Courage to say No to vested interests is vital for economy

By Alan Ahearn

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ANALYSIS : What did I tell yesterday's Fianna Fáil meeting? If you weren't there, read on. . .

HOW PAINFUL will the economic downturn be and long will it last? The simple and honest answer is that the slump will be severe and will probably last longer than most people think. The consensus among economic forecasters is for a moderate decline in real GDP this year, followed by a pick-up to low positive growth in 2009. A robust recovery, with growth of roughly 4 per cent, is pencilled in for 2010.

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This projected path for economic activity looks implausible. Weak incoming data, a deteriorating outlook for growth abroad and the scale of adjustment in the housing market that has still to take place point to significant contractions in GDP both this year and next. The economy may stabilise in 2010 as the drag from new homebuilding fades, but we will probably have to wait until 2011 for a rebound to strong growth. This assumes good policy choices by the Government. Poor policy choices would prolong the downturn.

The main factor depressing growth is the necessary contraction in the construction of new homes associated with the unwinding of the speculative house price bubble. The share of residential investment (which includes new homebuilding as well as repairs, maintenance and improvement) in the economy looks set to drop from 15 per cent of GNP in 2007 to 8 per cent in 2009.

Other components of spending, such as consumption, business investment, government expenditure and exports, will be nowhere near strong enough to plug the hole in GNP of seven percentage points spread over two years. In fact, several of these components are also contracting.

Episodes of two consecutive years of negative growth are rare in developed economies. The Nordic property and banking crisis in the early 1990s produced two of fewer than a handful of examples over the past half century. Finland spectacularly suffered a cumulative 10 per cent drop in GDP during 1991-1993, while Sweden's economy shrank 5 per cent over the same period.

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The international experience of housing booms and busts shows that real (that is, inflation-adjusted) house prices typically decline for nearly five years following the peak. Real house prices peaked in Ireland in the fourth quarter of 2006. Typically, house prices give up almost all of the gains recorded in the five years before the peak. That translates into a drop in real house prices here of about one third by 2011.

There are reasons to believe that the adjustment might be even deeper. Interest rates typically fall sharply during housing busts, as central banks respond to recession and the related easing in inflation.

Although some analysts expect the European Central Bank to cut interest rates next year, the chances of interest rates dropping several percentage points (as usually happens) are slim. In addition, exchange rates typically depreciate during housing busts as interest rates decline. This provides support to exports and employment and cushions some of the contraction in housing. In contrast, the euro is stronger now than during the boom years against the currencies of our major trading partners, despite the recent rally in the dollar.

All told, other countries' experiences suggest that real house prices may have to fall between 40 and 50 per cent from the peak for the bubble to fully deflate.

Assuming a gradual stabilisation of rents, declines in house prices of this magnitude would restore rental yields to reasonable levels of about 7 per cent. The correction would also bring house prices back in line with disposable incomes, as measured by historical trends. The resulting improvement in affordability will boost demand and revive transactions.

Vested interests such as stockbrokers and the construction industry are lobbying the Government to introduce schemes supposedly aimed at increasing the availability of mortgage credit.

Careful analysis of these proposals is crucial, because schemes that benefit property investors and developers may prove highly detrimental to the overall economy and people's welfare.

In assessing whether a particular proposal is in the national interest, a number of considerations are relevant.

First, only proposals that offer a solution to a clearly identified market failure should be considered.

Proponents of government intervention in the mortgage market argue that lenders are now demanding unreasonably large deposits from first-time buyers.

But this argument seems to confuse the asking price for a house with its true market value. Lenders correctly believe that the market-clearing values are well below current asking prices and have therefore reduced the amount they are willing to lend.

Moreover, the recent experiences of three first-time buyers reported by Simon Carswell in last Saturday's Irish Times suggest that claims of a severe credit crunch may be greatly exaggerated. All three buyers in recent weeks were offered mortgages of 92 per cent of the asking price. Requiring a deposit of 8 per cent of the price is not an unreasonable lending practice. It also makes sense for lenders to look for larger deposits on certain types of properties and from more risky buyers.

Second, government intervention is probably not necessary if the identified market failure is temporary and self-correcting. Banks can be expected to demand smaller deposits when house prices have moved down closer to market-clearing levels, since the risk of prices falling further will have diminished. Moreover, for a given loan-to-price ratio, lower house prices mean lower deposits.

Third, any scheme that involves a State subsidy to homebuyers would hinder the adjustment process and prolong the pain. Incentives to homebuyers should take the form of cuts in house prices by sellers, not exchequer-financed subsidies. Proposals that involve State agencies providing low-interest home loans or mortgage guarantees should be rejected.

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Existing programmes such as affordable housing schemes were explicitly designed to offer subsidies to lower earners and therefore should not be expanded to middle-income buyers.

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By not interfering with the adjustment in house prices, the Government will allow the housing market to work off the overvaluation.

Our economic recovery will be led by exports, boosted by inflows of foreign direct investment, ongoing productivity improvements in our export sectors, and at some stage stronger growth abroad. The gains from these trends will be outweighed in the near term by the housing bust, but they will eventually come to dominate.

A successful rebalancing of our economy over the next several years will require the Government to take courageous decisions. Most important will be the courage to slash spending to restore order to the public finances, the courage not to interfere with the housing market, and the courage to say No to vested interests.

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