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HOUSE PRICES AND HOUSEHOLD DEMAND: THE CASE OF THE IRISH ECONOMY

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House prices and household demand: The case of the Irish economy1 [1]

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Introduction

The role of credit in macroeconomic developments has been a focus of research since the international financial crisis of the late 20 00s. In particular, it has been shown that significant increases in credit, often associated with changes in household wealth, can influence economic activity. Very often in these circumstances, if there then follows a swift contraction in lending, the economic fallout can be quite severe.

The Irish economy presents an obvious case study for studying the influence of net housing wealth on the macroeconomy (and specifically the labour market). The financial crisis of 2007/08 coincided with the demise of Ireland's Celtic Tiger economy, which had seen the Irish economy transformed from being one of the European Union's poorer performing countries in the early-to-mid 1990s to one experiencing strong economic growth thereafter up to 2008. Economic conditions deteriorated rapidly after 2008, with unemployment rising to 16 per cent by early-2012 and house prices falling by over 50 per cent. After this severe recession, the Irish economy started to stage a sustained recovery that was maintained through to 2019. Even when controlling for the effects of certain multi-national-related activities, domestic economic indicators such as output growth have significantly out-performed all other European economies over the period 2014 - 2019.

Developments in the Irish economy since the early 2000s have gone hand in hand with substantial changes in both the domestic financial system and residential property market. The Irish credit market experienced a transformation from the early 2000s through the mid-2000s, where the change in domestic banks' lending policies resulted in credit supply rising substantially above its long run rate of increase.

[1] This Bulletin summarises the findings of: David Cronin and Kieran McQuinn (2021). "House prices and the credit-driven household demand channel: The case of the Irish economy." Credit and Capital Markets, Vol. 54, Issue 2, pp. 199–221, 2021. The views expressed here are those of the authors and do not necessarily represent the views of the Central Bank, ESRI or the European System of Central Banks

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Due to the combination of the changes in the mortgage credit market and the improvements in general economic conditions, house prices rose sharply. Between 1995 and 2007, prices, in nominal terms, increased by 334 per cent with the largest annual rates of house price inflation occurring in the later years of that twelve-year period.

The international financial crisis of 2007/08 coincided with a collapse in new credit provision in the Irish economy. House prices fell by more than one half between 2008 and 2012. Like the general economy, Irish house prices have rallied significantly since then, increasing by 85 per cent between 2012 and 2019. Whereas the sharp rise in house prices during the 2000s was accompanied by easy credit conditions, the price increases since 2012 have occurred at a time of household deleveraging and more prudent lending practices (e.g., caps on loan-to-value ratios).

RESULTS

In this paper, we first establish the relationship between Irish house prices and key economic variables such as income levels and interest rates over the sample period (2002-2019). Against this background, statistical models indicate that net housing wealth had a significant effect on employment levels, via the non-traded sector, during the severe downturn of the late 2000s and early 2010s. The decline in wealth led to decreased consumption, which resulted in lower non-traded labour demand. This does not hold thereafter with no relationship between labour market developments and housing net wealth evident, a period when the impact of credit on the residential property market dissipated substantially. We conclude that the distortionary effects of increases in credit associated with household net wealth on economic activity no longer hold.

POLICY IMPLICATIONS

Looking ahead, as Ireland, along with other western economies, faces a harsh downturn owing to the Covid-19 pandemic, the susceptibility of the Irish labour market to changes in credit-driven housing net wealth appears no longer to be particularly relevant. This is because of the substantial deleveraging of households' credit positions during the 2008-2012 recession and more prudent lending policies in relation to new mortgage applications during the 2010s. Housing net wealth is no longer closely linked to credit provision to households; Irish household debt had, by 2020, declined by 35 per cent since its peak value in 2008. Consequently, while a downturn in house prices could occur as a result of a deterioration in key economic variables during the pandemic, it seems that the adverse effects of the sharp deterioration in net housing wealth that occurred after the 2007/8 financial crisis on the labour market will not be pertinent on this occasion.

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