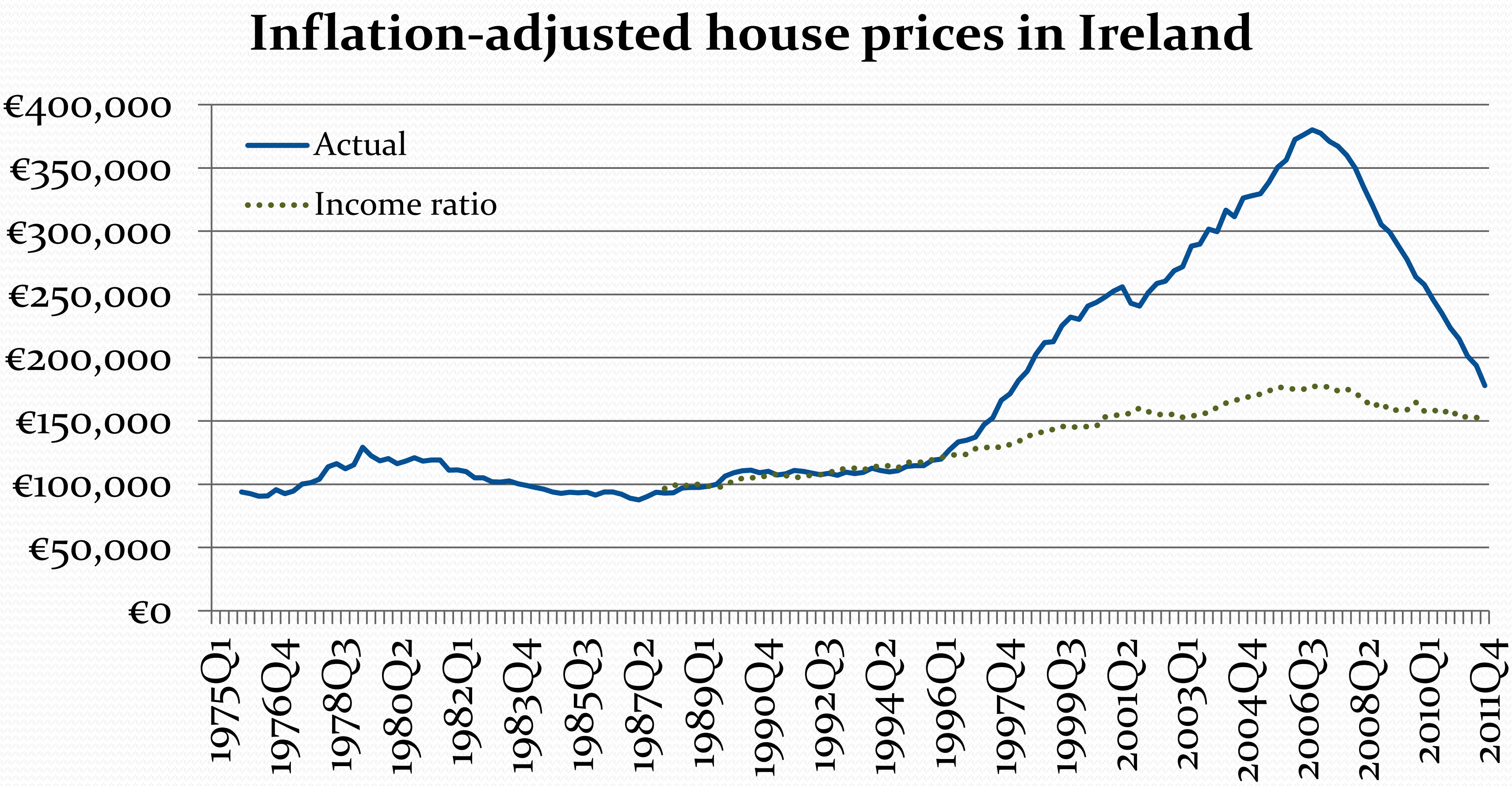
- Supply is largely fixed
  - Both generally: in housing markets (compared to other markets) supply moves slowly
  - And specifically: in Ireland at the moment, very little construction activity happening
- To understand where house prices will "land", we need to understand demand
- This is often thought of "in short-hand" as the ratio between incomes and house prices

House prices relative to incomes

- Between 1988 and 1995, the average house price was 3.6 times household income
  - Household income in 1990 was 1.15 times average income (compared to 1.33 in 2005)

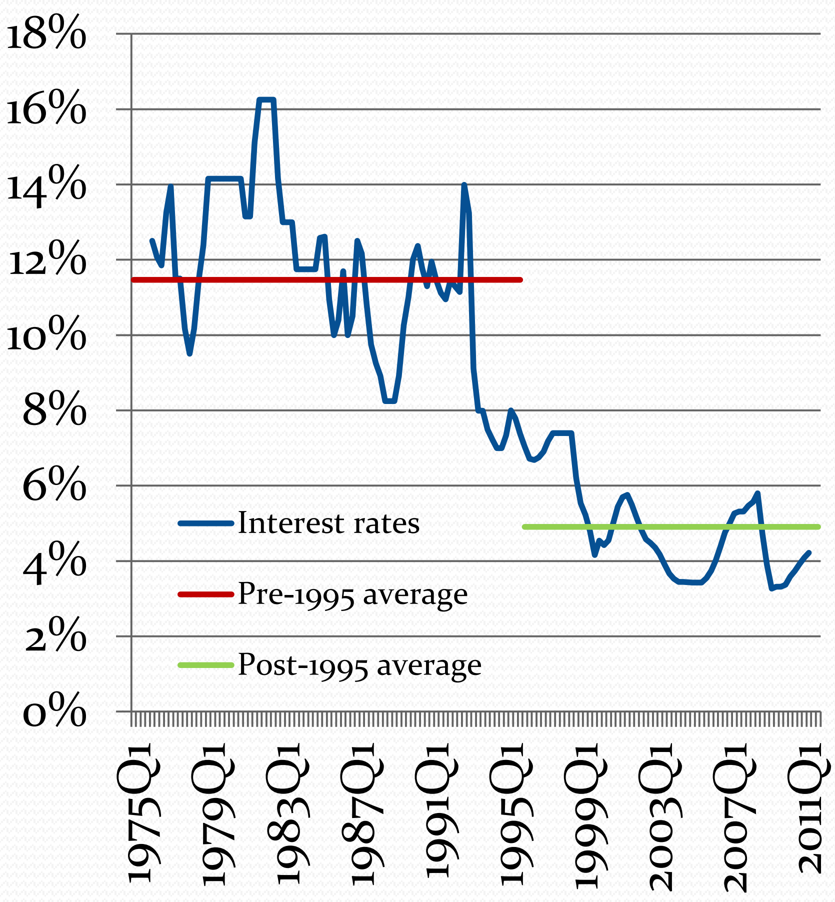
- The ratio in 2005-2007 was over twice this (an average of 7.4)

What if house prices had reflected household income?



But the income ratio is a symptom – not the cause

- Some of the increase above the dashed line may not be due to a bubble
- It may be because Ireland went from a high interest rate environment to a low one



The ultimate value of real estate comes from the service it offers

- Income multiples also tell us very little about why house prices vary spatially
- Rents matter – even if you are not a renter or a landlord
- One of the most important services in a developed economy's GDP is "imputed rent"
  - What would an owner-occupier pay in the rental market to enjoy their accommodation?
- The ratio of rents to house prices is the fundamental measure of health in a property market

Rents and house prices reflect a huge range of “non-market” services

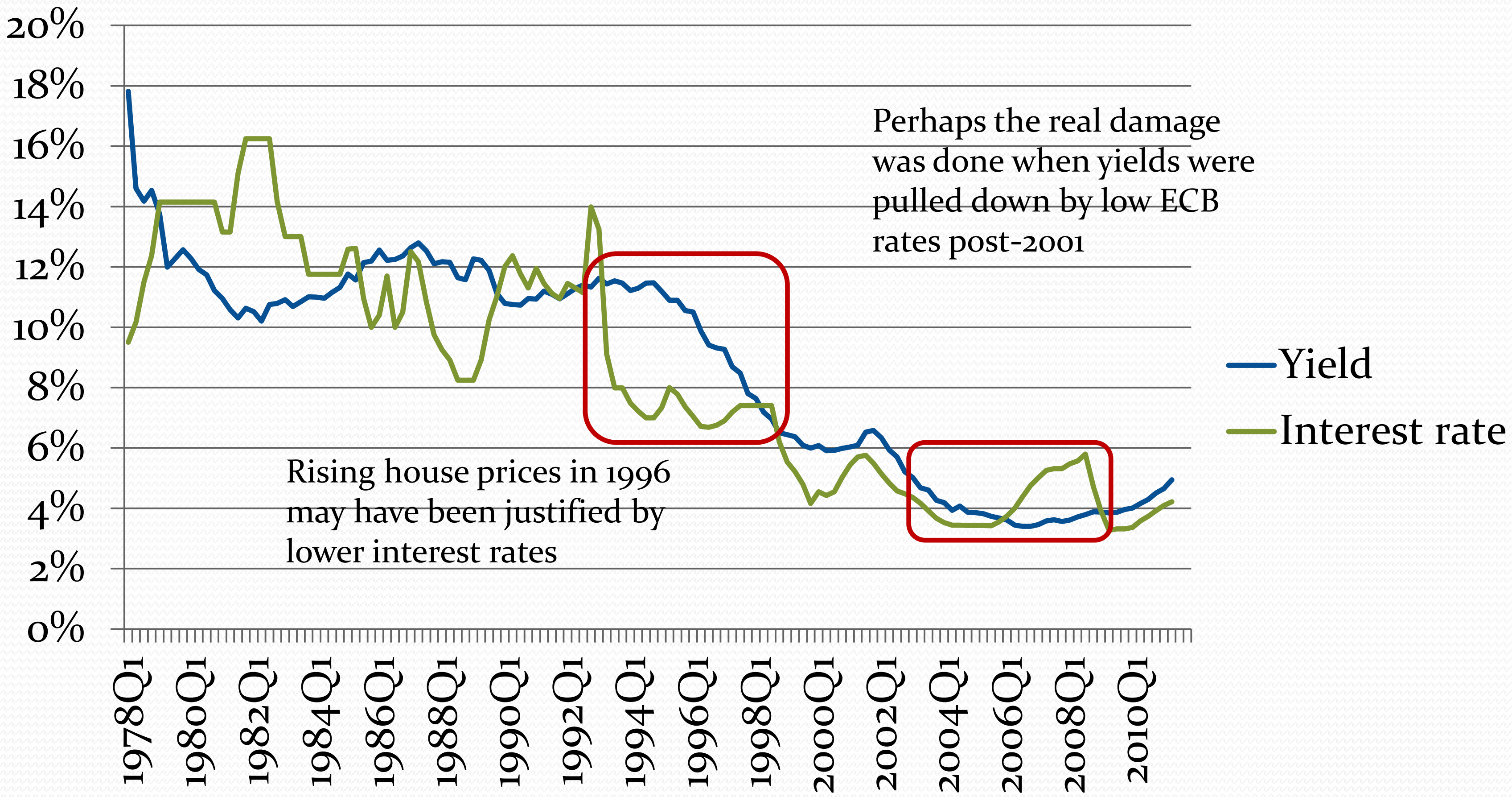
Amenity	Bubble	Crash	Urban	Rural	Sales	Let
Coast (+)	9.8%	11.1%	14.5%	10.2%	10.2%	6.5%
Bathe (+)	19.3%	15.4%	17.9%		17.9%	14.8%
Lakes (-/+)	1.7%	3.5%	2.4%		2.4%	4.5%
Rivers (-/+)	−1.5%	−1.9%	0.0%	−1.8%	−1.8%	−0.2%
Waste (-)	2.0%	−0.4%	2.8%	0.5%	0.5%	−0.9%
Pollute (-)	−1.0%	−1.9%	−4.5%	−1.4%	−1.4%	1.4%
Roads1 (+)	3.3%	1.4%	2.3%	2.1%	2.1%	1.6%
Roads2 (+)	3.4%	3.0%	2.8%	3.0%	3.0%	1.0%
Station (+)	11.0%	10.9%	11.1%		11.1%	9.5%
Track (-)	−2.7%	−1.7%	−3.8%	−2.5%	−2.5%	−2.9%
P/School (-/+)	−8.9%	−9.8%	−9.4%	−8.8%	−8.8%	−2.9%
S/School (+)	2.2%	2.2%	3.5%	2.6%	2.6%	2.6%
Hosp (-/+)	−4.4%	−6.5%	−2.7%	−5.6%	−5.6%	−3.8%

Figures show the estimated effect of moving a property from 1km away from a particular amenity to 100 metres away

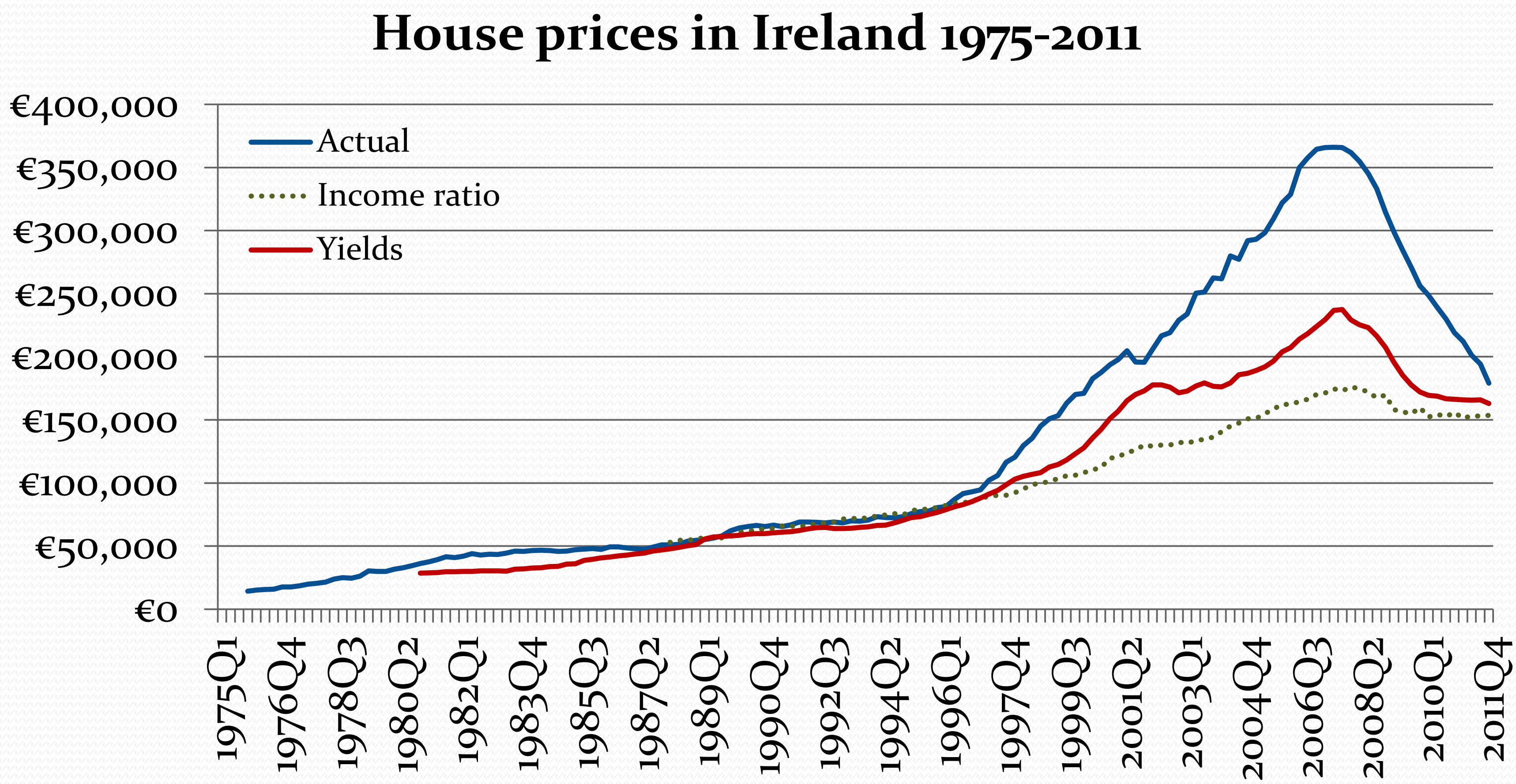
The ratio of rents to house prices is like the “return” on housing

- Think like an investor: a property that rents for €800 a month has an annual rental value of €10,000
- Knowing that this property has an annual “dividend” of €10,000, what would you buy this property for?
  - If you had lots of cash, you would compare the return to, say, interest rates on savings accounts
  - If you were borrowing, you would compare the return to the cost of borrowing

The rent-to-price ratio is closely related to interest rates



What if house prices had reflected rental yields?



Crystal-ball gazing

- Asking prices fell by an average of 52% between 2007 and the end of 2011
  - If asking prices have fallen a further 5% since then and accepted bids are typically 10% below the asking price, then prices are down 58%
- The average transaction price now is in the region of €155,000
  - This is in line with both income multiples and rental multiples…
  - … but prices won't actually stabilise until credit returns

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- **Governments can manage the property market**

Government can put in place good market foundations

- Caution: Intervention was part of the problem
  - As of 2006, the Irish property market the most intervened in among developed economies
  - In addition to tax breaks for construction and mortgage interest relief, also no annual property tax or capital gains tax!

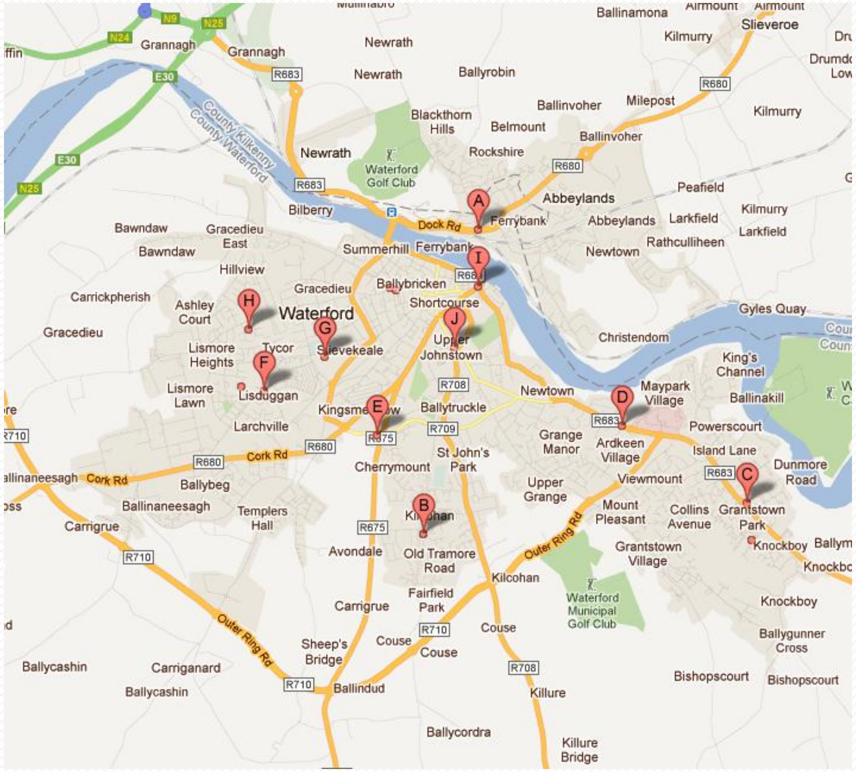
- New intervention has to be aware of the stylised facts of property markets

Three principles will go a long way

- Sensible land use
  - E.g. site value tax, which encourages socially beneficial use of land and penalises land banks, derelict sites
- Sensible lending
  - E.g. “covered bonds”: to lend over 30 years, banks must borrow over 30 years – effectively creates culture of fixed rates so Ireland would be less prone to ECB decisions

Three principles will go a long way

- Sensible borrowing
  - E.g. improving the “informational infrastructure” – publicly available house price register
- Huge role for information technology and the internet



Thank you

- Comments and questions welcome
- For more, see ronanlyons.com or get in touch on Twitter (@ronanlyons)