

## THE IRISH HOUSING MARKET

### SOFT LANDING ACHIEVABLE

There are undoubtedly risks to the Irish housing market with price inflation still relatively high, a surge in supply and substantial reliance on the investment market. However, we believe that comfortable affordability levels, continuing low interest rates and the improved economic climate, particularly a robust labour market, together with untapped demand, should cushion the market, allowing it to achieve a soft landing.

### SUMMARY

- Though house price inflation remains high, the trend is moderating. By end 2004 it could be down to around 10%. Prices may then rise by just 3 - 5% in 2005.
- The gradual decrease in house price inflation should reduce the threat of a market crash. However, there are still risks. One of these is the current high level of supply.
- Completions could average 80,000 this year and around that again in 2005, though we do expect a slowdown in the pace of housing output over the course of next year.
- Supply at these levels cannot be absorbed indefinitely. However, we believe that the house building industry will respond to easing demand and slow completions so as to prevent oversupply threatening the stability of the housing market.
- It would more likely take one or two other factors to cause a housing market crash - either a significant deterioration in the labour market or a sharp increase in interest rates. Neither of these seems a likely scenario in the short term.
- Residential property yields have fallen significantly and, for new investors, property only makes sense on the expectations of significant capital gains.
- Given the current level of output, the market would be at considerable risk if investors started leaving in the face of falling rental incomes. While, as yet, there is little evidence of any significant investor withdrawal, investor interest is likely to wane and the sector requires careful monitoring.
- Despite the potential threats, there are several factors that should provide support to the market.
- On top of the benign interest rate environment and robust labour market, there is still a high level of untapped demand from those currently priced out of the market. Any moderate decline in house prices could help release this demand, thus putting a floor under the housing market.
- In addition, there has been a marked shift in affordability. Affordability is being made more comfortable, in part through the lengthening of mortgage terms but also, we believe, through a move to lower cost housing units.
- Mortgage lending remains buoyant, reflecting strong housing activity and firm prices. With output levels expected to stabilise and price rises likely to moderate further, mortgage growth can be expected to slow in 2005.

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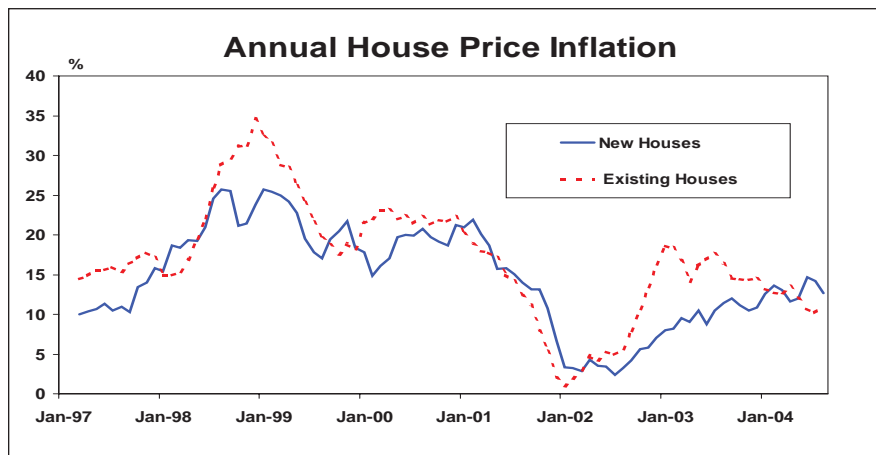
## Prices : *Moderating Trend To Resume*

*House price inflation still high despite earlier moderating trend*

After moderating in the early part of the year, the pace of growth in Irish house price inflation has been stable in recent months. Permanent tsb data show that average house prices grew by 11.5% year-on-year in August and that average house price inflation has been stuck in a 11-11.5% range since May. This, though, is down from the 13.7% inflation rate recorded in December 2003 and well below the recent peak of 15.6% witnessed in July last year. In the three months from June to August prices rose by 1.0% per month on average, after an average 0.8% per month increase in the first five months of the year.

*New house price inflation has been remarkably sticky*

The August data show a downturn in new house price inflation as the sharp rise in August 2003 falls out of the annual comparison. As a consequence, new house price inflation is now rising at 12.7% year-on-year, down from 14.2% in July. New house price inflation, though, still remains remarkably high, given the scale of supply hitting the market. From mid-2002 to end 2003, the pace of growth of new house prices was significantly less than that for existing properties but this situation has reversed in 2004.



This may, to some extent, reflect a correction after the rapid increase in existing house price inflation witnessed over the course of 2002 and 2003. Existing house price inflation peaked in January 2003 at 18.6% and has declined to 10.9% in August 2004. Meanwhile, despite the record number of completions, new house price inflation continued to increase over the first half of 2004 to a peak at 14.7% in June before subsequently falling back to 14.2% in July and 12.7% in August.

Our earlier expectations that the high level of supply of new houses coming on to the market, on top of record completion levels last year, would begin to dampen new house price inflation have yet to be realised. However, we are encouraged by the deceleration in new house price inflation in July and August. We remain of the view that supply of some 80,000 units per annum will impact on the rate of new house price inflation.

*Overall inflation rate down to 10% by end 2004, then 3-5% in 2005*

This, coupled with a continuation in the downward trend in the inflation rate for existing properties should see the rate of overall national house price inflation moderate further over the balance of 2004. By year end it could be down to around 10%. Given the continuing high level of supply, prices may rise by just 3-5% in 2005.

## Completions : Another Record Year

*No slowdown in pace of completions*

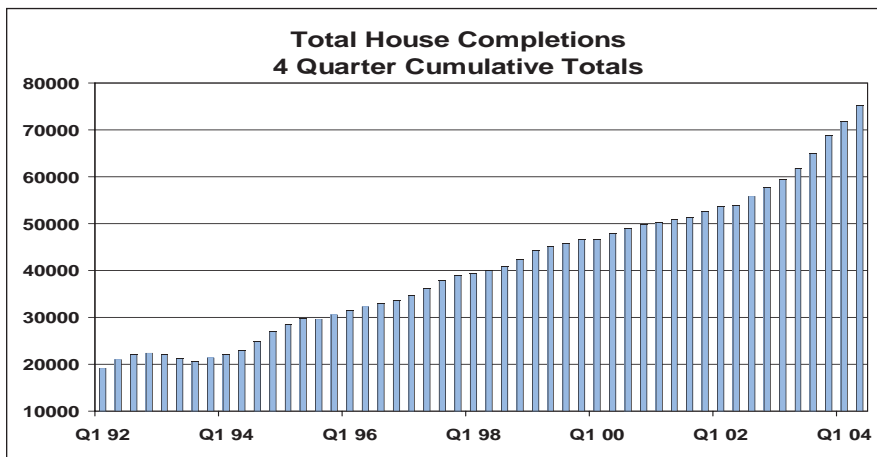
While the gradual decrease in average house price inflation should reduce the risk of a market crash, there are still pitfalls for the housing market. One of these is oversupply. Indeed, the most recent data from the Department of the Environment (DoE) show that total house completions rose by 21% year-on-year in H1 2004. This is on top of the 19% increase in completions in 2003, which brought them to a record 68,819.

The more detailed breakdown available for Q1 shows that private house completions, which account for over 90% of total output, increased by almost 26% year-on-year in the period with social housing actually falling by some 18% year-on-year.

*Registrations imply continued strong output*

The trend in new house guarantee registrations, which provide the best proxy for private housing starts, indicates that completions are set to continue growing strongly on a year-on-year basis over the balance of the year and into 2005. New house guarantee registrations increased by 8% year-on-year in Q1 2004, and then by around 25% in Q2.

However, after the strong Q2, the pace of growth has eased in more recent months, with registrations down 1.5% in Q3 compared to year earlier levels. This leaves registrations up 10.5% year to date following growth of 11.5% in 2003, which brought the total to 56,859. This in itself had represented a remarkably robust performance given the record rise of 77% in registrations in 2002.



*80,000 completions in 2004 and 2005*

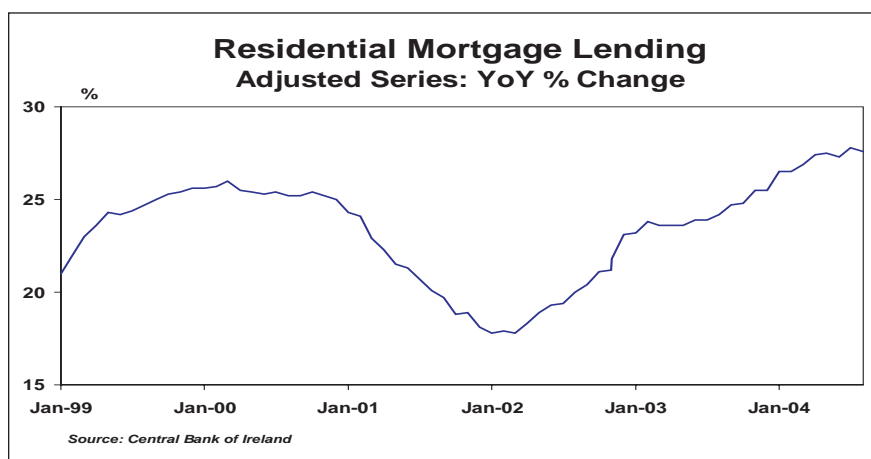
It now looks as if completions will total some 80,000 for the year as a whole. While we expect supply levels to begin to decline over the course of 2005, we need to see further signs of a downturn in housing registrations. This would indicate that developers are indeed slowing the pace of construction and that the Q3 slowdown in the pace of growth of registrations is not just a reaction to Q2 strength.

Even assuming that the housebuilding industry does react to the potential threat that would be posed by substantial oversupply and that it moderates the pace of construction activity, completions could well total around 80,000 again next year.

## Mortgage Lending : Remains Strong

*Mortgage lending remains very firm*

The strength of housing demand, plus rising house prices, is reflected in continuing strong demand for mortgage credit. Indeed, the latest official data from the Central Bank and Financial Services Authority of Ireland (CBFSAI) show that net mortgage lending growth (new mortgages minus redemptions) has remained very strong in recent months and on, an underlying basis, has been growing at over 27% year-on-year since April this year.



*Strong growth in new loans*

Meanwhile, Department of Environment data on gross new mortgage lending also highlight the surge in the number of new mortgages paid, though these data are only available up to Q1 2004. Indeed, in the first quarter of the year 22% more new mortgages were paid than in the same period a year earlier.

The total number of new mortgages written this year could well be around the 100,000 level, compared to 84,749 in 2003. While these numbers greatly exceed the level of completions, they also include equity withdrawal, overseas property investment and home improvement loans.

	New Loans Paid			
	Number	YoY%	Average Value	YoY%
1998	61,407	6.1	74,700	20.6
1999	70,817	15.3	92,025	23.2
2000	74,258	4.9	102,322	11.2
2001	66,786	-10.1	114,755	12.2
2002	79,292	18.7	136,523	19.0
2003	84,749	6.9	158,892	16.4
2004 Q1	21,765	22.0	152,603	9.1
Year (est)	100,000	18.0		

*Source: Department of the Environment, AIB ERU*

## Estimated Demand : Higher Than Expected

*Supply greater than had  
been expected*

Just six months ago, we forecast that housing demand for the period from April 2002 - April 2006 would total some 246,400 units, an average of 61,600 per annum. This was on the basis of estimates of population growth, net inward migration, demand for second homes and of the proportion of adults heading up households.

The strength of housing output so far this year and early indications for 2005 suggest that supply will be far higher than we expected. Supply over the period could well total something closer to 290,000 units with output over the two years from April 2004 - April 2006 in total almost 35,000 greater than we had originally forecast.

This begs the question as to where these additional houses are going. Housing demand falls into four broad categories:

- Population Growth
- Migration
- Change in Headship; and
- Second, Vacant or Replacement units.

*Demand model has had to  
be revised upwards*

Revised AIB Supply and Demand Model		
<b>Supply</b>		
	Post Census 2002 Estimate	Revised Estimate
April 02 - April 03	59,400 (a)	59,400 (a)
April 03 - April 04	70,000	71,800 (a)
April 04 - April 05	65,000	83,000
April 05 - April 06	<u>52,000</u>	<u>75,000</u>
Total	246,400	289,200
Avg Per Annum	61,600	72,300
<b>Demand</b>		
(per annum)		
Population Growth	21,800	21,800
Migration	8,800	12,000
Change in Headship	6,000	8,000
Second, Vacant or Replacement Units	<u>25,000</u>	<u>30,500</u>
Total	61,600	72,300
<i>(a) actual</i>		

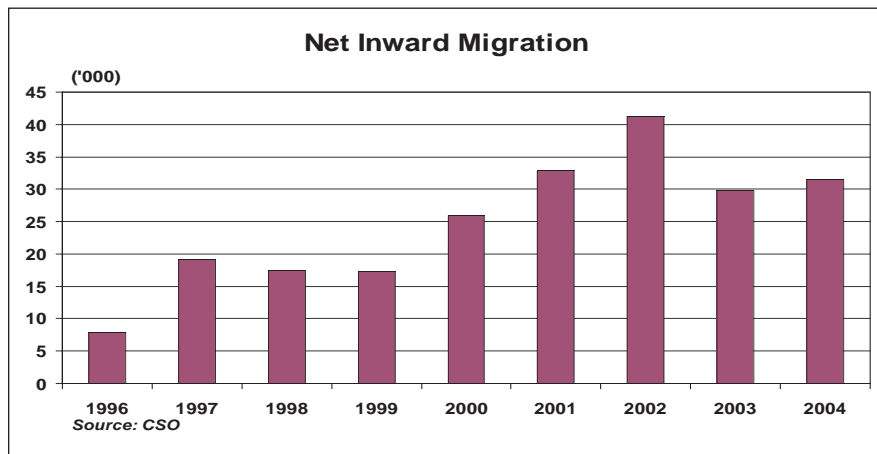
### Population Growth

Housing needs to satisfy population growth (assuming no change in headship rates) are a function of the demographic structure. We see no reason to change our earlier forecast of demand of 21,800 units per annum over the period to satisfy underlying population growth.

## Migration

*Increase in net inward migration*

Our estimate of demand for 8,800 units per annum due to migration was based on net inward migration levels of 25,000 per annum over the April 2002 - April 2006 period. However, the latest data show that net inward migration over the first two years of this four year period has outpaced this estimate, averaging 30,700 per annum.



It is difficult to see net inward migration levels dropping back over the second half of the period. The free movement of labour from the new EU accession states, against the background of a pick up in Irish economic growth, should help to sustain a high level of net inward migration. We have thus increased our net inward migration estimate for the two years from April 2004 - April 2006 to, on average, 32,000 per annum.

Applying the same housing demand to migration ratio as previously, this would imply the need for 12,000 housing units per annum for the full period from 2004 - 2006.

## Headship

*Some additional pick up in headship rates*

As we commented before, in our April 2004 Report on the Irish Housing Market, one notable fact that emerged from the 2002 Census was that there was virtually no change in Irish headship rates during the six years from 1996 to 2002 - that is to say, no overall increase in the percentage of adults that were heading up households. Furthermore, there was no increase in the proportion of households containing only one adult. These findings were particularly surprising given the changes in Irish social structure, especially increased marital breakdown, over the period. Irish headship rates are, in addition, low by comparison with, for example, the UK.

*One adult households likely to rise*

This suggests a level of untapped demand for, in particular, one adult households. Our original estimate of housing demand for the 2002 - 2006 period incorporated an increase in Irish headship rates as some of this demand was satisfied.

We have revised up slightly our estimate of demand due to increased headship rates. Anecdotal evidence supports the view that young adults, in particular, are finding it easier to enter the housing market due to improved affordability - in large part due to the extension of mortgage terms out to as far as 35 years, which has significantly improved the ability to service a mortgage. We have, thus, increased our estimate of demand from headship changes for the April 2002- April 2006 period to 8,000 per annum from 6,000 previously.

### Second, Vacant or Replacement Units

*Strong demand for holiday homes*

Assuming that our other demand estimates are correct, the balance of estimated housing completions, totalling an average of 30,500 units per annum, would represent either second homes, vacant units or replacement of obsolete units. There are no data available on the level of replacement of obsolete homes nor on the extent to which the balance represents second (holiday type homes) or investment properties that are currently vacant.

Anecdotal evidence supports the view that there have been, and still are, a large number of holiday developments being built. What remains uncertain, however, is how many unlet investment properties there are. Any significant overhang of such properties would represent a real threat to the housing market.

### Longer Term Demand

*Demand to fall significantly*

We estimate that housing demand could fall quite significantly over the 2006-2011 period. We have assumed that there will be a further increase in headship rates. However, demand to satisfy population growth should be slightly lower as the number in the key 25-34 age group will decline. Meantime, the level of net inward migration is likely to drop back as economic growth stabilises and as the impact of EU expansion diminishes. Furthermore, there could well be a substantial fall off in the number of second, vacant or replacement units, as demand for second (holiday) homes declines and with housing less appealing as an investment. Thus, overall, demand could be just 52,300 per annum in 2006-2011, a substantial fall from the estimated annual average 72,300 for the 2002-2006 period.

AIB Demand Estimates			
April to April	1996-2002 actual	2002-2006 forecast	2006-2011 forecast
<b>'000 per annum</b>			
Population Growth	18,600	21,800	20,800
Migration	7,600	12,000	6,500
Change in Headship	1,250	8,000	10,000
Second, vacant or Replacement units	<u>17,300</u>	<u>30,500</u>	<u>15,000</u>
<b>Total</b>	<b>44,750</b>	<b>72,300</b>	<b>52,300</b>

## **Risk Factors :**

### ***Rental Sector and Supply Levels Require Monitoring***

The current high levels of supply should eventually put downward pressure on prices. However, we don't see it as posing an imminent threat to the housing market. It would more likely take one or two other factors to cause a housing market crash - either a significant deterioration in the labour market situation or a sharp increase in interest rates. Neither of these seems a likely scenario in the short term. Another threat could well come from a significant withdrawal of investor interest, though, as yet, there is little evidence that this is happening on any scale.

#### **Oversupply**

*Supply of 80,000 cannot be absorbed indefinitely*

The market cannot continue to absorb supply of 80,000 units per annum indefinitely. This is especially so with some 40-50% of current output apparently either second, replacement or vacant properties rather than being for owner occupancy purposes or rented properties.

*However, building industry has proved responsive*

However, we continue to believe that the Irish house building industry is flexible and responsive. In this regard, any evidence of a potential supply overhang is likely to see builders quickly moving to slow the pace of completions. Furthermore, the industry, as a whole, is in a healthy state after several years of strong profits and is not expected to find itself in the position of having to offer stock in difficult market conditions.

#### **Interest Rates**

The ECB has maintained the refi rate at 2% since June 2003. However, the tone of some of the ECB commentary has been somewhat more hawkish recently, warning about the dangers of second round effects from higher energy costs and highlighting the inflation risks posed by excess liquidity. It has emphasised that it remains vigilant with regard to all developments that could pose a risk to price stability.

*Sharp rise in interest rates not anticipated*

The grounds for early policy tightening, though, look weak. We are forecasting that the ECB will not tighten policy until 2005. We see the refi rate at 2.75% by end 2005, still a very low level. Thus, it is difficult to see interest rates in Ireland rising to the extent that the housing market is put under threat.

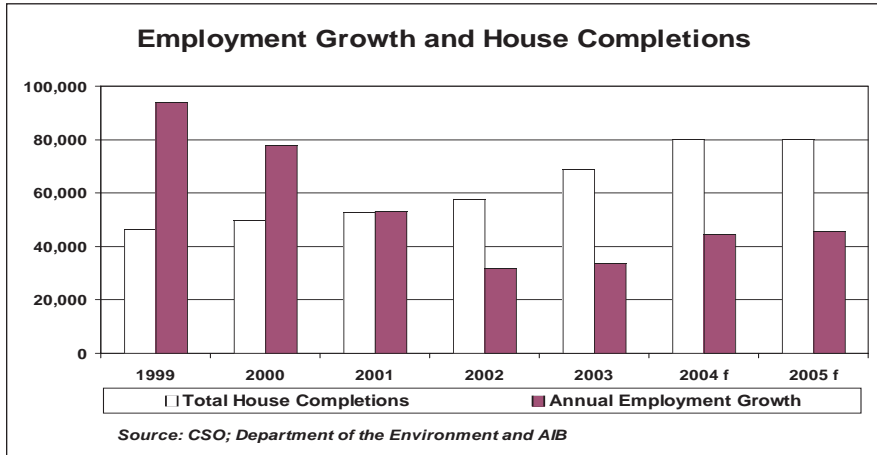
#### **Economic Outlook**

*Economic outlook supportive of housing market*

Rather than being a threat to the housing market, near term housing demand should be supported by the improvement in the Irish economic outlook. Not only did the Irish economy weather the global economic downturn remarkably well in recent years, there has been a good pick-up in the pace of economic activity in 2004.

Particularly encouraging, in regard to the housing market, has been the strength of the labour market. Total employment grew by 1.8% in 2003, up from 1.4% in 2002. The labour market data for H1 2004 have been robust, showing a rise of 2.6% yoy in employment. Furthermore, unlike in 2002 and 2003, most of the job growth in H1 2004 was in full time employment.

For the balance of 2004 and beyond, the outlook for employment is positive. Public sector employment may not expand at the same rate as in 2003 but private sector services employment should see further growth. We expect total employment to rise by 2.5% in 2004 and again in 2005.



Labour force growth is expected to rise by close to 2.5% in 2004 and 2005, broadly in line with employment growth. Thus, the unemployment rate should remain low, at around 4.5%.

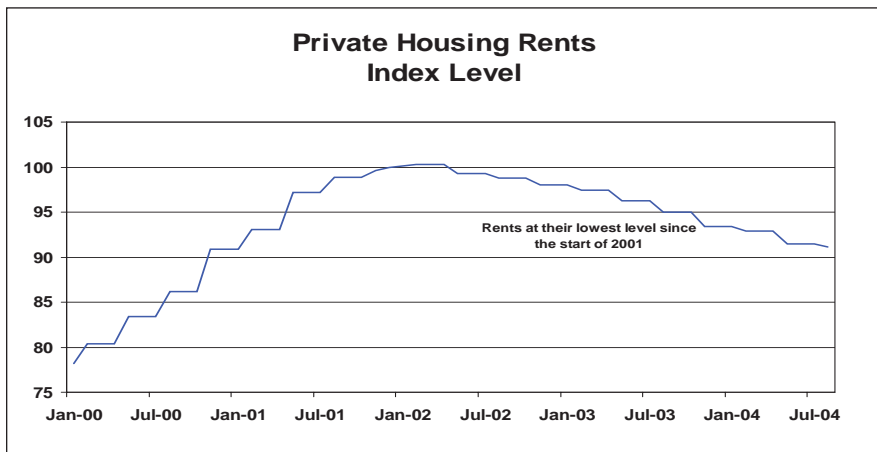
**Investment Sector**

*Increasing number of properties are investment assets*

Our estimates show that some 40-50% of the current new house supply is being absorbed by either second (holiday) homes, the replacement of obsolete units or are unlet investment properties. Investment properties, and to some extent second (holiday) homes, should be considered as an investment asset. This sector represents a potential risk to the overall housing market, especially given the signs of a downturn in the rental market.

*Fall in rental incomes .....*

The private housing rents component of the consumer price index has been in continuous decline since the second quarter of 2002. In August this year, rental levels were down 4% on year earlier levels and more than 9% off their early 2002 highs. This leaves them below the levels of some three and a half years earlier.



*..... but capital gains for existing owners*

However, over this period average house prices have increase by some 40%. These price rises, coupled with low interest rates, provide a significant cushion to investors already in the market. For new investors, though, rising prices and falling rental incomes have led to a substantial erosion of yield levels. As the figures below from Gunne Residential illustrate, residential property yields have fallen significantly in recent years.

<b>Residential Property Yields</b>			
	<b>South Dublin</b>	<b>North Dublin</b>	<b>West Dublin</b>
1998	5.9%	5.6%	5.7%
1999	5.5%	5.5%	5.6%
2000	4.7%	4.7%	5.3%
2001	4.8%	4.6%	5.2%
2002	4.3%	4.1%	4.3%
2003	3.7%	3.7%	3.7%
2004	3.2%	3.2%	3.3%

*Source: Gunne Residential*

*Property over valued on an investment basis .....*

From a situation where residential property was yielding over 5% in the late 1990s, yields have fallen to close on 3%, a level which calls into question its attraction over other forms of investment. The CBFSAI has estimated that, on a price/earnings ratio basis, new house prices at end 2003 could have been as much as 55% overvalued with existing house prices up to 63% overvalued. On a discounted present value basis, the overvaluation was not as great, but still substantial at 20%.

For new investors, property at current yield levels only makes sense on the expectations of significant capital gains. If expectations of future price gains diminish, low yields from declining rental incomes and high house prices must serve to deter new investor interest - all the more so should equity markets rally and thus woo back investors. This has the potential to exert downward pressure on house prices. If returns from residential property are further eroded by a continuing decline in rental incomes, or as interest rates rise, the threat from investor withdrawal will intensify.

*..... thus investor interest requires continued monitoring*

Should investors start leaving in the face of falling rental incomes, it would pose a considerable risk to the housing market. As yet, though, there is little evidence of any significant investor withdrawal. Estate agents report still strong interest from investors in the first half of 2004. However, the level of investor interest in the housing market is likely to wave and warrants continued careful monitoring.

## Market Supports : Should Prevent Housing Market Crash

Despite the undoubted risks to the Irish housing market there are several factors that should provide support and prevent a housing market crash.

### First Time Buyers - Pent Up Demand

*Any fall in prices could unlock pent-up demand*

As we have highlighted earlier, Irish headship rates are low and there remain a significant number of potential new entrants who are currently being priced out of the housing market. Should there be a moderate house price decline, this could be sufficient to draw more new entrants into the housing market, helping to put a floor under the market.

### Low Interest Rates

*Benign interest rate environment*

As we have argued earlier, the interest rate environment is expected to remain relatively benign, especially in the near term, which should provide support to the Irish housing market.

### Favourable Economic Outlook

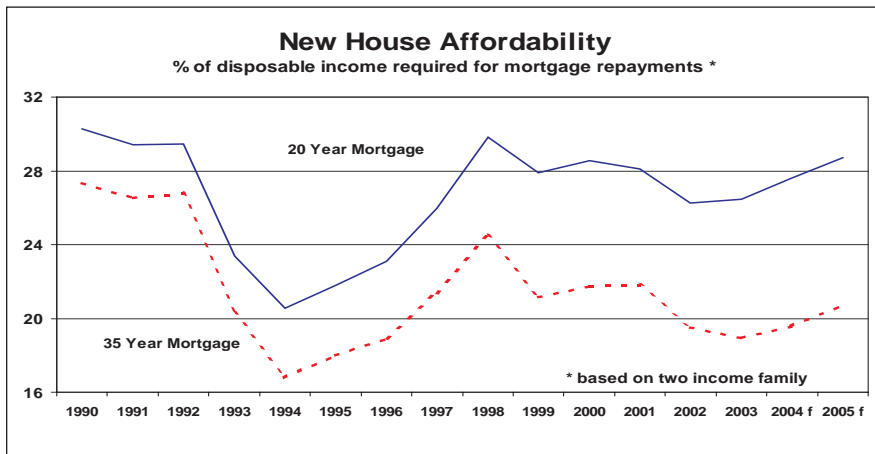
*Robust labour market*

As we have also set out earlier, the improvement in the Irish economic outlook, and robustness of the labour market in particular, should support the Irish housing market.

### Improved Affordability: Extended Term Mortgages

*35 year mortgages have greatly improved affordability*

The extension of mortgage terms out to as far as 35 years in some instances, compared to the 20-25 year mortgages that previously were the norm, has led to significant improvement in overall affordability. Changes in the length of mortgage contract have a substantial impact on the proportion of disposable income required to service mortgage repayments. For example, on the same income assumptions, a new 35 year mortgage would have absorbed less than 19% of disposable income in 2003 compared to over 26% for a 20 year mortgage. Thus, the move to longer mortgage terms for some borrowers can have a very significant impact on their ability to service a new mortgage.



*Only modest deteriorating trend in affordability*

The continued strong uptrend in house prices this year, in the context of stable mortgage rates, means that there has been a modestly deteriorating trend in overall affordability in 2004. Looking ahead, given the expected modest rise in interest rates, it is to be expected that there will be a further moderate deterioration in the overall affordability trend in 2005 - in the absence of a marked fall in house prices.

Furthermore, wage increases next year may be somewhat lower than in 2004. However, the improvements in the public finances should allow for a reduction in the income tax burden in 2005. Thus, with house price inflation expected to moderate and only a modest rise in interest rates anticipated, the deterioration in the overall affordability trend in 2005 should be relatively limited.

This is also good news for housing in that, according to the CSO, in Q3 2003 the majority (88.4%) of recent first time buyers said that they found their mortgage repayments manageable. While some 10% had some difficulty, only less than 2% reported that they found them very difficult to manage.

*Mortgage repayments not a constraint to house purchase*

The survey thus provides an indication that the level of mortgage repayments may not at present be a major constraint on house purchase. Furthermore, it identified the fact that the average cost of mortgage repayments for recent first time buyers was little more than the average level of private sector rent. This implies that mortgage repayment costs may not be a major disincentive for many in switching from rental to owner occupancy - though such a move would do nothing for overall housing demand.

#### **Improved Affordability: Lower Cost Units**

*Some evidence of move to lower cost units*

We also continue to believe that there has been a shift towards more affordable units, either through location, size or quality. This is hard to quantify. However, there are some indications of such a shift towards lower cost units. Permanent tsb data show that house prices in the Dublin area increased by, on average, 16% in 2003 on a like-for-like basis. However, permanent tsb also give an indication in the trend of overall average house price movements. These show average house prices in Dublin City up just 14% in 2003 while those in Dublin County rose by 13.5%. We would speculate that this difference is explainable, in part, by such a move to lower cost units.

Furthermore, DoE data indicate a marked levelling off in the average value of mortgage loans paid. This value was stable at around €150,000 between Q2 2003 and Q1 2004, with the exception of a sharp spike upwards to €161,000 in Q4 2003. Given the strong rise in average house prices over the period, this could well reflect such a move towards lower cost units.

Finally, planning permission data indicate that the trend towards lower cost units may continue. The average floor area of apartments for which permission was granted has been declining since Q3 2003, and in Q2 2004 was, at 74.2 sq.m., the smallest since the beginning of 2001.