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## A TAIL OF TWO COUNTRIES

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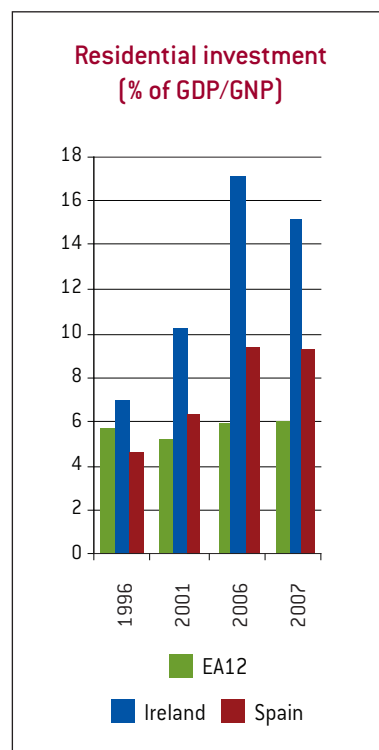
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**SUMMARY** The outlook for two of the euro area's best performing economies to date, Ireland and Spain, has darkened dramatically recently amid severe downturns in housing markets. What do these countries' experiences tell us about the functioning of EMU? The source of rapid growth was different in the two countries, but both experienced large inflows of migrants and significant housing booms. Against a backdrop of low one-size-fits-all interest rates in the euro area after 2002, housing markets overheated. These bubbles have burst and the slump in residential investment from elevated levels threatens to drag both economies from one tail of the growth distribution to the other.



Source: Eurostat and CSO.

### POLICY CHALLENGE

Euro area governments should monitor and prick housing bubbles. The Greenspan doctrine that policymakers should not tackle bubbles when they are inflating is under re-examination worldwide, but may not be appropriate in any event for individual EMU member states, who do not control their interest rates. Governments should use countercyclical changes to the housing tax system to dampen future housing cycles. Regulatory policies and supervisory practices should be designed to prevent a loosening of lending standards and abnormally fast growth in credit during housing booms. EU surveillance of member state economies should be broadened to include asset market developments.



ONE OF THE AIMS of Economic and Monetary Union (EMU) is to promote the catching-up of lower income member states. When the Maastricht Treaty was signed, the lower income group of countries included Greece, Ireland, Spain, and Portugal. Ireland has experienced a rapid increase in income per capita since then, while Spain has also progressed towards convergence.

EMU contributed to this convergence by, among other things, delivering a sharp reduction in interest rates and greater access to finance from abroad, which boosted interest-sensitive spending such as investment and facilitated fast growth in credit. These developments, combined with other features of the Irish and Spanish economies such as demographic factors and the tax treatment of housing, generated housing market booms in both countries.

The rapid growth in Ireland's economy was initially driven by a positive shock to productivity in the traded sector. The Spanish expansion, in contrast, reflected a positive shock to domestic demand. In both cases, the shocks put upward pressure on the relative price of non-traded goods and services, including housing<sup>1</sup>.

From this perspective, the housing booms can be seen as part of the convergence process, since fast increases in house prices were to be expected as price levels of non-traded goods converge. However, as in other housing cycles, the housing booms in Ireland and Spain turned into disruptive bubbles, as irrational exuberance

caused price increases to feed upon themselves and housing valuations became unhinged from fundamentals. The drops in real interest rates (Figure 1) to inappropriately low levels after EMU entry created difficulties for both countries. These difficulties reflect the well-known 'Walters' critique' of one-size-fits-all monetary policy: real interest rates have moved in ways that have been partly destabilising (Miller and Sutherland, 1991, and Kirsanova et al 2006).

These bubbles have now burst, with damaging consequences for the Irish and Spanish economies and potentially for these countries' financial systems. The experience underscores the dangers of overheating asset markets during the convergence process in a single currency area.

Developments in housing markets have been a major source of divergence within EMU over the past decade. The bursting of these bubbles is contributing to

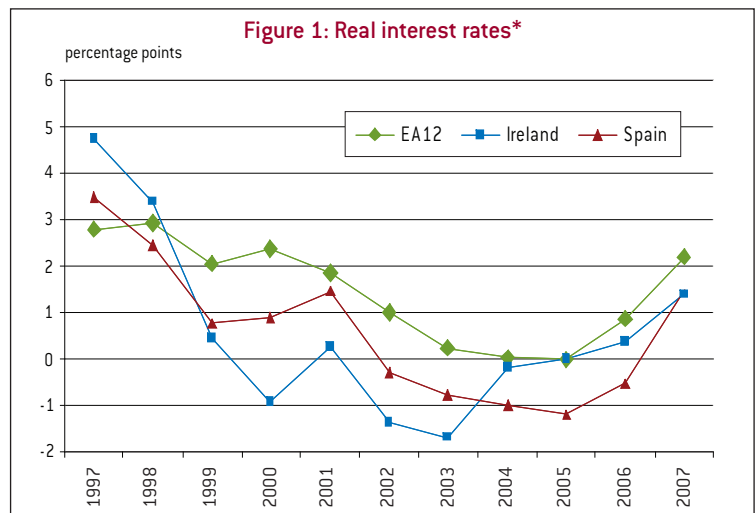
divergence by depressing growth in Ireland and Spain and threatening financial stability at the same time that the German economy is growing robustly. What are the implications for policymakers? The so-called 'Greenspan doctrine' that policymakers should not try to tackle asset bubbles and should

*'The Greenspan doctrine may not be appropriate for individual EMU member states.'*

'focus on policies to mitigate the fallout when it occurs' (Greenspan 1999) may not be appropriate for individual member countries of the euro area that do not have independent

monetary policies. Moreover, in light of the US subprime meltdown, policymakers and academics are re-examining the prevailing hands-off approach to asset prices. If there is a need to find a way to counteract bubbles more effectively, in euro area member states that responsibility will lie with national policymakers, not with the ECB.

The next section examines the behaviour of housing markets in Ireland and Spain during EMU and considers what features and policies may have facilitated the



Source: Eurostat and Ameco. \*Short-term nominal interest rates deflated by HICP.

<sup>1</sup> The shocks had different implications for external balances, however, with Ireland's current account balance remaining close to zero until 2005, while Spain's current account deficit widened sharply to more than 10 percent of GDP last year.



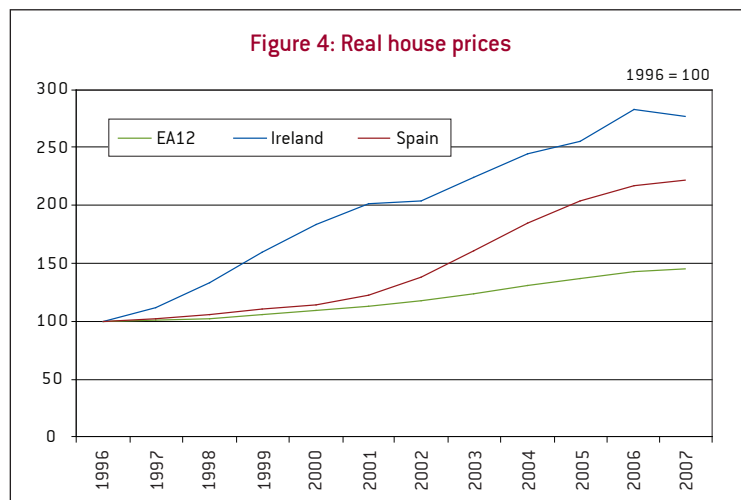
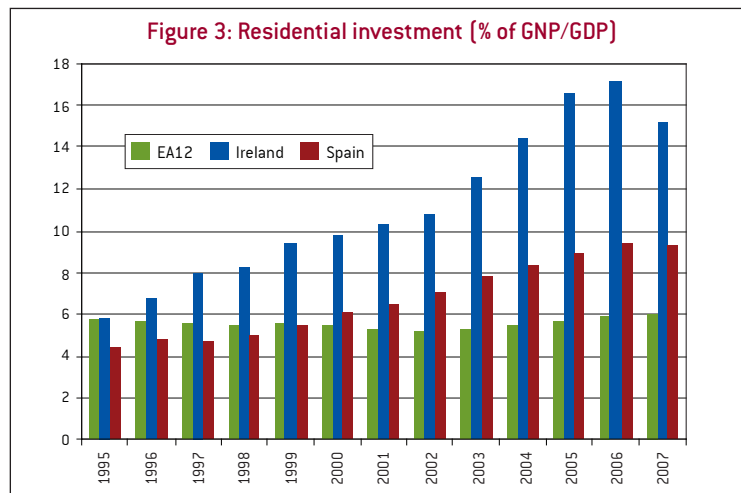
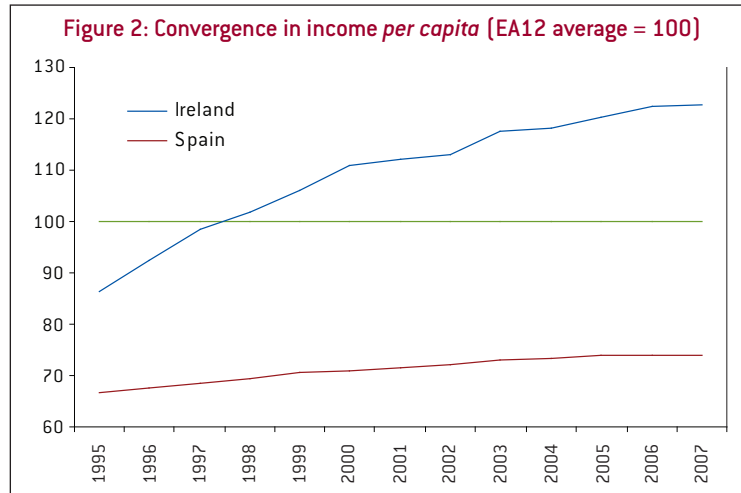
overheating of housing markets in these countries. Section 2 discusses the role of large migration flows in spurring growth in housing. Section 3 outlines near-term policy recommendations for Ireland and Spain as well as more general conclusions for EMU.

**1. HOUSING MARKET DEVELOPMENTS UNDER EMU**

A major objective of EMU is to foster economic convergence in Europe. Ten years after the launch of the single currency, two of the three so-called ‘cohesion countries’ that joined the euro in 1999, Ireland and Spain, have seen income per capita grow faster than the euro-area average (Figure 2). In Ireland’s case, the catching-up process has been spectacularly successful. In contrast, the other cohesion country, Portugal, has made little progress in catching up over the past decade.

Membership of the single currency has promoted convergence in Ireland and Spain mainly through the elimination of risk premia on interest rates and the resulting boost to investment spending. Increased financial market integration has boosted capital flows across euro area countries and has facilitated easier availability of credit to households and businesses<sup>2</sup>.

The boom in residential investment has led to a doubling of its share in GDP (Figure 3), directly contributing to annual growth of half a percentage point in Spain and a full percentage point in Ireland over the 1996-2006 period<sup>3</sup>. The surge in investment was accompanied by soaring



house prices (Figure 4). Other factors also contributed to the housing booms, notably sustained fast growth in disposable income; population dynamics including increased immigration flows; favourable tax treatment of home ownership; and demand by for-

Sources: Figure 2: AMECO and CSO; Figure 3: Eurostat and CSO; Figure 4: ECB, ESRI, Eurostat and Ministerio de Vivienda

<sup>2</sup> Ahearne, von Hagen and Schmitz (2008) provide evidence that capital flows from high-income euro area economies to low-income euro area economies have increased since the creation of the euro.

<sup>3</sup> We use GNP instead of GDP as a measure of output for Ireland to exclude the supernormal value-added recorded in some sectors that are dominated by foreign multinational companies.



eigners for retirement homes in Spain.

Housing markets in both countries began to show some signs of overheating around 2002. New homebuilding surged to levels well above estimates of medium-term housing needs. For example, assuming that Ireland's sustainable level of residential investment was closer to 10 percent of GNP, the rate of investment in housing since 2002 would have generated an excess stock of residential capital equivalent to about 25 percent of GNP<sup>4</sup>. Working off this surplus will imply a significant drop in housing investment, exert downward pressure on house prices and put a substantial drag on growth for several years.

Traditional measures of housing valuation such as price-to-rent and price-to-income ratios also began to signal possible overheating around 2002 (Figure 5). The compression of rental yields appears to be much greater than can be explained by declining interest rates. This implies that the

unusually high level of house prices relative to rents was mainly supported by large expected capital gains.

Against a backdrop of rising interest rates in 2006 and 2007, house prices and residential investment began to fall. The contraction in home building is expected to subtract directly about four percentage points from GDP growth in Ireland this year.

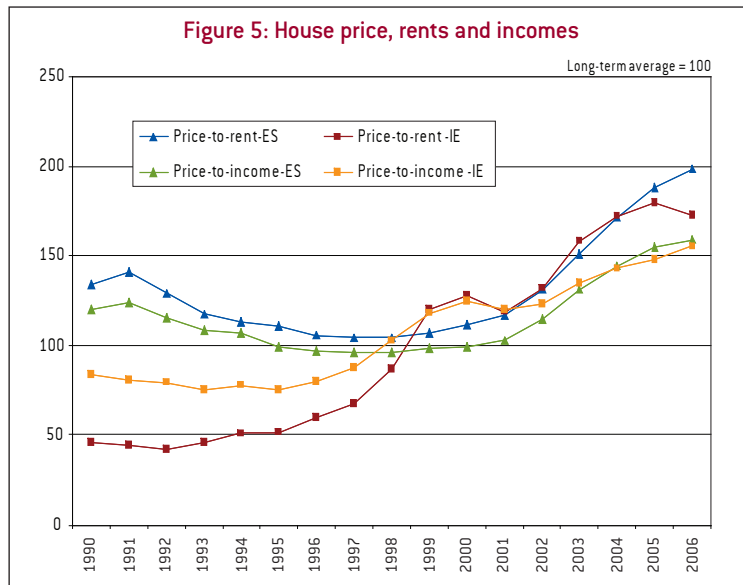
*What factors contributed to overheating?*

Developments in financial markets over the past year have highlighted the problems of asset price bubbles, especially bubbles in house prices. Under certain conditions, booms in house prices, though initially justified by economic fundamentals, can turn into price bubbles in which expectations of future gains become the main driver of current prices and housing values move out of kilter with conditions in the rest of the economy.

Conditions appear to have been conducive for housing bubbles in Ireland and Spain.

- Strong growth in domestic demand, productivity growth in the traded goods sectors, and the convergence of price levels have generated inflation levels in Ireland and Spain that have exceeded the euro area since 1999. Moreover, the strong economic performance of Ireland and Spain represented a significant divergence from the euro area economic cycle. As a result, real interest rates were inappropriately low for both these economies. O'Leary (2004) provides evidence based on Taylor rules that much higher interest rates were warranted by prevailing economic conditions (Figure 6). Low real interest rates reinforced the boom in interest-sensitive spending, particularly in consumer spending and the housing market.
- Ireland and Spain have generous tax provisions for owner occupied housing (van den Noord, 2005). Both countries have generous interest deductibility systems for owner-occupied housing and tax breaks for profits made on the sale of primary residences.

Figure 5: House price, rents and incomes

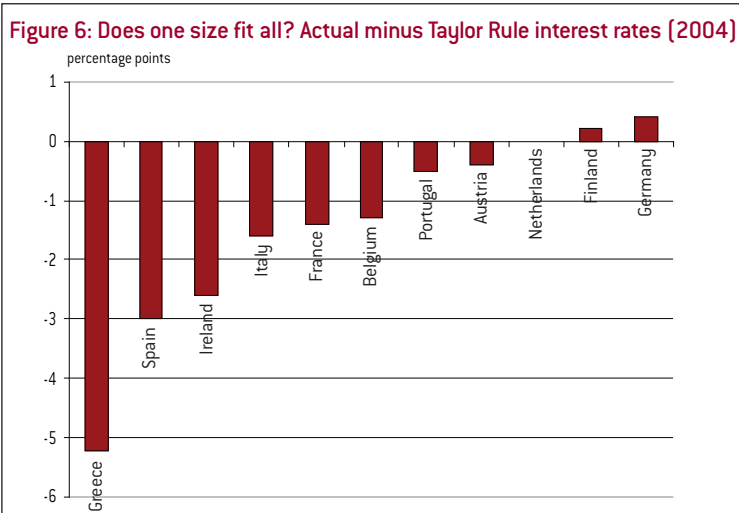


Source: OECD.

<sup>4</sup> This figure for medium-term residential investment is in line with recent projections of housing needs in Economic and Social Research Institute (2008). The resulting estimate of the excess stock of residential capital is consistent with data from Census 2006 that there were 266,000 vacant dwellings in Ireland in April 2006, representing 15 percent of the total housing stock. Many of these dwellings are thought to be investment properties.

**2. WHAT ROLE DID MIGRATION PLAY?**

Labour mobility is rightly regarded as a key channel by which a large currency area can cope with asymmetric shocks (Mundell 1961). Accordingly, one might have expected the dynamic growth of Spain and Ireland to



Source: O'Leary (2004).

have been smoothed via the labour mobility channel in view of the accelerated immigration inflows that the two countries have experienced in recent years (see Figure 7).

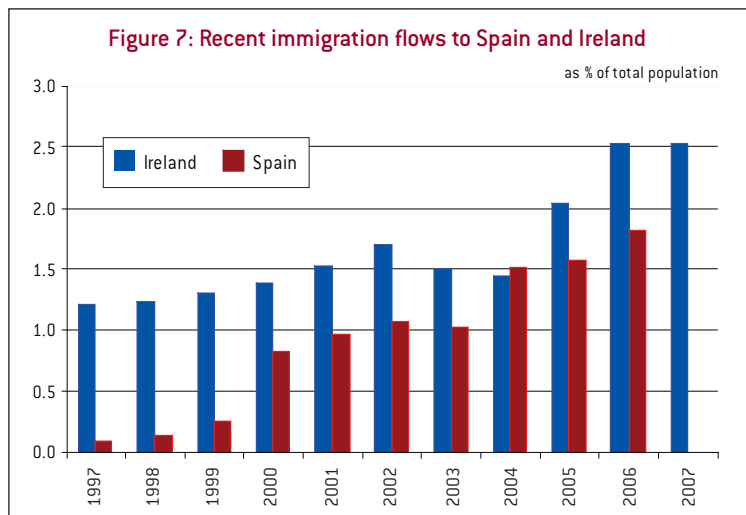
However, the matter is more complicated when a local economic boom is accompanied and to some extent fuelled by a rapid increase in house prices. To understand why, it is instructive to first reflect on the likely impact of immigration on the fundamental price of housing. On the demand side, immigration increases the number

of people requiring housing in the location in question. Thus, even if immigrants initially accept more crowded housing conditions than natives, they will increase demand for housing. On the supply side, immigrant construction workers can help to alleviate capacity constraints in a booming construction sector provided that construction workers are the binding constraint. Thus, immigration can help to increase the supply of housing.

Ultimately, it is an empirical question which effect will dominate. At

one extreme, it would be conceivable that a massive and temporary inflow of foreign construction workers who live in cramped conditions to maximise their savings and plan to return back home once the construction is completed would only marginally increase rental prices in the short run while substantially reducing housing prices over a longer time horizon simply by reducing construction costs and expanding the supply of housing. At the other extreme, there would be few construction workers among the immigrants and in any event there might be tight zoning laws in place so as to make an expansion in housing supply difficult no matter what. In that case, housing prices might increase substantially in response to immigration.

In his recent and careful study of the house price impact of immigration on US metropolitan areas, Saiz (2007) finds that immigration increases house prices. He estimates that a an inflow of one percent of immigrants increases rents and the value of houses by roughly one percent. Thus, the impact of immigration on house prices is estimated to be several times stronger than any positive or negative impact of immigration on native incomes<sup>5</sup>. Goldman Sachs (2007) estimate that a one percent increase in the number of households raises house prices by eight percent in the short run and by six percent once the house-building has responded to higher prices over the longer term.



Source: INE and Central Statistics Office Ireland.

Overall, it therefore appears unlikely that the net effect of

<sup>5</sup> See Borjas (2003), Longhi et al (2005), Ottaviano and Peri (2006).



immigration would take pressure off a booming housing market. This is the fundamental reason why the general argument that labour mobility will help to prevent overheating in a fast-growing member of a currency union is unlikely to fully apply in a boom that is to an important extent fuelled by house prices.

In addition, one can attempt to speculate on the role of immigration in a housing price bubble where real estate prices have risen well above fundamentals. One channel by which important migration flows might help to sustain a bubble is by adding an important dimension of speculative expectations. Specifically, there could be a tendency to rationalise excessively high real estate prices by long-term linear extrapolation of current migratory trends, underestimating the pro-cyclical and therefore mean-reverting component of immigration. For example, the extreme upward revisions in long-term population projections for Spain until 2050 (see Figure 8) are largely driven by changes in assumptions about future net immigration rates. But

of course such [potentially flawed] expectations about future population trends directly feed through to current real estate prices.

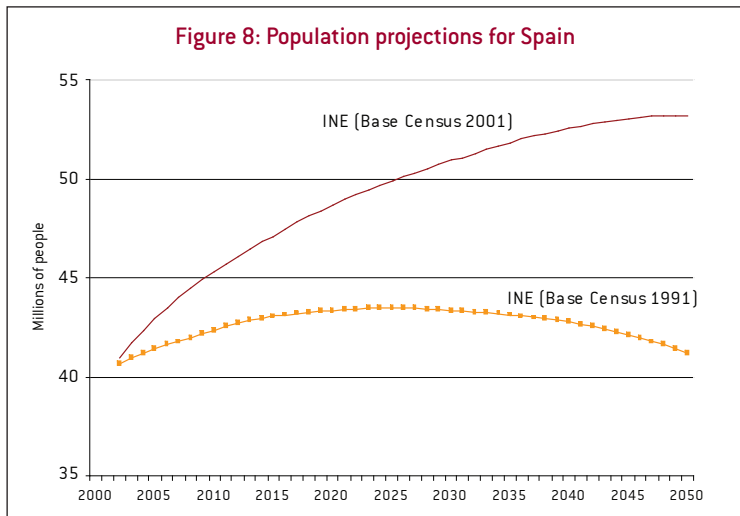
Furthermore, once real estate prices have reached bubble levels largely in excess of what would be justified by reasonable assumptions about the future, one key channel of welfare losses as a result of the price bubble is the excess diversion of resources into the construction sector. If the price elasticity of supply is reduced through the ready availability of immigrant construction workers, the wasteful excess construction activity is likely to be larger than it would have been without immigration. Whether this greater supply response in the real estate sector will also accelerate the bursting of the bubble [thereby at least shortening the time until the bubble bursts] is difficult to predict and ultimately depends on the mechanisms that are driving the bubble expectations. Hence, even the availability of cheap

labour for construction may have ambiguous welfare effects in a housing bubble economy.

Summing up, it was clearly reasonable that real estate prices have increased substantially in Ireland and Spain not only in response to increased real incomes and low interest rates but also in response to immigration driven by genuine economic opportunity. However, it appears also clear that the problems of divergence between Ireland and Spain [whose rapid growth was in part driven by the real estate sector] and the rest of the Euro area should not have been expected to be smoothed by a reliance on the labour mobility channel alone. Price misalignments and distortions may even have been temporarily exacerbated by immigration.

While these arguments do not imply that the surge in migration to Ireland and Spain has been harmful overall, they do suggest that immigration has perhaps been less beneficial to the local economy than was hoped at the height of the economic boom. And now that the bubble has burst, the practical question arises to what extent immigrants especially in the construction sector will contribute to the adjustment by onward or return migration and to what extent they will move into unemployment or growing sectors

*‘Working off the surplus will put a substantial drag on housing investment for several years.’*



Source: INE.



### 3. POLICY CONCLUSIONS

Developments in housing markets in Ireland and Spain raise questions about how policymakers should respond in the near-term to support economic activity in the face of housing slumps. But the experiences also raise broader questions about the functioning of the euro area and how national policy frameworks should be adapted to allow member countries to respond more appropriately to asymmetric shocks. These lessons may be particularly relevant for new catching-up countries in the euro area.

In the near term, how should policymakers in Ireland and Spain respond to the bursting of housing bubbles in those countries?

- Policymakers should not prevent house prices from declining to more sustainable levels. House prices will eventually decline to levels that bring the supply and demand for housing back into equilibrium. Falling prices and the lack of demand imply that some property developers will go bankrupt. Governments should not try to prevent such a shakeout in the industry.
- As home-building contracts, governments should support non-housing parts of the economy to maintain growth. Increased infrastructural spending might be particularly useful, because such spending would fill a gap in demand and provide employment to laid-off construction workers. Moreover, better (public) transport infrastructure may help to

mitigate future house price bubbles by reducing the premium on centrally located housing.

- Governments should avoid actions that would add to the supply of housing in the near term. For example, the Spanish government has approved measures to promote the construction of social housing at a rate of 150,000 new houses per year, in part to support the housing industry. Such measures may worsen the inventory overhang problem and prolong the adjustment process.
- Insulation investments in residential housing have long been recognised as an economically attractive way to reduce carbon dioxide emissions with particularly short payback periods on investment. Therefore, relatively small subsidies for such insulation activities might go a long way towards stimulating such insulation investments to improve the existing housing stock. The introduction of such subsidies might give rise to a double dividend of environmental benefits plus a cushioning of the required but painful contraction of the construction sector. Both Ireland and Spain already have policy initiatives in this regard that could be built upon and expanded<sup>6</sup>.

We also draw more general conclusions for EMU. Over the past decade, house price increases the euro area as a whole have been unremarkable (Figure 4) and therefore not a major factor for the ECB. However, there have been

local housing bubbles that have added to divergence in the euro area and now threaten economic prospects and financial stability in some member states. Our focus is on measures that would make national economies less vulnerable to destabilising housing booms and busts.

- Euro area governments should prick housing bubbles using countercyclical taxation of housing. Whenever ECB interest rates become inappropriately low for a member state, for example, aggressive reductions in tax breaks on housing should be introduced to offset the stimulus coming from ECB policy. Mortgage interest relief could be eliminated. A tax on interest payments for flexible-rate mortgages might also be called for, as well as increases in property tax and capital gains tax on owner-occupied homes. These measures could be reversed when the ECB pushes interest rates back up.
- Housing booms associated with credit booms are particularly damaging (Mishkin, 2008). In Ireland and Spain, financial liberalisation and increasing banking competition have contributed to lower mortgage interest rates and facilitated access to credit by households. The process of liberalisation and further competition has also induced the creation of new mortgage instruments such as 100 percent (or even higher) mortgage products, interest-only mortgages and mortgages with longer repayment periods. This has resulted in a rapid expansion of credit

<sup>6</sup> In April 2008, the Irish government announced the introduction of a new Home Energy Saving Scheme that subsidizes energy efficient investments in residential housing with a subsidy volume of initially € 5m but potentially up to € 100m.

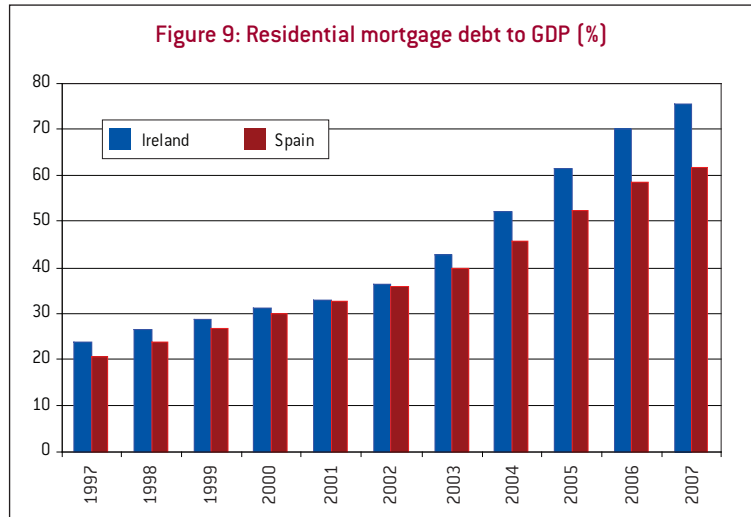




(Figure 9). These experiences suggest that banking regulations should be used more forcefully to dampen bubbles. In particular, regulations should address banking practices that contribute to credit-driven bubbles and perhaps should allow bank supervisors to play a counter-cyclical role.

- There are no incentives from the euro area system for national governments to lean against the wind of housing bubbles. There should be, because housing markets are so large and housing busts are always very disruptive. A country with a housing boom with easily meet SGP rules on fiscal targets since booms boost government revenues. As recommended in the recent Commission (2008) report on the lessons from the first ten years of the euro, a more effective surveillance of macro-economic developments is needed at the euro area level. This surveillance should not be concerned by budgetary developments alone, but recognise that housing market bubbles and their consequences can severely hamper the smooth functioning of EMU. For this reason, they are a matter of common concern.

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Source: European Mortgage Federation and Bruegel calculations.

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