

## Statement to the Oireachtas Committee of Inquiry into the Banking Crisis in Ireland

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### Introduction

In the invitation to appear before the committee I was asked to address issues relating to the International, EU and domestic policy context for the Banking Crisis in Ireland. In particular, to the

- Sources of growth in Ireland in the 1990s and in the years prior to the banking crisis;
- Credit growth from the late 1990s onwards;
- The housing market;
- Increasing size of the construction sector;
- Fiscal policy prior to the crisis.

Over the period 2001-2007, in a wide range of publications, together with my colleagues we repeatedly warned about the dangers posed for the Irish economy by the growth of a property market bubble and of the need to use fiscal policy to defuse the situation. If the advice on fiscal policy had been followed, Ireland would probably have escaped much of the damage that was suffered over the recent crisis. However, we did not draw the connection between the growth of a property market bubble and the risks to the financial system and, in 2008 in our *Medium-Term Review*, I failed to foresee the impending financial collapse.

In this statement I first describe the factors that underpinned the period of rapid growth in the 1990s. I briefly consider the external environment, emphasising the developments which contributed to the overheating of the economy in the 2003-07 period. I then discuss the turning point, after which the economy was set on an unsustainable growth path, and the “bubble” years of 2004-2007. In the final part of this statement I consider how economic policy could have prevented the disaster that happened in 2008.

In addition, in the attached Appendix, I detail the policy advice provided by myself and colleagues in a range of publications between 2001 and 2008, including, as requested, successive ESRI *Medium-Term Reviews*

### The Economic Recovery of the 1990s

Having spent the 1980s dealing with a major budgetary crisis, the Irish economy entered on a period of rapid growth beginning in the early 1990s. The ground had been prepared for the recovery by a substantial improvement in competitiveness and the return of order to the public finances in the 1980s. The recovery began in earnest in 1994.<sup>1</sup>

The improved competitiveness and sustainable public finances, combined with growth in Ireland’s markets provided the proximate cause of the turnaround, but there were a number of underlying strategic factors which were of greater importance in the long run. These included the completion of the EU single market at the end of 1992, which proved of particular importance for Ireland; the effects of investment in education, especially in the 1980s, on the productivity of labour and on labour force participation; and the rising participation of women. Together these factors helped

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<sup>1</sup> Had it not been for German monetary policy raising EMS interest rates, consequential on the expenditure effects of German unification, it might have begun earlier around 1990. Barrell, 1996 and Bradley and FitzGerald, 1991.

sustain a dramatic increase in output, which supported an export led boom over the second half of the 1990s (Bradley, *et al.*, 1999 and Honohan and Walsh, 2002).

Because the rapid growth was fuelled from outside Ireland it resulted in a major improvement in the public finances and a movement into surplus on the current account of the balance of payments. This improvement in the current account meant that domestic savings were funding domestic investment and there was no dependence on a capital inflow through the banking system.

A significant part of the growth of the 1990s represented a catch up on the rest of the EU 15 (O'Gráda, 2002). Through bad policy Ireland in the post-war years Ireland had fallen well behind the living standard of the rest of the EU 15. In particular, Ireland failed to invest in education and it also maintained a closed economy long after the rest of Western Europe. It was only when these policy defects were addressed that Irish living standards in the late 1990s approached the level that might have been expected if wiser policies had been followed in the post-war period. In summary, while the rest of the world wondered what was the secret of Irish economic success, the answer was that Ireland had reversed the exceptionally unwise policies of an earlier era.

By the end of the 1990s, and into the first few years of the 2000s, the catch up phase was completed and the rate of productivity growth slowed down. While exports continued to grow, domestic demand began to rise rapidly; people reacted to their higher living standards by increasing consumption and, especially, through increasing investment in housing. This rise in domestic demand was further fuelled by stimulatory fiscal policy. Rising expectations saw a gradual disimprovement in competitiveness due to wage inflation, adversely affecting exports. The current account of the balance of payments turned negative.

While I expressed serious concerns about the stimulatory nature of fiscal policy in an article in the ESRI Quarterly Economic Commentary (FitzGerald, 2001a) and in other publications in 2001 (Barry and FitzGerald, 2001), it was probably only in 2003 that growth really began to outstrip the potential of the economy, giving cause for real concern. The bursting of the dotcom bubble in 2002 temporarily took the excess steam out of the economy in 2002. However, this was only temporary as the economy returned to rapid growth in 2004.

### The external environment

With the advent of EMU in 1999, control of monetary policy formally passed to the ECB. However, in the run up to EMU in the second half of the 1990s the management of monetary policy had already effectively passed from the Central Bank. Under EMU the interest rate is set based on the needs of the Euro area economy as a whole, rather than according to the needs of individual economies, such as that of Ireland.

EMU also facilitated the free movement of capital and, as anticipated, it reduced the risk premium and, hence, the cost of capital, both for the Irish government and Irish firms. In principle, this reduction in the cost of capital was a good thing for Ireland (Baker, FitzGerald and Honohan, 1996). Over the previous twenty years Irish borrowers on average had to pay 2 per cent more than borrowers in Germany, adversely affecting Irish competitiveness (FitzGerald, 2001b). However, a consequence of EMU membership was that the interest rate could not be used to manage excess demand in an individual economy, and the consequential effects on wage inflation.

Prior to EMU, Ireland and Spain had probably underinvested in housing, given their demographic profile, because of the high cost of funding (Conefrey and FitzGerald, 2010). In permitting a more rapid adjustment of the housing stock, the lower cost of capital arising from EMU was beneficial.

However, it was the failure to appropriately control this surge in investment which eventually proved lethal.

When the property boom got out of control in the period 2003-2007 the intensity of the investment in property ran well beyond the available domestic savings, resulting in a growing current account deficit on the balance of payments. The counterpart to the deficit was a growing inflow of funds through the banking system.

The demand for credit to fund investment ran well ahead of the ability of the banks to fund it on the basis of their domestic assets. However, it proved very easy (and cheap) for them to borrow additional funds abroad and to continue to fund the growth in credit. The nature of that funding was short-term and essentially volatile.

In the period before EMU a constraint on such an expansion might have been the exchange risk involved in such borrowing – it would certainly have raised the costs for the banks and, hence, the cost of credit. However, the experience of EU countries outside EMU shows a change in the world financial system had taken place.

Partly due to US Fed policy, there was a huge supply of cheap credit available on world markets. You did not have to be a member of EMU to benefit from it. Estonia and Latvia, though outside EMU, experienced a massive inflow of funds through their banking system funding a property boom very similar to that of Ireland. Thus EMU membership made the inflow of capital to fund the Irish property bubble a little easier but, like Latvia and Estonia, Ireland would have faced the same temptations outside EMU. This highlights the fact that appropriate domestic policies are the only guard against property bubbles.

### The Turning Point, 2003-2008

There is no simple definition of when the rapid but sustainable growth in the economy moved into a new and dangerous phase. However, I would argue that 2003 was probably the turning point. The current account of the balance of payments was in deficit that year, though the size of the deficit was small.<sup>2</sup> However, wages had been rising rapidly for a number of years and the loss of competitiveness was beginning to take a toll. House prices in 2003 returned to growth at more than 10 per cent a year. Finally, the demand for credit was outstripping the ability of the banks to fund it from domestic sources. As a result, the banks began borrowing an ever increasing amount of money abroad.

While the demand for housing had a real basis in terms of a rising population of adults, housing completions at nearly 70,000 were running far ahead of the actual increase in population and there was no sign of the rate of increase in house prices slowing. An important factor driving the demand for housing was the very low user cost of housing. (The user cost takes account of the expected capital gain on housing.) With a self-fulfilling expectation of a capital gain driving the user cost of housing negative, it was not surprising that demand for housing was very high. In turn this fuelled prices which fed back on people's expectation about future prices. This was a bubble in the making.

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<sup>2</sup> A current account deficit is not necessarily dangerous. If it is used to finance a surge in investment in productive capital and if the corresponding capital inflow that finances the deficit is long-term in nature, then the deficit will prove temporary and sustainable; when the capital stock begins to produce goods for export the deficit will be reversed. However, if the deficit is due to a rise in consumption or investment in housing (which will not produce goods for export) then the deficit should be a cause for concern. This is especially the case if the nature of the capital inflow that finances the deficit is short term in nature.

Over the period to 2007 the current account deficit ballooned, reflecting the fact domestic savings were nowhere near enough to fund the investment boom, especially the boom in housing. House prices continued to rise and the economy continued to lose competitiveness, aggravating the current account deficit. The rapid rise in household indebtedness was facilitated by the continuing rise in bank borrowing abroad.

It is impossible to identify when the bubble became irreversible – when a collapse became inevitable. With the benefit of hindsight, probably the last chance to stop the build-up in debts and the loss of competitiveness was in 2006. By the end of that year and moving into 2007, house prices were so far above their equilibrium level (as identified in the model in the 2005 *Medium-Term Review*, Duffy *et al*, 2005) that a collapse became inevitable. As discussed in the Appendix, the dangers were apparent, even if disaster was not certain.

One further factor which aggravated the costs of the collapse was the fact that housing, and the building and construction sector generally, was allowed to expand to become a major share of the economy. By 2006, investment in housing represented 14% of GNP, up from 9% in 2000 (and 2% in 2013). Building and construction investment rose from 17% to 24% of GNP over the same period (8% in 2013). This meant that when the building and construction sector collapsed there was a massive collapse in demand and, hence in GNP.

This contrasts with the situation in the UK, which also suffered from a housing price bubble. However, in their case they did not allow a significant increase in building in the boom so that, when prices collapsed, there was not a direct effect on domestic demand from falling investment. As a result, the employment effects of their property market collapse were completely different from what they were in the Irish case.

The expansion of the building sector in Ireland meant that it had to bid resources away from elsewhere in the economy. This was done through raising the rate of inflation, in particular in wages. This served to kill off a significant number of firms and jobs in exporting firms, jobs that did not seem important at the time but which proved to crucial once the recession hit.

### The Policy Response

The dangers that the economy faced as a result of the over-inflation of house prices, the build-up of debt and the loss of competitiveness in the economy were foreseeable and, as set out in the Appendix, foreseen. The build-up of the bubble could have been prevented by appropriate fiscal policy or by appropriate prudential action by the Central Bank and the regulator, or both. Either one of these policy instruments, if appropriately deployed, could probably, on its own, have prevented disaster. If they had operated in consort to avoid danger there is no doubt that the major effects of the crisis could have been averted.

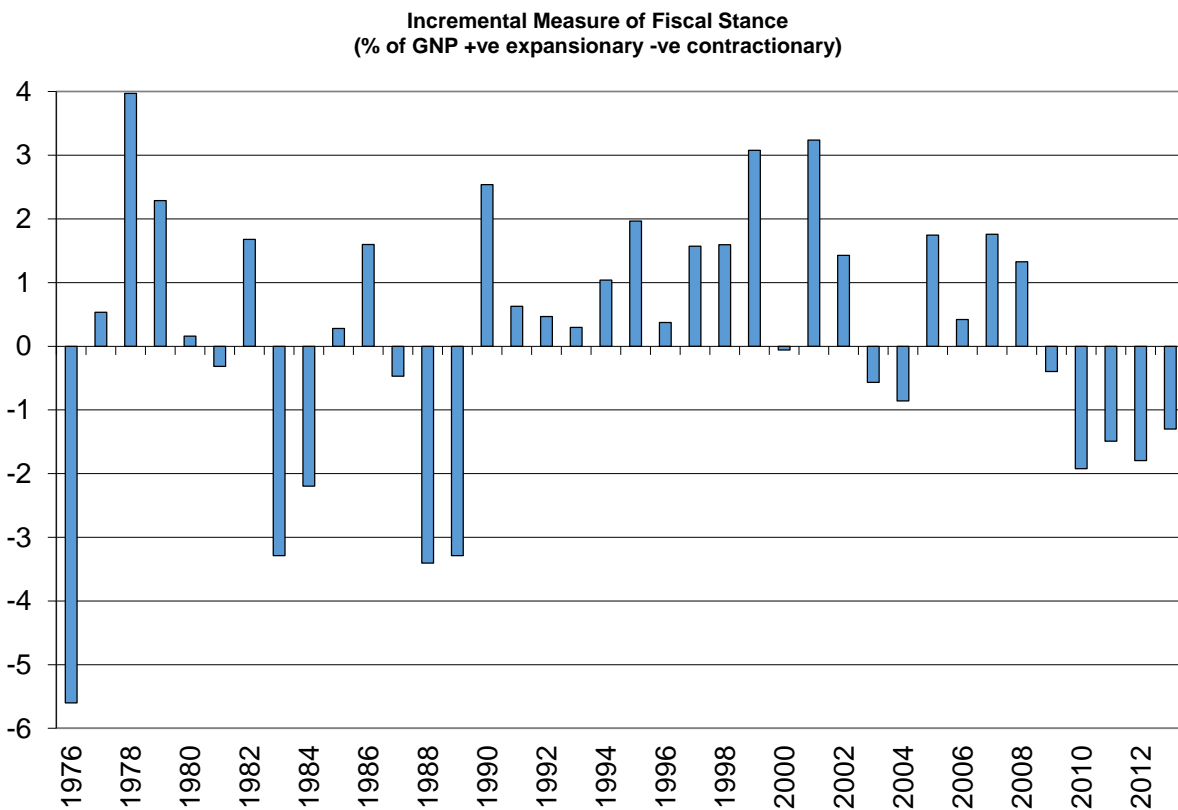
### Fiscal policy

From 2001 onwards, in many publications, myself and my colleagues pointed to the need to tighten fiscal policy. Instead, as shown in the attached figure, in an economy that was growing strongly and well above potential, fiscal policy pumped money into the economy in 6 out of 8 Budgets between 2001 and 2008. This greatly aggravated the situation. If, instead, the government had run a deflationary fiscal policy, as recommended in many of our publications, and built up a substantial surplus this would have taken the steam out of the housing market and reduced pressure on the labour market.

The case of Finland is instructive. Having experienced a property price and banking crisis in the early 1990s it ran a substantial government surplus over the 2000s, with a surplus in 2007 of 5% of GDP.

This prevented the economy overheating, leaving Finland in a much better situation to face the world recession beginning in 2008.

Figure 1:



Source: Bergin, FitzGerald, Kearney and O'Sullivan, 2011

In addition, to operating a much tighter fiscal policy, in a series of papers over the 2001-2007 period I and my colleagues recommended using specific fiscal instruments to cool the housing and property markets (see the Appendix). These included: abolishing all tax incentives for building, including mortgage interest relief; taxing mortgage interest payments to mimic the effect of an interest rate increase; introducing a property tax; cutting government expenditure on investment in building and construction.

The UK Treasury, in a paper published in 2003, recognised that in EMU, because the interest rate would not be available as a policy instrument to manage the housing market, a different instrument would be needed to prevent dangerous bubbles (Treasury, 2003). They recommended raising stamp duty. However, my view was that in raising stamp duty this would achieve the desired impact through raising prices, which would add to household debt. Instead I recommended a tax on mortgage interest payments as this would reduce the ability of households to take on debt leaving households less indebted. However, either of these instruments (and others) could have been used to the same basic effect.

If a combination of a tighter fiscal policy and specific fiscal measures targeted at the housing and property markets had been deployed up to 2005, or even in 2006, the property market could have been brought under control and the bubble, which developed, would have been avoided. In turn, with a lower volume of investment in housing and significantly lower prices, households would have been much less indebted. Also, as a result, the banking sector would have had a much smaller

balance sheet and their dependence on funding from abroad, especially dependence on what proved to be the very volatile interbank market, would have been dramatically reduced.

### Banking Regulation and Macro-Prudential Policy

The other policy instrument which could have, and should have, been deployed was prudential policy by the financial regulator (the Central Bank). There were a range of possible instruments that could have been deployed from varying capital ratios dynamically to others such as the imposition of loan to value or loan to income limits.

If the credit channel had been choked off in the 2003-7 period by the regulator this would have halted the rise in house prices or, at least, achieved an appropriate moderation. The importance of credit in facilitating or driving house prices was identified in Fitzpatrick and McQuinn, 2007.

### Conclusion

By 2007 it was probably too late to prevent a major crisis from occurring in 2008. However, if urgent action had been taken in the form of a tightening of fiscal policy or regulatory action to reduce pressures in the building sector, this would have reduced the subsequent damage. It would have reduced the indebtedness of the household sector by stopping the boom earlier and it would also have prevented the banking sector from further expanding its bloated balance sheet. However, policy-makers, if they ever considered such action, might have decided that bursting the bubble deliberately in 2007 or early 2008, with serious consequences, was much less attractive than hoping for redemption and delaying action.

### More Detailed Discussion - References

As well as the references in the text, set out below, and the references to ESRI publications in the Appendix, there are three other papers which set out in more detail the analysis in this statement.

Bergin, Adele / FitzGerald, John / Kearney, Ide / O'Sullivan, Cormac, "The Irish Fiscal Crisis", *National Institute Economic Review*, No. 217, July 2011, pp. R47-R59, Published online 3 August 2011

Conefrey, Thomas / Fitz Gerald, John, 2010, "Managing Housing Bubbles in Regional Economies Under EMU: Ireland and Spain" *National Institute Economic Review*, Vol 211 No 1, 2010, pp.211-299, <http://dx.doi.org/10.1177/0027950110364103>

FitzGerald, John, 2012, "Restoring Credibility in Policy Making in Ireland", *Public Money and Management*, Vol. 32 No. 1, January, pp. 27-34.

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Baker, T., J. FitzGerald and P. Honohan eds., 1996, "Economic Implications for Ireland of EMU", Dublin: The ESRI, Policy Research Series no. 28.

Barrell, R., N. Pain and I. Hurst, 1996, "German Monetary Union: An historical counterfactual analysis", *Economic Modelling*, Volume 13, Issue 4, October 1996, Pages 499–518.

Barry, F. and J. Fitz Gerald, 2001. "Irish Fiscal Policy in EMU and the Brussels-Dublin Controversy" in *Fiscal Policy in EMU: Report of the Swedish Committee on Stabilization Policy in EMU*, Stockholm: Statens Offentliga Utredningar.

Fitz Gerald, John, Bergin, Adele, Kearney, Ide, Barrett, Alan, Duffy, David, Garrett, Shane, McCarthy, Yvonne, 2005, *Medium-Term Review: 2005-12*, No. 10. Dublin: The ESRI.

Bradley, J. J. FitzGerald, and D. McCoy, 1991, *Medium-Term Review: 1991-1996*, No. 4. Dublin: The ESRI.

Bradley, J., J. FitzGerald, I. Kearney and D. Smyth, 1999, *Medium-Term Review: 1999-2005* No. 7. Dublin: The ESRI.

FitzGerald, J, 2001a, "Fiscal Policy in a Monetary Union: the Case of Ireland" special article in *Quarterly Economic Commentary*. Dublin: The ESRI.

FitzGerald, J., 2001b, "Managing an Economy under EMU: The Case of Ireland", *The World Economy*, Vol 24 No. 10

Fitzpatrick, T. and McQuinn, K., 2007, "HOUSE PRICES AND MORTGAGE CREDIT: EMPIRICAL EVIDENCE FOR IRELAND", *The Manchester School*, Volume 75, Issue 1, pages 82–103, January 2007

HONOHAN, P. and B.WALSH, 2002. "Catching up with the Leaders: the Irish Hare", *Brookings Papers on Economic Activity*, Vol. 1, pp. 1-57.

Ó GRÁDA, C., 2002. "Is the Celtic Tiger a Paper Tiger?" in D. McCoy et al., *Quarterly Economic Commentary*, Spring, pp. 51-62., Dublin: The Economic and Social Research Institute.

Treasury, HM, 2003, *Fiscal Stabilisation and EMU*, London: HM Treasury.

## Appendix: Implications for Fiscal Policy, *Quarterly Economic Commentary and Medium-Term Review, 2001-8*

### Introduction

Since the early days of the ESRI, in the mid-1960s, it has published its *Quarterly Economic Commentary* (QEC). This *Commentary* provides a set of forecasts for the Irish economy as a basis for forming economic policy, especially fiscal policy. Traditionally, in the general assessment in the QEC, the authors discuss the implications of their analysis for how the economy is actually working and also the implications of the analysis for economic policy.

Since 1986 the ESRI has published the *Medium-Term Review (MTR)* roughly every two or three years, which considers the challenges facing the economy over a longer time scale than the QEC. It teases out the implications for public policy, especially fiscal policy, of a range of scenarios for the future considered in the MTR.

This Appendix reports the implications for fiscal policy of the analysis in the ESRI *Quarterly Economic Commentary* and the *Medium-Term Review* in the period 2001-2008, the period leading up to the banking crisis. In addition to these publications the ESRI also undertook a series of studies for the Department of Finance on investment priorities. The analysis in these reports also had major implications for fiscal policy. In accordance with its mandate, the ESRI published these reports on their completion. Where relevant, the policy of implications of these reports are also discussed in this Appendix.

As with all the ESRI's reports, the conclusions in each report were the personal responsibility of the authors and they did not represent the views of the ESRI. The ESRI, as with all its publications, operated a quality control process where the publications were vetted in advance by independent reviewers to ensure that they met an appropriate academic standard.

### 2001-3

In 2001 in a special article in the QEC, I expressed serious concerns about the stimulatory fiscal policy being pursued. Because of the concerns about the rate of house price inflation, and the fact that monetary policy was not a suitable instrument for managing this problem within EMU, it was recommended in this article that the government tax mortgage interest payments to help manage demand for housing and prevent excess inflation. By taxing mortgage interest payments the government could mimic the effect of a substantial rise in interest rates on the housing market.

I presented a similar analysis at the Brussels Economic Forum and in a paper by Frank Barry and myself. In 2001, in an article in the journal *World Economy*, I also discussed the need to use fiscal policy to control excess demand in the housing market because within EMU, as monetary policy was not a suitable instrument.<sup>3</sup>

The following 2001 publications all deal with this issue:

"Fiscal Policy in a Monetary Union: the Case of Ireland", *Quarterly Economic Commentary*, March.  
[http://www.esri.ie/pdf/QEC0301SA\\_Fitz%20Gerald.pdf](http://www.esri.ie/pdf/QEC0301SA_Fitz%20Gerald.pdf)

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<sup>3</sup> If there were a single Euro area housing market then interest rates could have been used for this purpose, as in an economy like the UK. However, because the problem of overheating in the housing market was limited to a few countries it would not have been appropriate for the ECB to have modified monetary policy.



“Fiscal Policy in a Monetary Union: the Case of Ireland”, Proceedings of the Brussels Economic Forum, Brussels, EU Commission DG II.

“Managing an economy under EMU: The case of Ireland”, World Economy, November 2001  
[http://www.esri.ie/publications/search\\_for\\_a\\_publication/search\\_results/view/index.xml?id=171](http://www.esri.ie/publications/search_for_a_publication/search_results/view/index.xml?id=171)

“Irish Fiscal Policy Under EMU and the Brussels-Dublin Controversy”, Barry F., and J. Fitz Gerald, in Fiscal Policy EMU, Report of the Swedish Committee on Stabilisation Policy in EMU, Stockholm: Statens Offentliga Utredningar, ISBN 91-38-215 18-7

Medium-Term Review 2003-2010

[http://www.esri.ie/publications/search\\_for\\_a\\_publication/search\\_results/view/index.xml?id=1655](http://www.esri.ie/publications/search_for_a_publication/search_results/view/index.xml?id=1655)

In this publication, published in 2003, reflecting the uncertainty inherent in any forecast, two main scenarios were included – a high and a low. In addition to the high and low scenarios that provide bounds to the central forecast, we also included a scenario linked to a dollar shock. This shock was based on the general view held by forecasters that the US economy would slow sharply at some point – due to external imbalances. This analysis suggested that if such a shock occurred it would have led to a slowdown in world growth and it would have knocked 5.5 per cent off Irish output and added almost 4 percentage points to the unemployment rate. Of course, as ever, the timing of when this might have occurred was unclear. Nonetheless, this scenario highlighted concerns about growing imbalances in the US economy and how, in unwinding them, there could be significant negative effects on the Irish economy.

In the final chapter – and peppered throughout the document – is a conclusion that the construction sector in Ireland was too large, and that house price inflation was unsustainable over the medium term. This is discussed under the heading of Domestic Fiscal Policy. That section is followed by a section which discusses the loss of competitiveness affecting the economy, partly as a result of the building boom.

“As is evident the level of debt remained broadly stable until 1993, but over the period of strong economic growth there has been a sharp rise in the level of personal indebtedness. The strength of the rise suggests that growth in personal debt has outpaced income growth over the period. The vast majority of this increase has been in borrowings for housing purposes. House mortgage finance and other housing finance amounted to just over 29 per cent of personal disposable income in 1990. By 2002 this had risen to 60 per cent. In contrast, other personal debt (finance for investment and other advances) has risen from nearly 13.5 per cent of personal disposable income in 1990 to 17.5 per cent in 2002. The rapid rise in the ratio of personal debt to income suggests that the exposure of households to an economic shock has increased. As much of the increase is the result of borrowing for housing purposes this suggests that the Irish economy is exposed to a shock affecting the housing market.” P. 58

In the conclusions it was stated that:

“The continuing rise in house prices above a level that would be sustainable in the long run is a continuing cause for concern. While it seems very unlikely that the rise in prices will be punctured in the short term, there remains the danger that in the longer term a sudden downward adjustment in prices could destabilise the economy. Monetary policy, formulated by the ECB in the wider interests of the EMU is, if anything, aggravating this problem. “

“Under these circumstances, the role of fiscal policy in controlling domestic inflation becomes more important in the context of EMU. In addition to its potential effects through the labour

market, fiscal policy can also affect the allocation of resources within the economy by changing incentives. This enhanced role for fiscal policy within EMU was also recognised in the papers recently released by the UK Treasury on the UK's readiness for EMU."

Fiscal policy has generally not been used actively in Ireland to reduce demand for housing. "However, fiscal policy could have a significant effect on the domestic housing market through changing household disposable income, and especially through changing the cost of capital for homeowners. Against the background of a deflationary shock from the recent change in exchange rates, if inflation in the housing market were to continue, it might be prudent to take fiscal action to halt the rise. When the pressures ease, such fiscal action could be unwound, providing support to a market where prices might have begun to fall." p. 81

However it is true that this MTR was reported as having a very upbeat tone and that it argued that the economy had the potential to grow at 5 per cent out to 2010.

Mid-Term Evaluation of the NDP

<http://www.esri.ie/UserFiles/publications/PRS50.pdf>

Later in 2003 the ESRI published a Mid-Term Evaluation of the National Development Plan, a report undertaken for the Department of Finance. In Autumn 2003, in the Mid-Term Evaluation of the NDP (Policy Research Series no. 50), along with other colleagues from the ESRI (and other researchers), we further expanded on the concerns about too much money being pumped into the housing market. Appendix 1 of the report spelt out a model of the housing market and used it to show that the government's planned investment in social housing was not sustainable. Money needed to be taken out of the housing market through fiscal policy measures to make space for any social housing programme.

2005-7

Medium-Term Review: 2005-2012

[http://www.esri.ie/UserFiles/publications/20060831092754/MTR10\\_%202005-2012\\_Main%20Text.pdf](http://www.esri.ie/UserFiles/publications/20060831092754/MTR10_%202005-2012_Main%20Text.pdf)

In the *Medium-Term Review*, published in December 2005, we were so concerned that the Irish economy was overheating that we produced two sets of benchmark forecasts – a high growth and low growth scenario. We argued that the US economy would have to slow down and that when that happened it would have caused the Irish economy to grow below potential with a significant rise in unemployment out to 2010. In that scenario the slowdown in the US and world economies was assumed to begin in 2007. However, the scale of the slowdown scenario was much less than what actually occurred.

In that MTR we also developed a very important scenario where house prices in Ireland fell by one-third in 2007. In this scenario the unemployment rate increased to over 10 per cent by 2010. This section concluded with the following:

"In addition, this scenario assumes that the financial sector would prove to be robust in the face of the major shock to the housing sector and the very rapid doubling in the unemployment rate. Should significant problems arise due to the high level of household indebtedness this could greatly complicate the recovery process."

The following extract is taken from pp. 96-97 of the *MTR*

“While there is always the possibility that the building and construction industry will achieve a soft landing over the next decade and a half, such a desirable scenario is looking increasingly unlikely as the building and construction sector continues to increase its share of national output. With the potential output of the economy constrained by a limited capital stock and a labour supply that is adversely affected by domestic congestion costs, the building and construction industry has to bid scarce resources from other sectors of the economy to maintain its momentum. “ .....

“The result of the higher labour costs and higher cost for the output of the building industry is that the rest of the economy is being squeezed. This is particularly true for the tradable sector, especially manufacturing. The rapid rise in labour costs has forced many firms in the manufacturing sector to close, thus releasing the resources that the building industry needs. While in a successful economy such a process of change goes on all the time, it has dangers if the need for the shift in resources is unlikely to be permanent. For example, if there is a rapid slowdown in the building and construction industry in the future releasing resources, both capital and labour, for use elsewhere in the economy, it seems very unlikely that the manufacturing firms that have closed will rapidly reappear to use these resources. The consequence is that the sectoral shift in favour of building cannot be rapidly reversed without considerable pain.”

“As discussed in Chapter 6, in the long run the building and construction industry is likely to account for a much smaller share of the economy. In particular, the extent of the resources being devoted to building new dwellings is truly exceptional. This sector is very vulnerable to a shock, in particular any change in external circumstances which would cause unemployment to rise and expectations about future incomes to fall. Such a change could bring about a collapse in the housing market, including in housing prices. As illustrated in the scenario examined in Chapter 6, this could have very serious consequences for the domestic economy. It could take a number of years to recover from such a downturn and the intervening years could be extremely unpleasant no matter how wise the policies pursued.”

“Under these circumstances what would be a prudent policy to follow? Because of the very considerable risks inherent in reallocating so much of our national resources to the building sector it would seem desirable to stop using public policy to boost the growth of the building and construction sector. It would also be prudent to manage the public finances to leave scope for government action to offset, albeit to a limited extent, the consequences of a sudden and unexpected collapse in the building and construction sector.”

“The policy levers needed to slow the building industry are well understood. They involve taking money out of the sector, thereby reducing demand. This can be done both through raising taxes that directly affect demand for the output of the building and construction sector and also through changing the pattern and timing of government capital expenditure.”

“There are a range of tax changes that would differentially affect investment in building and construction, including housing. In particular, the ending of all tax write-offs for such investment would be a key first step. If that proved insufficient, consideration could be given to a range of additional measures. As suggested in Fitz Gerald (2001), the ending of tax relief on mortgages, would help reduce demand for dwellings. Further measures, such as a property tax, as suggested recently by the Competitiveness Council could also be considered.”

The tone of this MTR was significantly different from earlier MTRs and this was picked up in the media coverage. There were front page headlines saying ESRI forecasts house prices to fall by one third etc.

For example, the Irish Independent in its editorial the morning after the *MTR* was published in 2005 said:

“No one will be accusing the ESRI of a surfeit of seasonal spirit this Christmas, thanks to the gloomy report on the economy it issued yesterday. So is it a case of Bah Humbug? Has Ebenezer Scrooge taken up residence in the ESRI offices? Time will tell, but there is a great deal in this report that we should be chewing on with the turkey. An obvious point is that a boom which is increasingly reliant on a high level of activity in the construction sector, cannot go on forever.”

The following day Brendan Keenan went on to say:

“Builders and estate agents yesterday took issue with the claims by the Economic and Social Research Institute (ESRI) that the property market poses a threat to the economy and should be cooled down. .... The ESRI recommended an immediate end to tax reliefs for property and possible introduction of a property tax and abolition of mortgage interest relief. ...

As the ESRI says, we have reason to be concerned about the future.

If our present overheated state coincides with a global slowdown, the ESRI says property prices here could fall by as much as a third as the economy slows.

Even if that does not happen in the next year or two, the ESRI is predicting the present boom will start to run out by 2010, because inflation and inadequate infrastructure will choke the Tiger.

The good news is that we have time to manage the adjustment.

And it need not be a catastrophe. A return to a less frenetic society without the stresses of the never-ending boom might not be all bad. But none of us would want to see the doomsday scenario as sketched out by the ESRI coming true.

Those of us who remember the bad times of rising inflation, prices and unemployment would never want to see those days again. It was a time which has made us all appreciate what we have today.”

#### [Quarterly Economic Commentary 2005-6](#)

Winter 2005: argued that the budget was too generous. The government should have budgeted for a surplus.

Spring 2006: it argued that fiscal policy was too lax. “should avoid adding demand to an economy that is growing so quickly”. In the General Assessment it discussed the possibility of a house price bubble together with the deterioration in competitiveness.

Summer 2006: it warned about questions concerning the medium term sustainability of economy: viz. size of construction sector, growing balance of payments deficit and growth in real wages.

#### [Investment Priorities Report, 2006](#)

Editors Fitz Gerald J. and E. Morgenroth, Ex Ante Evaluation of the Investment Priorities for the National Development Plan 2007-2013, Policy Research Series No. 59, Dublin: The Economic and Social Research Institute.

<http://www.esri.ie/UserFiles/publications/20080306153016/PRS059.pdf>

In October 2006 the ESRI published this report, which had been commissioned by the Department of Finance. The report contained very extensive analysis of the dangers to the economy of an

overambitious National Development Plan (NDP) further inflating the building sector and housing in particular. This report argued that the overinflated building sector was crowding out the tradable sector of the economy and that this could have serious consequences. It argued that if the government wanted to expand investment it needed to take money out of the economy, especially building and construction.

The warnings given in this report about the dangers inherent in the building sector boom received front page coverage in the media when it was published in 2006.

Quarterly Economic Commentary Spring 2007

[http://www.esri.ie/UserFiles/publications/20070330143924/QEC2007Spr\\_Main%20Text.pdf](http://www.esri.ie/UserFiles/publications/20070330143924/QEC2007Spr_Main%20Text.pdf)

Authors: Alan Barrett, Ide Kearney and Yvonne McCarthy

“Table 12 indicates that the increase in investment inflows since 2003 is matched by an increase in the share of building and construction investment in Ireland, specifically the phenomenal growth in housing investment. If the growth in investment in housing has been the driving force behind the recent growth in net foreign borrowing, then this could be expensive in the future in terms of financing the debt since the rate of return on housing investment is lower than more productive investments. While the evidence is not yet conclusive, Honohan (2006) highlighted that the net foreign borrowings of Irish credit institutions to lend to Irish residents have grown with “astonishing speed” since 2003. If it is true that the increase in net foreign borrowing is being used to fund the very rapid growth in private sector credit, which in turn is being used to finance the current boom in the housing market, then this situation is not sustainable.”

.....

“The corollary of this is that house prices are over-valued given the current rate of house completions and the underlying demand for primary dwellings. In the Spring 2006 QEC, we discussed OECD estimates that house prices were as much as 15 per cent overvalued in mid-2005 and raised the spectre of a possible house price bubble in the Irish market. We have revisited this prospect here using an equation for housing demand described in Duffy, Fitz Gerald and Kearney (2005), and given our forecast numbers for income, house building, population and real interest rates. Based on this analysis our simulation results would suggest that house prices in 2006 were overvalued by a similar level of magnitude.”

“In this context our forecast for housing investment in 2008 can be regarded as relatively benign, implying a soft landing for the Irish housing market. Our calculations on the very rapid growth in the market for second dwellings in recent years raise the possibility that this may incorporate speculative investment on the asset value of residential property. In these circumstances a decline in real house prices could lead to a much larger reduction in the scale of house building. Given the growing importance to the exchequer of property-related taxes – stamp duties and capital gains tax together accounted for over 16 per cent of total tax revenue in 2006 – such a contraction could result in lower revenues from these sources.”

## 2008

Medium-Term Review 2008-2013

<http://www.esri.ie/UserFiles/publications/20080515155545/MTR11.pdf>

This report came out at the beginning of the “great recession”. It had an upbeat tone which, as subsequent events have shown, was wholly unwarranted. This was based on the assumption,

adopted internationally, that the credit squeeze effects would be short lived, with world growth back at trend by 2010. There was a scenario on a credit crunch. However, even this shock was much too mild. The *Review* completely missed the possibility of a financial collapse.

The *Review* began off by saying:

“Despite the very real difficulties that are currently being encountered, the essential message of this Review is that the economy will eventually rebound, and return to its medium-term growth path. The analysis in the Review suggests that the Irish economy is resilient in the face of adverse circumstances.”

.....

“A third scenario looks at the possibility that the current slowdown in the world economy could be sharper and deeper than in the Benchmark. This scenario suggests that a severe liquidity crisis in the US could lead to a more serious recession there, with serious short-term consequences for Ireland. In such an event the Irish government deficit could mushroom, posing serious problems for policymakers. However, what this scenario also shows is that, if the problems in Ireland were appropriately managed, the US recession would not do long-term damage to the Irish economy. In the medium term, when the global economy recovered, the rate of growth in Ireland would accelerate to return the economy to its medium-term growth path.”

This analysis took no account of the potential financial collapse that might occur in the US and, especially in Ireland. It did not provide any preparation for the dramatic shock that was to hit the Irish economy five months after the *Review* was published.