

Blowing Bubbles and Bursting Them: Managing Housing Markets Under EMU

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Introduction

- Housing markets are idiosyncratic
- Drivers of housing:
 - Demographics
 - Cost of capital
- EMU changed environment for household sector
- Building in the economy & housing markets today
- Managing housing markets under EMU

Housing markets: idiosyncratic

- US housing market
 - First time that there is a general decline
- Europe
 - No general trend – even in 2006
 - Germany and Italy in doldrums
 - Ireland, Spain, UK exceptional inflation
- Is globalisation and financial integration promoting a convergence in housing cycles?
- Affects risk – diversity of exposure not enough

Housing - Long-Term Drivers

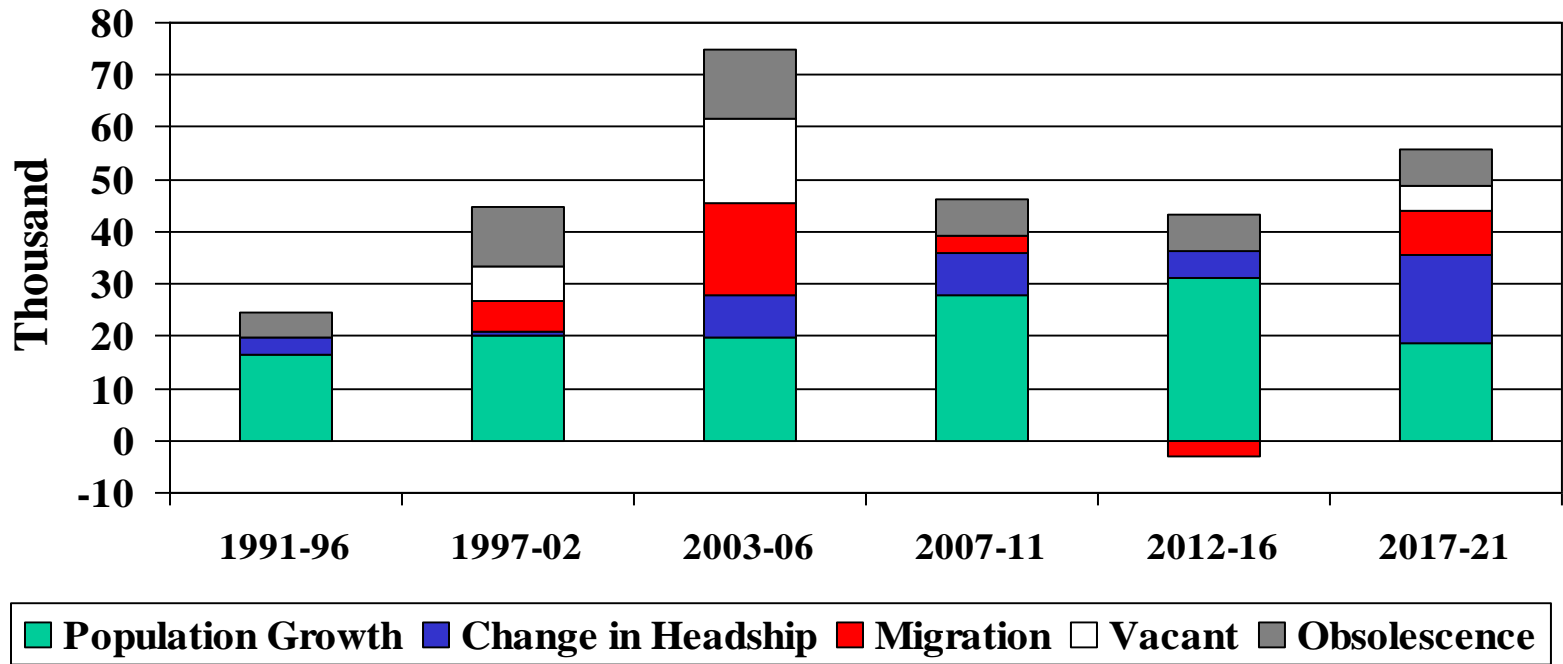
$$H^* = f(P, Y, r, N, C, z)$$

- Optimal stock a function of:
- Price, income, user cost, demographics, cost of building, credit
- Expectations, preferences, holiday homes?
- Demographics
 - Natural increase, “headship rates”, migration
- Cost of capital

Dwellings per 1000 Adults

	All Dwellings	Occupied
Denmark	620.8	594.6
France	633.6	525.6
Germany	598.5	
Ireland 2001	525	464
Ireland 2006	574	478
Netherlands		534.0
Poland	453.5	421.2
Spain	655.1	443.6
UK	574.8	550.8

Irish Housing Demand - Components



Cost of Capital

- EMU and financial liberalisation

Risk premium: percentage points

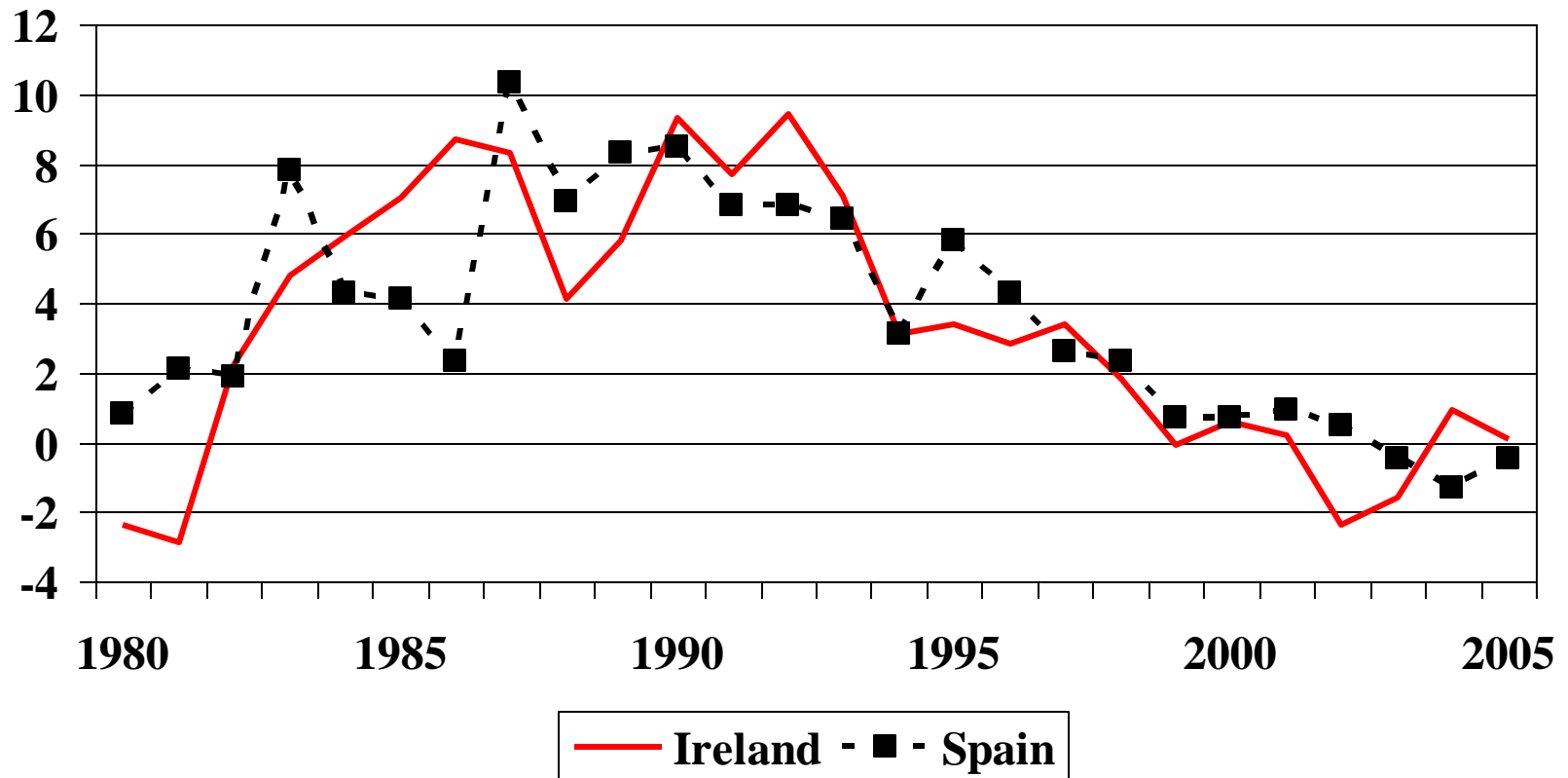
Relative to DM

	1980-98	1985-98
Ireland	2.0	1.6
Spain	1.4	1.9
UK	2.1	

Cost of Capital

- EMU and financial liberalisation
 - Fall in risk premium especially for households
- Real cost of capital
 - Companies – inflation in output prices
 - Households – depends on local consumer price

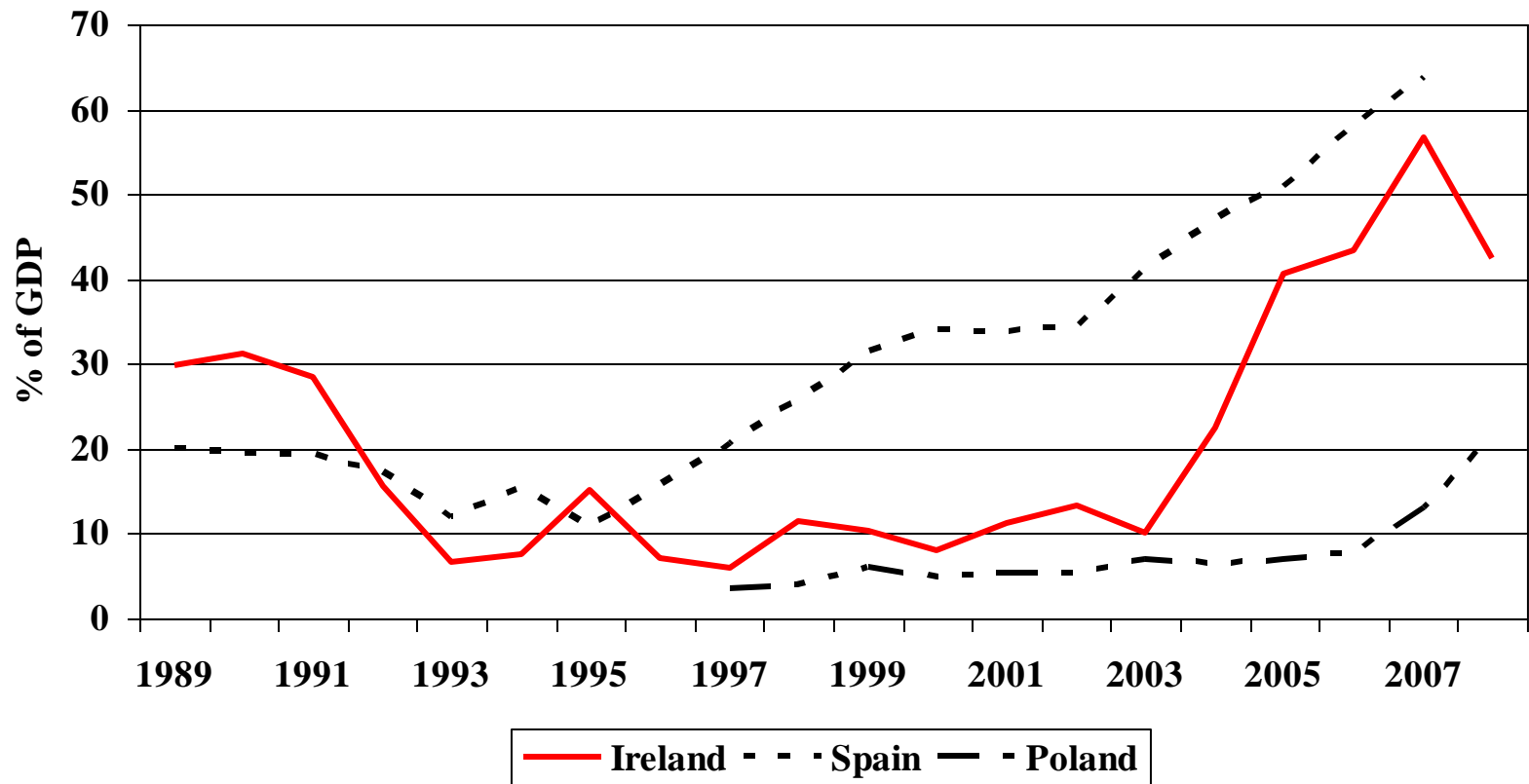
Real Interest Rates



Household sector financing

- Borrow from banks
- If big financing requirement
 - Banks borrow abroad
 - Balance of payments deficit
- Reduction in risk premium – real rates
 - Increased investment -Banks increase credit
 - If credit > domestic resources
 - Pre EMU – exchange risk premium – ration?
 - Post EMU – “unlimited” Euro area funding

Net Foreign Liabilities of Banking System



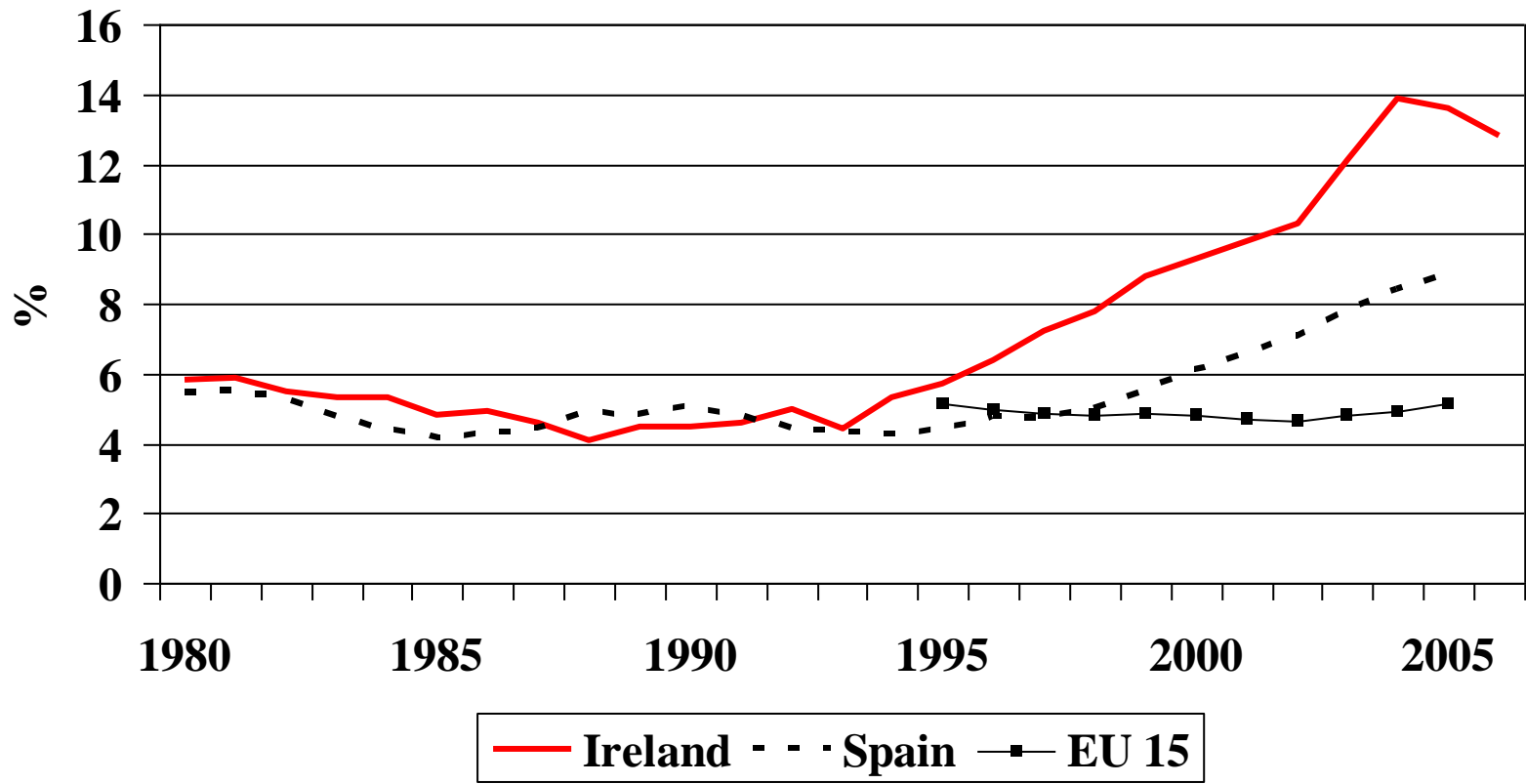
Role of Building in Economy

- Effects of change in share:
 - Wealth effects, Demand effects
- Size of Housing/Building
 - Optimal v Actual capital stock
 - housing, infrastructure
- Crowding out of tradable sector
- Crowding in of tradable sector in bust?
- Role of the labour market

Housing, % of GDP, 1970-05

	Average	Max	Min	2005
France	5.4	7.9	4.1	4.6
Germany	6.5	8.2	5.2	5.6
UK	3.6	4.5	2.8	3.9
Ireland	6.1	13.9	3.7	13.9
Spain	5.4	8.9	4.1	8.9
Poland, 1996-05	2.6	3.0	2.2	2.7

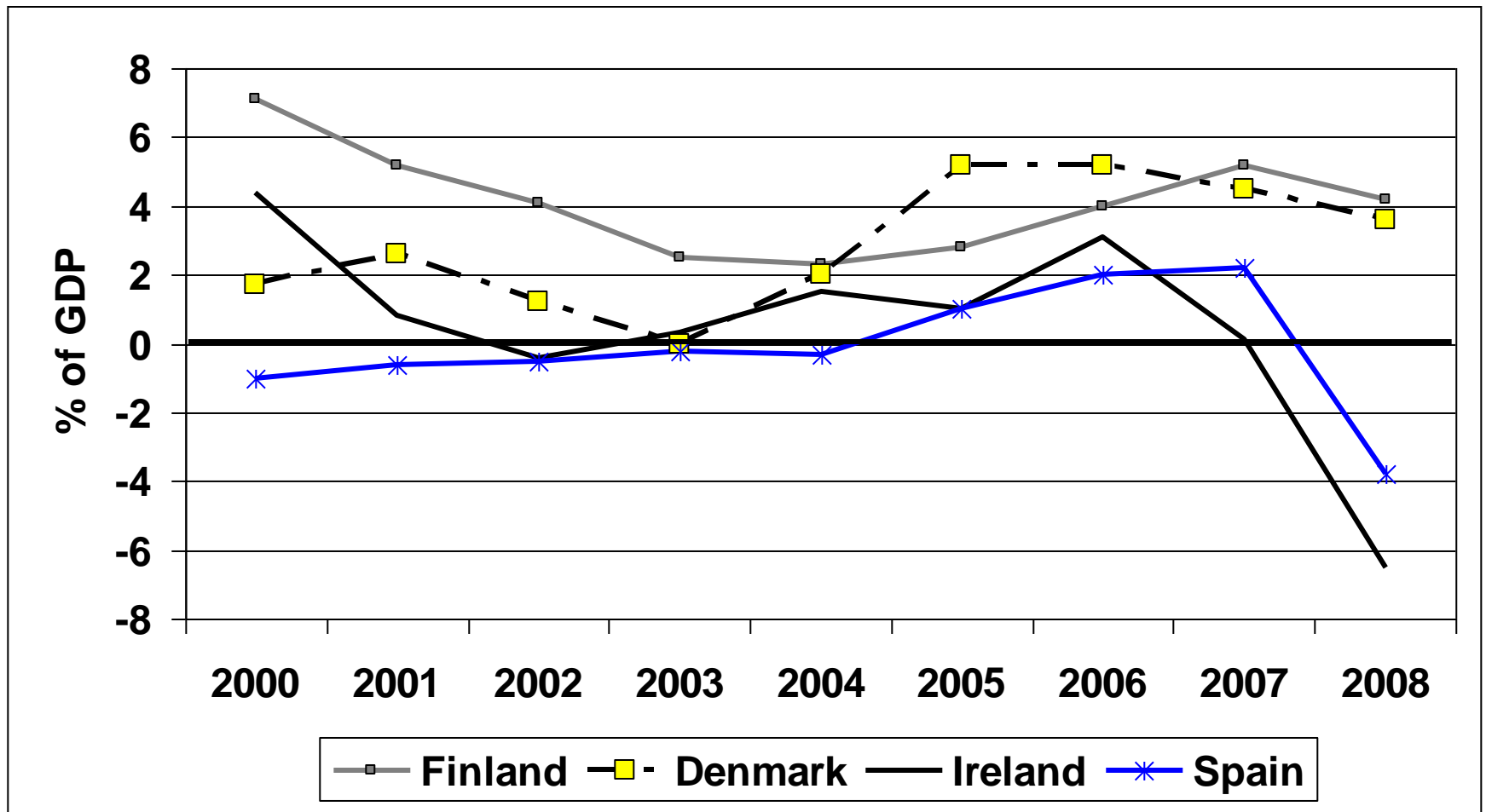
Housing investment share of GNP



Managing Housing Markets

- Housing bubbles can do a lot of damage
- EMU changes instruments available to governments
 - Interest rates
 - Taxation
 - Financial regulation
- Stability & Growth Pact not the story
- Need to run substantial surpluses & target housing
- Financial regulation – necessary but not sufficient

General Government Balance



Conclusions

- Ireland and Spain
 - Need more dwellings in long term
 - Mismanagement of housing markets has big macro-economic costs
 - Aggravated by failure of financial regulation
 - Crowds out tradable sector
 - Costs a function of how far & how fast the fall
- Governments must manage housing market
 - EU-12 – especially Poland