



The Irish Economy



THE IRISH HOUSING MARKET

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Executive Summary

The Irish housing market continues to attract considerable interest, both domestically and abroad. AIB Global Treasury Economic Research Unit has thus undertaken this analysis of the housing market as part of its ongoing assessment of the Irish economy.

Housing supply is at very high levels. However, the market is well underpinned on the demand side, not only by demographic factors but also by investor demand, the strength of demand for second homes and by the level of unsatisfied, pent-up demand. Thus, prices are unlikely to crash and the risk of negative equity on any meaningful or material scale is small.

Demand, though, is unlikely to be sustained at current levels, where output is running at 65,000 - 70,000 units per annum. There are risks, in particular, of a downturn in the high level of second homes but this could be offset, at least partially, by a rise in headship rates. In regard to the latter, affordability is the key. There is some evidence that the market is responsive to current conditions both through providing housing supply at lower price levels and by improved affordability from extended mortgage terms.

Meanwhile, the macro outlook is reasonably supportive, with the economy expected to pick-up momentum and interest rates likely to remain relatively low. Finally, while growth in mortgage demand is likely to slow, loan demand through equity withdrawal could take up some of the slack.

Summary

- Despite regular media speculation about the risk of a crash, the Irish housing market, at present, exhibits none of the signs of a bubble about to burst, certainly from the demand side.
- **However, the level of supply is high. Completion levels of 65,000-70,000 per annum cannot be sustained indefinitely. Some downward adjustment of this level and a redistribution of supply towards more affordable housing will be required to sustain equilibrium in the market.**
- Given the strength of supply, price rises should adjust to a more moderate growth pattern. New house prices, though, have risen strongly in recent months and near term are likely to remain supported by any pass through by developers of increased development levies imposed by local authorities.
- Continued strong supply, though, should moderate the pace of new house price rises and, indeed, may eventually be accompanied by a fall in average new house prices. This could quite possibly be due in part to a lowering in quality or size, or by increased density of development. As such it would not be reflected in a decline in like-for-like price indices.
- Second-hand house prices, meanwhile, should move to a more moderate growth rate. **Overall, house price inflation could slow to around 7% by end year.**
- Long term demand factors such as population and migration flows remain supportive of housing demand.
- Surprisingly, headship rates have remained unchanged in recent years. This probably reflects, in part, the fact that young and single people have been priced out of the market. Any decline in house prices, rise in disposable income, shift towards longer term mortgages, or the building of more affordable housing, could help to release this pent up demand.
- **An increasingly large proportion of housing supply has been absorbed by demand for second homes in the past two years, a situation that is unlikely to prove sustainable.**
- A pick-up in economic growth and the continuing low interest rate environment should be positive for near term demand. However, with interest rates near the bottom of their cycle, housing affordability seems set to deteriorate modestly from its current long term average.
- **A key determinant of housing demand is employment growth. In this regard, the outlook for the labour market is positive.**
- Mortgage demand remains buoyant, reflecting strong supply and firm prices. With output levels expected to stabilise and price rises likely to moderate, mortgage growth can be expected to slow.
- **Overall, we believe that, while risks remain, the housing market will be able to move to more moderate and sustainable growth patterns in terms of both supply levels and prices over the next few years. Notably, we do not envisage a period of material negative equity emerging.**

*Jenny Pollock
14th April 2004*

Prices: *Moderation Expected*

Market crash unlikely

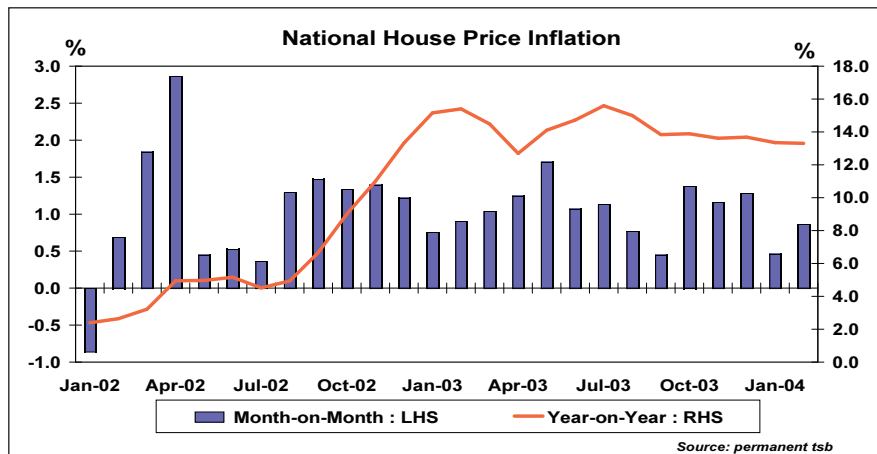
Towards the end of 2003 there was considerable media speculation about the possibility of a housing market crash. At present, though, the market does not appear to be a bubble about to burst. In particular, there is little sign of disorderly market behaviour. That being said, given the strength of supply, price rises need to move to a more moderate growth pattern. Otherwise, the housing market could be increasingly vulnerable to some setback.

The most up-to-date price data are provided by permanent tsb. Having run in excess of 20% in the period 1998 - 2000, permanent tsb data show that house price inflation moderated considerably in 2001, before accelerating again in 2002. House price inflation remained high right throughout 2003 and in the opening months of 2004.

Very little moderation in house price inflation in recent months

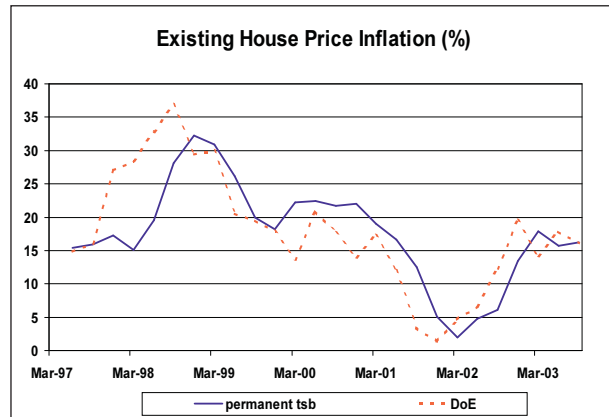
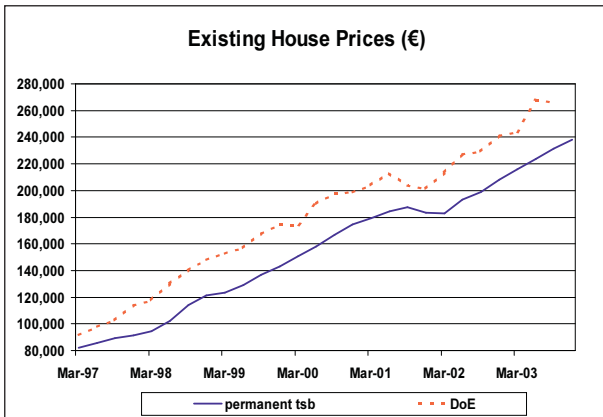
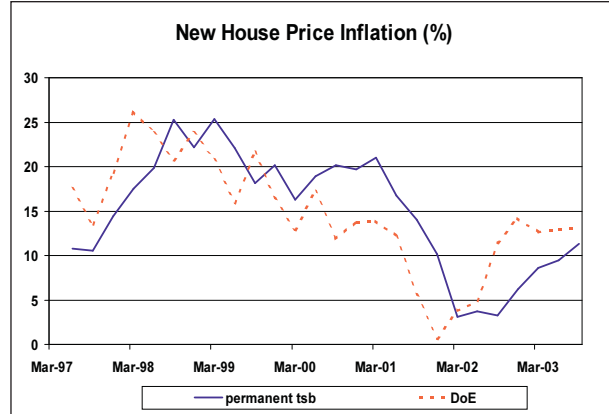
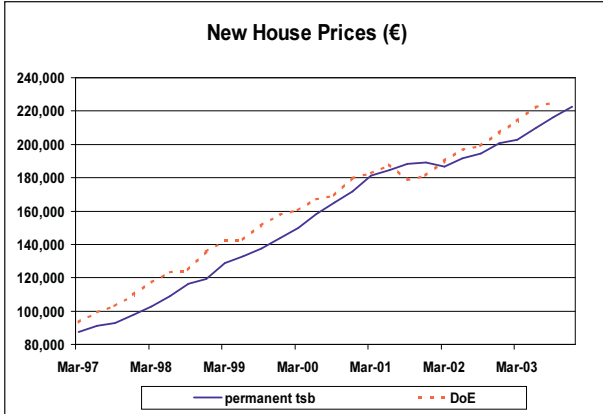
The latest permanent tsb data are for February 2004 and show house prices growing by 13.3% year-on-year nationally, down slightly from the 13.7% year-on-year rate in December 2003. There has been very little moderation in the annual inflation rate in recent months. February's 13.3% represents only a slight decline from the tight 13.6-13.9% range seen between September and December 2003.

This, though, was below the bottom of the 14 - 15.6% range that new house price inflation occupied throughout the opening eight months of last year, with the exception of April when it dipped down to 12.7%. Furthermore, prices rose by an average of 0.7% in January/February 2004, a notable decline on the average increase of 1.3% per month in Q4 last year.



Different price indices.....

Permanent tsb data are used in this report to monitor market movements as official house price data from the Department of the Environment (DoE) are only available on a quarterly basis and with a time lag. The most recent Department of the Environment data are for Q3 2003. Permanent tsb data, on the other hand, are available on a monthly basis and are more up to date, with the most recent figures being for February 2004.



..... show similar trends

As the accompanying charts illustrate, trends in permanent tsb data provide a good proxy for total market price movements. While the DoE reports a slightly higher level of absolute prices, both for new and existing properties, the trends in the year-on-year inflation rates are very similar.

While the DoE index is a simple average of prices paid for housing transactions, the permanent tsb price index takes into account the different characteristics of the properties involved. **Thus, any major shift in the structure of the housing market, for example a move towards smaller more affordable housing units, would only be reflected in the DoE data.** The permanent tsb index, on the other hand, gives a better picture of changes in prices on a like-for-like basis.

Market Segmentation

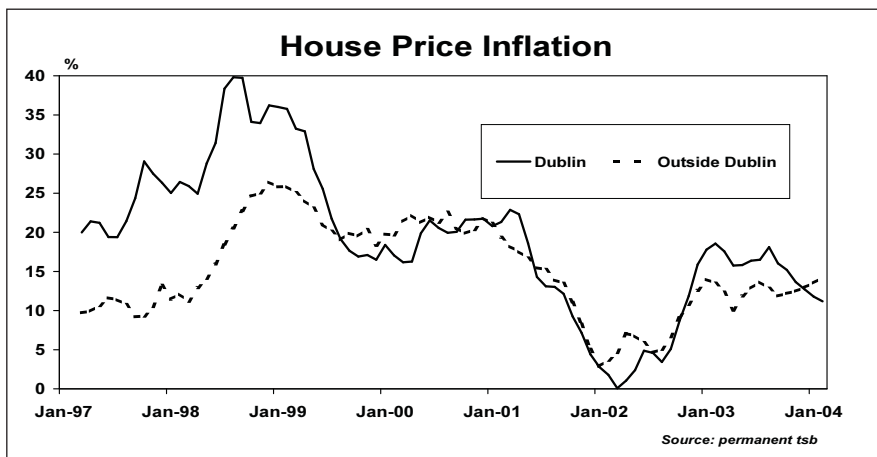
For 2003 as a whole, the permanent tsb data show that national price inflation averaged 14.3%, well up on the 6.1% average increase recorded in 2002. The Irish housing market, though, is not a uniform entity. Considerable variations exist in both annual inflation rates and prices on a regional basis and also between new and second hand dwellings.

Dublin v Elsewhere

Strong Dublin house price inflation beginning to moderate

Indeed, there has been a notable moderation in the rate of house price inflation in Dublin. This slowed to 11.2% by February this year from a peak of 18.1% in August 2003. Prices, though, continued to rise on a month by month basis, with the exception of a modest 0.6% decline in September last year.

By contrast, the annual rate of house price rises outside of the Dublin area has ticked up slightly. House price inflation outside Dublin was running at 14.2% in February this year, the fastest pace since July 2001. The slower pace of price appreciation in Dublin in recent months probably reflects, in part, the stronger price growth in the earlier part of last year and a growing reluctance to chase prices higher. House prices in Dublin are already significantly higher than elsewhere in the country, averaging €309,300 in February 2004, compared to an average of €207,300 outside of the capital.

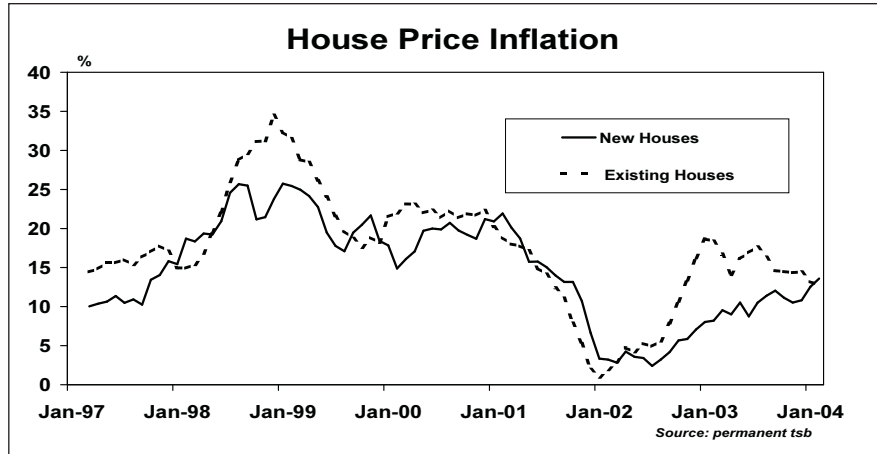


New v Existing

New house prices inflation has accelerated

Meanwhile, there has been a marked acceleration in the pace of growth of new house prices in recent months despite the high level of supply. Indeed, new house prices rose by an average 1.3% in the three months December 2003 - February 2004. As a result, new house price inflation overtook that for existing properties in February for the first time since mid-2002.

New house price inflation picked up to 13.6% in February this year from 10.8% in December 2003, having averaged 10.1% for 2003 as a whole. This compares with an average 2003 inflation rate of 16.0% for existing properties, which eased slightly to 14.4% year-on-year in December 2003 and even further, to 12.8%, in February this year.



Prospects

Record completions could eventually lead to a fall in the absolute level of new house prices

We expect that the rate of increase in overall national house prices will moderate during 2004. This is particularly so in the light of the continuing high level of supply of new houses expected to come on to the market, on top of record completion levels last year. Indeed, while new house price rises have been exceptionally strong in recent months we expect a significant decline in the pace of new house price inflation over the balance of the year. Further, we would not be surprised if the large number of completions **eventually** leads to a decline in the absolute level of average new house prices.

However, in the near term, a fall in new house prices in absolute terms seems unlikely. In particular, any pass through of increased development charges imposed by local authorities would serve to provide support to new house prices.

Furthermore, should downward pressure on prices emerge after several strong years, many developers may well be in a position to hold on to completed or partially completed housing stock rather than releasing further phases of a development at lower prices.

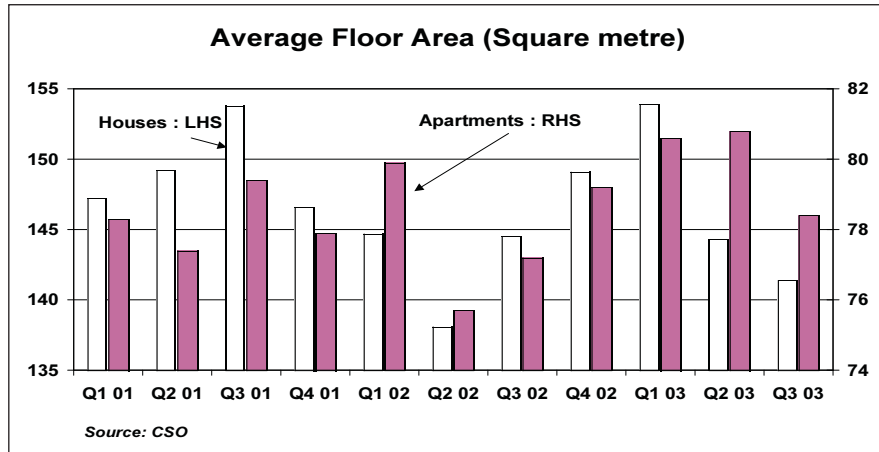
This may be achieved through quality reduction ...

Should a fall in new house prices eventually occur, it would not necessarily mean that there would be a universal fall in like-for-like new house prices. Rather, there is a possibility that **any move to lower average new house prices may be in part achieved through a lowering of quality or size**. This could be the result of a decline in square footage, a reduction in the quality of the finish, a higher density of development or by choice of location.

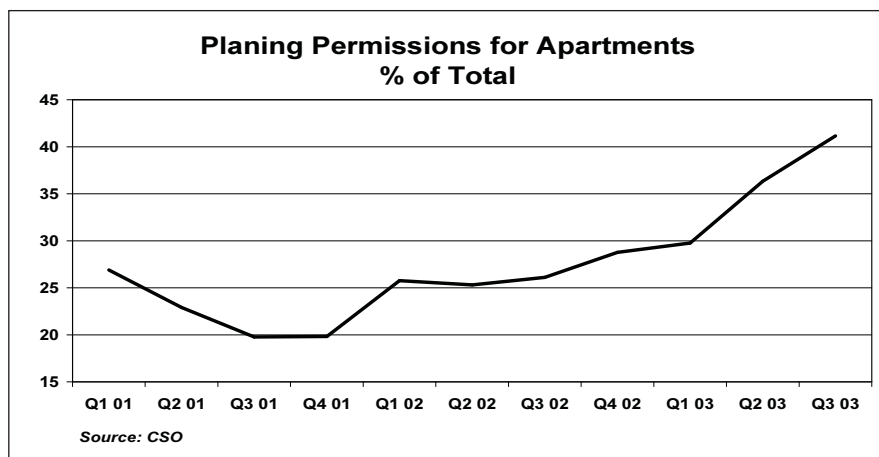
..... and not reflected in price indices

Such a decline in average new house prices due to “quality” changes would, thus, not be recorded in like-for-like house price indices such as that produced by permanent tsb.

An early indication that developers may indeed be already moving towards a smaller house size is given by planning permission data. These show the possible beginning of a downturn in average floor areas particularly for houses and to a lesser extent for apartments (see following chart).



Another indication from planning permissions data of a move to higher density and smaller floor area is given by the surge in the percentage of permissions being granted for apartments rather than houses. Apartments accounted for 41% of the total permissions granted in Q3 2003, up from an average of just 26% in 2002 (see accompanying chart) and 23% in 2001.



Meantime, we would also expect further moderation in the pace of growth of existing house prices. Easing new house price inflation and lowered expectations of future price gains can be expected to depress the pace of growth of prices in the second hand market.

Investor demand also key

There is, though, also some not insignificant risk to second hand house prices, should investors start leaving the market in the face of falling rental values. However, while anecdotal evidence points to some waning in investor interest,

as yet there is no evidence that, on balance, investors are withdrawing from the housing market to any material degree. Recent price rises and low interest rates provide a significant cushion to investors. In particular, with interest rates so low, mortgage payments include a large proportion of principal repayment.

Little near term impact from decentralisation

Civil service decentralisation is unlikely to have any near-term impact on the relative strength of house prices in Dublin vis-a-vis the rest of the country. The process is likely to take some time to come to fruition, quite possibly more than the three year time frame the government has in mind. Furthermore, many of the Departments are moving to towns within outward commuting distance of Dublin which could lead to a delay in families relocating.

House price inflation may ease to 7% by December

Overall, by December 2004, the average national rate of house price inflation could have slowed around 7%. This would still mean, though, that for the year as a whole an average increase some 11% could still be recorded.

Period Averages	permanent tsb House Price Inflation Y-o-Y				
	National	Dublin	Elsewhere	New	Existing
1998	22.6	32.3	18.1	21.3	24.0
1999	22.5	24.3	21.7	21.3	23.3
2000	20.5	19.6	21.1	18.8	22.1
2001	14.0	14.6	14.4	15.3	13.0
2002	6.1	5.2	6.7	4.1	6.6
2003 Q1	15.0	18.0	13.1	8.6	17.9
Q2	13.8	16.0	11.6	9.4	15.7
Q3	14.8	19.9	12.8	11.3	16.2
Q4	13.7	13.8	12.5	10.8	14.4
Year	14.3	16.1	12.5	10.1	16.0
2004 Average	11			11	10
Year End	7			8	6

Completions : *Strong Trend Continues*

Further strong rise in output

The latest data from the Department of the Environment show that total house completions rose by 19.3% in 2003, to a record 68,819. This follows a 9.7% increase in 2002 when completions totalled 57,695. This in turn was well above completion levels in 1998-2000 which ranged between 40,000 and 50,000 per annum. Moreover, it is double the levels achieved in 1996 and treble the levels of 1993.

House Guarantee Registrations

Slowdown in the pace of growth of new house registrations

New house guarantee registrations provide the best proxy for private housing starts and thus of future output levels. Detailed data from the Department of Environment as yet are only available up to Q3 2003. These show that the pace of growth in registrations slowed in the first nine months of 2003. The slowdown is not surprising given the record rise of 77% in registrations in 2002.

The growth rate of total new registrations slowed to 22% year-on-year in Q1 last year, followed by a virtually flat year-on-year performance in the next two quarters. Indications are, though, that the pace of new registrations picked up again somewhat in Q4. Overall, then, new house registrations probably reached close to the 55,000 level in 2003, up from 51,017 in 2002, an increase of around 8%.

Further moderation in housing starts expected

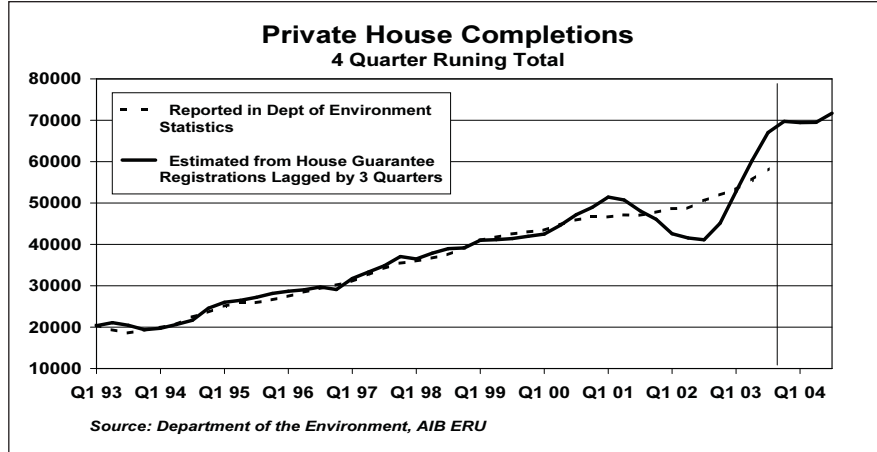
Looking to 2004, we would not be surprised to see a moderation in the pace of housing starts. It is quite possible that builders will begin to slow the pace of housing construction in order that the market does not become oversupplied, particular in the face of media speculation of the risks of a market collapse. At this stage, we are pencilling in a moderate fall in total registrations to 52,250 for 2004, a decrease of 5%.

As yet, though, there is little evidence that housing starts have begun to slow. Indeed, HomeBond registrations, which account for some 80% of total house guarantee registrations, were up by 5% year-on-year in Q1 2004.

Private Completions

Strong historic relationship between registrations and completions

The Department of the Environment data show that private house completions rose by 17.2% in the first three quarters of 2003 compared to the same period a year earlier. Detailed data are not yet available for Q4 2003. As can be seen from the following chart, historically there has been a close relationship between registrations and private house completions, taking into account the time lag between start and completion, which has averaged about three quarters of a year.



....though this has become distorted

As can be clearly seen, though, this relationship has become distorted in the past couple of years. This, in part, reflects the impact of changes in the planning regulations. Furthermore, the time lag has recently become stretched by the increasingly common phenomenon of selling properties off the plans, with a long lead-time to completion. In some circumstances, 2003 registrations represent properties not scheduled for completion until well into 2004 or even 2005. The number of units involved is hard to quantify but is certainly not insignificant. If the historic relationship was to be fully restored, and taking account of past distortions, this would imply an additional 8,000 properties for completion in 2004/5 than would be expected from the level of registrations in recent quarters.

Output should remain strong

Overall then, the strength of house registrations in the latter part of 2003 and the overhang of completions from earlier starts is positive for private house completions in 2004. That being said, we expect some decline in the pace of housing starts over the course of 2004. Furthermore, builders may push completion dates out even further if there should be any deterioration in market conditions. After several good years, many developers would appear to be in a good position to hold on to property banks rather than be forced to sell into a falling market.

Once-off Housing

Indications of pressure on once-off housing

The other factor to be taken into consideration when estimating private house completions is the strength of once-off housing. Only properties built by contractors attract a house guarantee registration. These account for just over 70% of total private house construction, with the balance being once-off homes (detached properties usually in a rural setting).

Once-off housing, though, has become increasingly subject to more onerous planning restrictions. In addition, local authorities are imposing significant up-front development charges on housing construction. Planning permissions data give some indication of a possible resultant pressure in this sector of the market.

A detailed breakdown showing the level of permissions for once-off houses is only available from Q2 2002. The data, however, indicate that in Q3 2003 permissions for once-off houses had fallen to just 19% of total applications, compared with an average of approximately 25% for the earlier limited time frame for which data are available.

However, a significant relaxation of the restrictions on once-off housing has been announced recently. Thus, while the level of completions of once-off houses may well fall-off somewhat in 2004, it is quite likely to pick up again from 2005.

Social Housing

Moderate continued growth in social housing

Apart from private house completions, social housing has become an increasingly important element of housing construction. Social housing completions grew by an impressive 30% in the first three quarters of 2003 compared to year earlier levels. In terms of overall completions, the social housing sector accounted for some 9% of total completions in the first three quarters of 2003. There has been a strong increase in activity in the social housing sector over the past couple of years and the share of house completions represented by the social sector has risen from just 6% of the total in 2000.

	Total Housing Completions		House Guarantee Registrations (1)	
	Total	YoY %	Total	YoY %
1998	42,349	9.0	29,067	7.3
1999	46,512	9.8	33,852	16.5
2000	49,812	7.1	34,613	2.2
2001	52,602	5.6	28,845	-16.7
2002	57,695	9.7	51,017	76.9
2003 Q1	13,709	14.5	13,508	21.7
Q2	15,909	18.4	14,035	-2.0
Q3	18,140	21.4	13,641	0.4
Q4	21,061	21.5		
Year	68,819	19.3	55,000 (est)	7.6
2004 (f)	65,000 - 70,000	0	52,250	-5.0

*(1) Private housing only and excludes once-off housing
Source: Department of the Environment, AIB ERU*

The Public Capital Programme for 2004 allows for a 5% increase in government expenditure in the social housing sector, down just slightly on the 2003 estimated increase. Overall, there could well be a further moderate rise in social housing output in 2004.

Overall Completions

2004 completions could match 2003 levels

With private completion levels pulled down slightly by a drop-off in once-off housing but some modest growth in social housing, this would leave **total output in 2004 little changed from 2003 levels, at between 65,000 and 70,000.**

Housing/Land Stocks

Completion levels high in a European context

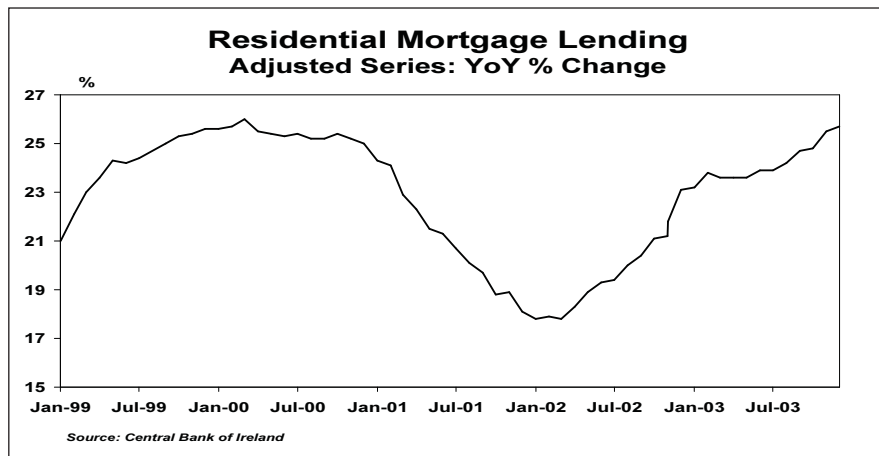
There are no data available on the total Irish housing stock. However, one way of putting completions of 65,000 - 70,000 per annum in context is to compare it to the experience elsewhere. At these levels, completions per 1,000 of the population in Ireland are more than three times the European average and more than 40% higher than Spain, the second highest. Furthermore, in 2002, the UK built three times as many houses as Ireland for a population 15 times as large.

Meanwhile, the Department of the Environment survey indicates that there were 368,705 housing units of serviced land available at June 2003, or over 5 year's supply at current output levels. Whether these land banks are in popular areas and whether developers are willing to release them for construction is another question.

Mortgage Lending : Remains Very Firm

Growth in mortgage lending has accelerated

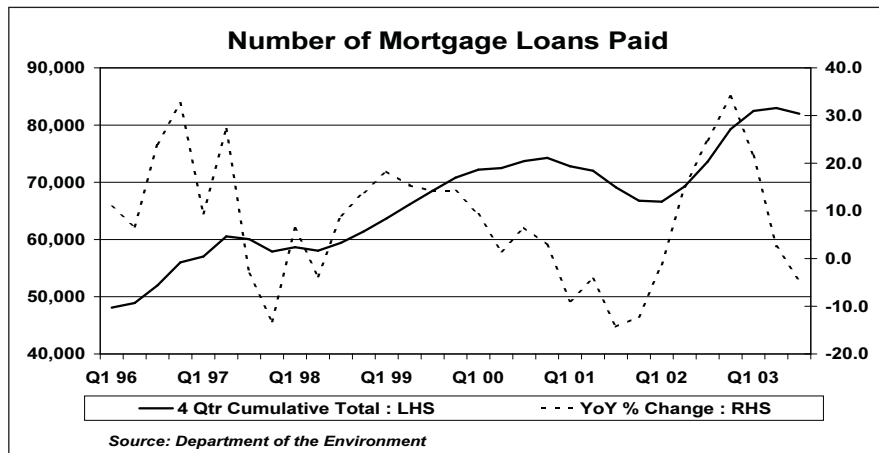
The strength of housing demand, plus rising house prices, is reflected in continuing strong demand for mortgage credit. Data from the Central Bank of Ireland show that **net** mortgage lending growth (new mortgages minus redemptions) remained very firm, at over 23% year-on-year, throughout last year. Indeed, it accelerated somewhat in the closing months of 2003, reaching 25.7% year-on-year in December. The uptrend has continued in the early months of this year with the pace of growth accelerating further to 26.1% in February 2004. This is well above the February 2002 trough of 17.8%.



Large number of new loans

The Department of Environment provides data on **gross** new mortgage lending. These data highlight the surge in the number of new mortgages paid out over the course of 2002. Indeed, in the last three quarters of 2002, some 24% more new mortgages were paid than in the same period a year earlier.

The number of new mortgages paid remained firm in the first three quarters of 2003, though the growth rate slowed markedly. In fact, the year-on-year rate turned negative in Q3 last year. Data are not yet available for Q4 2003.



The total number of new mortgages written last year could well approach the 85,000 level, compared to 79,292 in 2002. While these greatly exceed the level of completions, this undoubtedly reflects, in part, a level of equity withdrawal, overseas property investment and home improvement loans.

Increase in average loan size

Meantime, the average value of loans paid jumped to €185,000 in Q3 2003, up 23% in the quarter and 33% on year earlier levels. However, notably, the size of loans on second hand properties rose very sharply. By contrast, the average value of loans paid on new houses actually fell slightly in Q3 2003 compared to Q2 levels, though was still up nearly 10% year-on-year.

Move to fixed rate mortgages

The second and third quarters of 2003 also saw a significant pick-up in the proportion of new loans that were taken out at fixed rather than variable rates. The proportion of fixed rate loans had fallen to a low of just 35% by Q1 2003, from 69% in 1999, in continuation of the long term trend that had been in place since early 1999, with the falling interest rate environment favouring variable rate mortgages.

The pick-up in the proportion of new loans being taken out at a fixed rate, to 59% in Q3 2003, may reflect an apprehension by mortgage applicants that interest rates were at that stage at, or near, the bottom of their current cycle. It would also appear, however, that a significant proportion of these new fixed rate loans are being fixed for just one year. Indeed, a survey by estate agents Sherry Fitzgerald of its clients buying new homes in 2003 showed that, of those on a fixed rate mortgage, 61% chose to fix for up to 1 year with a further 24% fixing for one to three years.

	New Loans Paid				
	Number	YoY%	Average Value	YoY%	% at Fixed Rate
1998	61,407	6.1	74,700	20.6	67.5
1999	70,817	15.3	92,025	23.2	69.0
2000	74,258	4.9	102,322	11.2	47.4
2001	66,786	-10.1	114,755	12.2	46.9
2002	79,292	18.7	136,523	19.0	41.5
2003 Q1	17,842	21.6	139,839	11.2	34.9
Q2	21,001	2.6	150,621	13.3	42.8
Q3	20,747	-4.6	185,178	33.4	59.0
Year (est)	85,000	7.1			

Source: Department of the Environment, AIB ERU

Long Term Demand : *Well Underpinned*

Supply outstripping long term estimated demand

Based on long term demand estimates, the current level of supply of 65,000 - 70,000 houses per annum is too high. Indeed, the ESRI have produced a benchmark housing demand model which estimates housing demand for the 2001-2006 period at 53,300 units per annum. However, it should be noted that the estimated supply distribution for the 1996 - 2001 period differed markedly from the ESRI model forecasts. Thus, the ESRI estimate needs some revision. Indeed, as a first step towards estimating future demand dynamics, it is a useful exercise to examine the recent supply distribution.

Estimated Supply Distribution

Census 2002 shows that the number of households increased by 164,700 between April 1996 and April 2002, an average growth of 27,450 households per annum. What is surprising is that this household growth was almost entirely due to changes in population growth and to net inward migration.

Little change in headship rates

There was apparently almost no contribution to household formation from changes in social structure. Indeed, the proportion of adults in a particular age cohort registering as head of household - the so called headship ratio - remained, on average, virtually unchanged between 1996 and 2002. Only 7,500 new households were formed over the period as a result of slightly increased headship rates.

This is a somewhat surprising result, given the changes in Irish social structure that have taken place in recent years - notably increased marital breakdown along with an increase in the proportion of those who never marry. Furthermore, Irish headship rates are low compared with those in, for example, the UK.

Strong demand for second homes

The other, perhaps surprising, phenomenon to emerge in recent years has been the apparent strength of demand for second homes. (This category excludes rented (i.e. occupied) investment properties but includes vacant investment properties.)

While Census 2002 showed a 164,700 increase in households between April 1996 and April 2002, over the same period there was a total of 268,500 home completions (houses plus apartments). This leaves a balance of 103,800 new housing units unaccounted for. These housing units represent one of three things:

- * replacements for obsolete units;
- * second homes (ie for holiday or similar use); or
- * vacant properties.

An approximate estimate of the number of second or vacant homes can be obtained from the fact that 197,000 Census respondents said that the house

where they were resident on the survey night was built between 1996 and 2002. This implies that the remainder of the 268,500 properties completed over the period (totalling 71,500) represents either second or vacant properties.

We have already identified that the number of replacement, second homes and vacant properties built in the 1996-2002 period amounted to 103,800. This, implies that the balance of the unaccounted for homes, approximately 32,300 (i.e. 103,800 - 71,500) would by this analysis be replacements for obsolete properties. (It should be noted here that only 95% of census respondents cited the age of their properties. Thus, the census figure represents only a rough estimate.)

The resultant estimated supply distribution is presented in the table below and begs the question as to the prospects for these components in the years ahead.

1996 - 2002 Supply Distribution (Based on Census Data)		
	Total	Per Annum
Population Growth and Migration	157,200	26,200
Change in Headship	7,500	1,250
Replacement of Obsolete Units (est)	32,300	5,380
Second / Vacant Homes (est)	<u>71,500</u>	<u>11,920</u>
Completions	268,500	44,750

Demographic Outlook

Demographics underpin demand

Long term demographics remain positive for demand. Indeed, over the next few years population growth, in particular amongst the 25-34 year old age group (which is the key cohort in terms of household formation) along with changes in household structure should continue to be a fundamental factor supporting housing demand.

Census data show that the population in the 25-34 age bracket increased by 19% between 1996 and 2002, compared to growth of 8% for the population as a whole over the same period. Population projections prepared by the CSO indicate that the increase in the number of people in this age bracket should

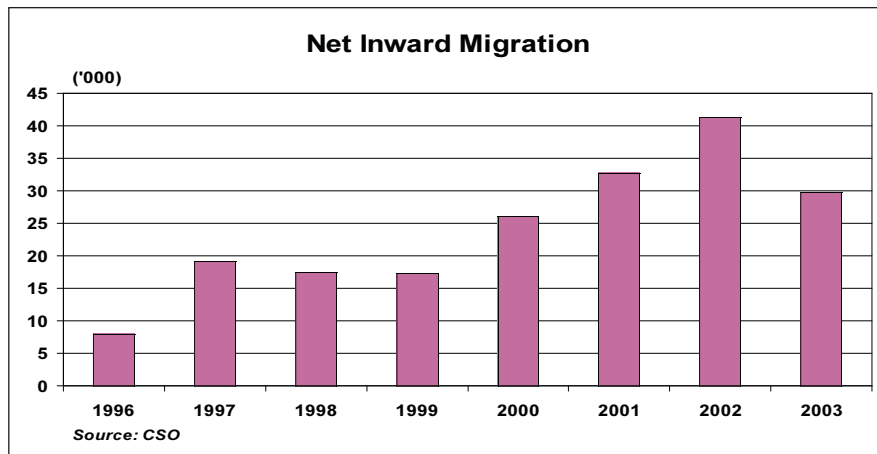
continue substantially outstripping overall population growth in the period up to 2006, possibly growing by a further 13% over the period.

In terms of longer term housing demand, it should be noted, however, that the CSO's projections for the 2006-2011 period indicate virtually no growth in numbers in the 25-34 age group, as the baby boomers of the 1960s and 70s will by then have all passed out of this age bracket.

Migration Trends

Migration levels should remain relatively high

One of the notable features of the 'Celtic Tiger' years was the strength of net inward migration. Increased economic prosperity resulted in significantly decreased emigration, a noticeable return of Irish migrants plus a substantial inflow of non-nationals. The CSO estimates that the level of net inward migration eased back somewhat, from its peak of 41,300 in 2002, but remained relatively high in the year to April 2003 at 29,800.



There are several factors which point to a continuing high level of net inward migration. While the pace of Irish economic activity has slowed, it remains high in a European context and is expected to regain momentum in 2004/05. Furthermore, the labour market remains relatively tight, with unemployment below 5%. EU enlargement may also have an impact on inward migration flows, especially given Ireland's relatively liberal approach to taking migrants from the new Member States. This will expand the pool of workers who can enter the country free of restriction. **Thus, migration flows should continue to bolster population growth and hence overall housing demand.**

Disproportionately strong impact on housing demand

Furthermore, the **nature of these migration flows has a disproportionately strong impact on housing demand.** The latest estimates, for the year to April 2003, showed that some 44% of immigrants were in the 25-44 age group,

a key cohort in terms of household formation. Meanwhile, 59% of emigrants were in the younger 15-24 age group, for which the headship ratio is only around half that of the 25-44 cohort.

It may be argued that non-national migrants, by and large, are unlikely to be high wage earners and thus would be unable to enter the mortgage market. Their family units, though, will still require housing. In the absence of a substantial response from the social sector this would lead to increased demand for private rented accommodation, boosting the market for investment properties.

Headship Rates

Apart from outright population increase, housing demand should also be supported by structural changes to Irish family life. The 2002 Census highlighted both the extent of increased marital breakdown and the increase in proportion of the population who never marry.

No change in Irish headship rates.....

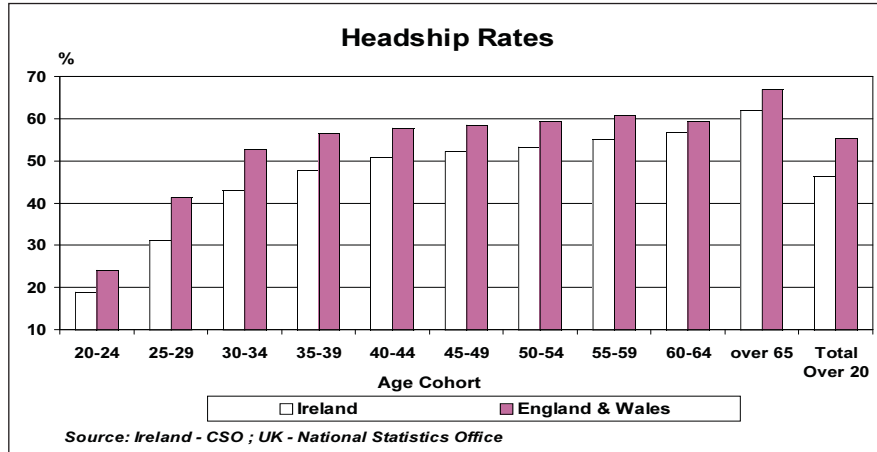
As yet though, these changes in social structure have not led to an increase in overall headship rates, or more particularly to any increase in the proportion of one adult households. The proportion of one adult households remained unchanged between 1996 and 2002 at around 21.5% of the total. This compares to the UK experience where the proportion of households headed by one adult is much higher, at 31% in 2001. Furthermore, this proportion has increased significantly in the UK in recent years and is up from 27% in 1996.

.....may reflect housing costs ...

The fact that there has been virtually no increase in the proportion of households headed by one adult in Ireland may well be a reflection of the cost of housing and the need for two incomes to support a mortgage. If this indeed is the case, **it implies a level of pent up demand from one adult households. Either a meaningful fall in price, an appreciable gain in disposable income, or a shift towards lower cost housing units could be the key to unlocking this demand.**

... implying pent-up demand

Overall headship rates are also significantly lower than in the UK. The following chart details headship rates in Ireland compared for those in England and Wales. What is most notable is the difference in headship rates in the 25-39 age cohorts, which are so fundamental in terms of housing demand. Any move towards UK levels in terms of either headship rates or more specifically increased home ownership by one adult households would be extremely supportive of housing demand, though, as noted above this would require an improvement in affordability.



Second / Vacant Homes

The apparent strength of demand for second homes was perhaps the most surprising result to emerge from the analysis of recent supply distribution. There are no real data on the nature of this market and no formal breakdown of its composition available. However, some of the properties could have been bought as investment properties for rental and which are now vacant due to an easing in the rental market. Some may have been bought as student accommodation for children and which have been kept as city accommodation. Most, though, are likely to be holiday homes.

A decline in demand for second homes in Ireland likely

The strength of second home purchases in recent years is possibly explainable by a combination of factors. One is government incentive schemes aimed at bolstering the tourist trade and regional economies through the construction of holiday homes. There is also the fact that the ability to purchase such a property is largely income related. The boom years of the 'Celtic Tiger' saw an increase in the proportion of the population in a position to afford such properties. This helped to drive prices away from lower income groups and first time buyers, leaving second home buyers taking a disproportionate share of the market.

With the scaling back of government holiday home schemes, and a more subdued economic background compared to the Celtic Tiger years, the demand for second homes in Ireland may well fall going forward. Furthermore, there is increasing competition from overseas markets for those looking to purchase holiday homes.

....but not necessarily negative for overall demand

However, **a decline in the demand for second homes in Ireland would not necessarily be unduly negative for overall demand.** Any resultant decrease in property prices could leave the way open for the release of pent up demand from, for example, lower income groups that have been unable to be satisfied at recent high prices.

Demand Models *

The ESRI has produced housing demand estimates based on the Irish demographic structure. These are outlined below. However, we feel that the ESRI model contains flaws in its underlying assumptions. Thus, we have produced our own demand model which resembles in part that of the ESRI but with our own assumptions.

ESRI model needs updating

The **ESRI** has estimated housing demand at 53,300 units per annum in the 2001 to 2006 period, dropping to 46,900 per annum in 2006-2011.

ESRI Demand Model			
'000 per annum	1996-2001	2001-2006	2006-2011
Population Growth	15.4	18.6	17.6
Migration	5.9	5.5	7.8
Change in Headship	12.4	10.6	11.7
Replacements *	<u>11.0</u>	<u>18.5</u>	<u>9.9</u>
Total Demand	44.6	53.3	46.9
* <i>i.e. Obsolete, vacant or second homes</i>			

However, its demand model has not been updated to take account of the supply distribution characteristics identified from an analysis of Census 2002.

Notably, the ESRI model assumed a significant increase in headship rates in the 1996 - 2001 period that did not occur. Instead, supply was absorbed by a substantial increase in second, vacant or replacement of obsolete homes and somewhat higher than forecast demand from population growth and migration flows.

ESRI Demand Model v Supply Distribution		
'000 per annum	ESRI Estimated Demand 1996-2001	Supply Distribution From Census Data 1996 - 2002
Population Growth and Migration	21.3	26.2
Change in Headship	12.4	1.25
Obsolete / Second / Vacant Units	<u>11.0</u>	<u>17.3</u>
	44.6	44.75

* These demand models use Census data and CSO population estimates as their basis. In any one year, these are point data for April. Thus, period ranges are from April to April in the relevant years.

AIB Demand Estimates

Demographics to boost demand.....

Our own demand estimates follow the same structure as used by the ESRI model, but with our own assumptions.

While the ESRI model has been reasonably good in terms of forecasting housing demand from population growth, its prediction for the 1996 - 2001 period appears to be a little shy of our estimate of the actual supply distribution, based on the 2002 Census data. We estimate that population changes resulted in demand for 18,600 housing units per annum, whereas the ESRI model predicts 15,400.

The ESRI predict that demand due to population changes in the 2001 - 2006 period will be some 3,200 per annum higher than in 1996 - 2001. This is consistent with the demographic structure showing a particularly strong increase in the 25-34 age cohort over the period. The ESRI then estimate that demand due to population changes will fall back by 1,000 per annum in the 2006 - 2011 period compared to 2001 - 2006, to average 17,600 a year.

We have used these changes in the absolute level of demand due to population change as the basis for our estimates. However, we have taken as the starting point our own estimate of the 1996-2002 average demand level, based on the latest Census data. We thus see demand due to population change rising from 18,600 per annum in the 1996 - 2002 period to 21,800 per annum in 2002 - 2006, before dropping back to 20,800 per annum in 2006 - 2011.

..... also inward migration

The ESRI has based their housing demand estimate from migration flows on net inward migration averaging 18,000 a year between 2000 and 2010. It predicts that housing demand due to net inward migration will fall slightly in the 2001-06 period to 5,500 per annum, compared to 5,900 in 1996-2001, before picking up again to 7,800 per annum in 2006-2011. The 2001-06 estimate looks to be on the low side, in our view, given the continuing high level of net inward migration flows in recent years.

In our model, we assume net inward migration of 25,000 per annum in 2002-2006 (which compares with the actual experience of 29,800 in 2003). We then assume that net inward migration falls to 18,000 per annum in 2006-2011. This (on the basis of the same net immigration to demand ratio as evident in the 1996 - 2002 period) would imply the need for an additional 8,800 housing units each year for 2002-06 and 6,500 per annum for the 2006-2011 period.

Some modest demand from increased headship

The ESRI model assumes that Irish headship rates increase to current UK levels by 2016. It is estimated that such a move would require, in total, an additional 230,000 new homes over the period. We feel that such a move to

UK headship levels, over what is a relatively short time frame, is overly optimistic. Changes in Irish social structure and cultural patterns significantly lag those in the UK. Thus, we are less optimistic about the strength of housing demand from increased headship rates.

However, with house price rises likely to moderate and improved affordability for young first time buyers through the availability of longer term mortgages, there could well be some modest increase in headship rates. This is especially so if builders further aid affordability through the provision of lower cost units. It is impossible to precisely forecast the extent of such an increase. In our model we assume that changes in headship will result in demand for an additional 6,000 housing units per annum over the 2002-06 period rising to 10,000 per annum in 2006-2011.

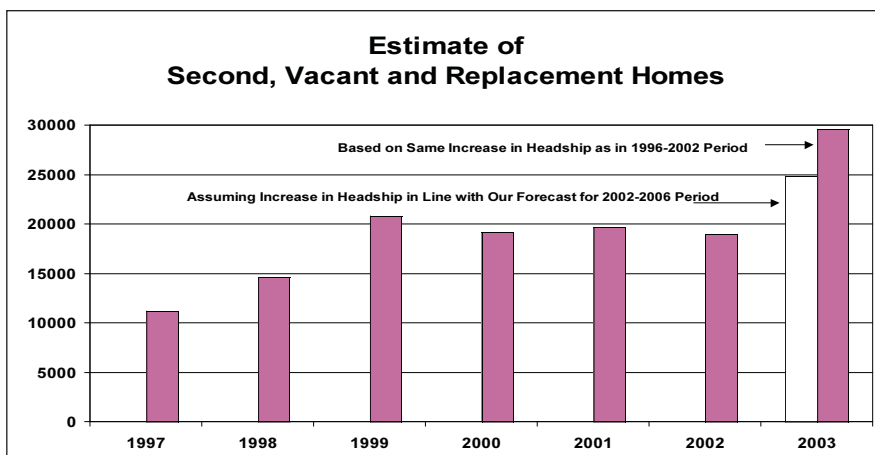
This would imply a need for, in total, only 74,000 new homes due to headship changes over the period to 2011, compared to the 230,000 estimated by the ESRI model over the period to 2016, on the basis of a move to UK headship rates. It should be noted, though, that UK headship rates are, in themselves, rather an arbitrary choice of level to attain to.

Second, vacant or replacement properties absorb residual completions

Finally, the level of second, vacant or replacement properties is calculated as a residual from the number of housing completions less the number of households formed through a combination of population growth, net inward migration and change in headship. We estimate that second, vacant or replacement units totalled, on average, 17,300 per annum between 1996 and 2002, with the level running at just below 20,000 per annum towards the end of the period.

Second, vacant or replacement homes rising strongly

Furthermore, the level of completions over the past couple of years suggests that the number of second, vacant or replacement properties has more than likely increased since April 2002. The chart below details our estimate of the annual number of second, vacant or replacement properties.



On the basis that housing demand due to changes in headship in the year to April 2003 was the same as it had averaged over the 1996 - 2002 period (i.e. 1,250 p.a.), this would imply that second, vacant or replacement properties totalled almost 30,000 in the year to April 2003. However, if we assume that headship changes saw demand for 6,000 properties in the period, which is in line with our annual average forecast for 2002-2006, then this figure would reduce to just under 25,000.

Given the relative inelasticity of demand from population growth, the continuing strong level of completions over the balance of 2003 and the supply outlook for 2004 imply that the level of second, vacant or replacement homes could well be even higher in 2004 and seems likely to remain firm into 2005 in the absence of any dramatic pick-up in headship rates.

Hence, taking account of the strength of completions and the outlook for supply in 2004 and into 2005, we are estimating an increase in the average number of second, vacant or replacement homes over the 2002 - 2006 period to 25,000 per annum, up from 17,300 in the period 1996 - 2002.

Decline in 'holiday homes' likely

Looking further ahead, we feel that demand for 'holiday homes' is likely to decline, especially given the scaling back of government incentive schemes, slower economic growth compared to the 'Celtic Tiger' years, the prospect of higher interest rates, increased development levies and the increasing attractions of overseas properties. Hence, the level of second, vacant or replacement homes could fall back to 15,000 per annum for 2006-2011. We must admit, though, that it is difficult to predict the demand for these type of homes, so the 15,000 forecast comes with a significant margin of error.

AIB model shows relatively high demand levels

The above assumptions combine to give rise to the following demand estimates. We see housing demand averaging just over 61,500 per annum in the period 2002 - 2006 before easing down to around 52,000 per annum in the 2006 - 2011 period. These are well above the benchmark ESRI forecasts.

AIB Demand Model			
April to April	1996-2002 actual	2002-2006 forecast	2006-2011 forecast
'000 per annum			
Population Growth	18,600	21,800	20,800
Migration	7,600	8,800	6,500
Change in Headship	1,250	6,000	10,000
Second, vacant or Replacement units	<u>17,300</u>	<u>25,000</u>	<u>15,000</u>
Total	44,750	61,600	52,300

In looking at our estimates, it shouldn't be forgotten, though, that around half of the April 2002 - April 2006 period has already elapsed. Completions totalled almost 59,500 in the year to April 2003, and look to be approaching 70,000 for the year to April 2004. We look for completions to remain firm at close to 65,000 in the year to April 2005, but to decline thereafter.

.... but supply still needs to fallback in coming years in absence of strong headship rise

On the basis of our estimates, and in the absence of a dramatic increase in headship rates, output needs to fall back significantly from 2005 onwards from current estimated levels of 65,000-70,000 per annum. Otherwise, the market would be in danger of being oversupplied, with a continuing very high level of second, vacant or replacement properties. This could manifest itself, in particular, in a rising number of vacant investment properties.

A possible alternative scenario is that a continuation of housing output at current high levels would be absorbed by a very large jump in headship rates. However, this would probably require a major shift in supply towards smaller, more affordable housing units. It would also represent a sea change in the market from the 1996 - 2002 period. Hence, the moderate rise in headship rates that we have assumed in our forecasts appears more likely.

Short Term Demand Factors : *Generally Favourable*

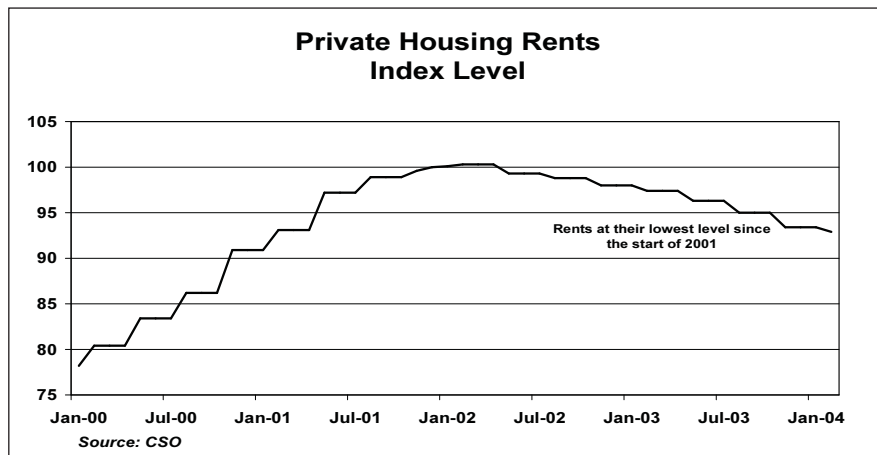
While long term demand factors remain very supportive of the housing market, demand in the short term is very much influenced by factors such as housing affordability, interest rate prospects, the economic environment (employment prospects in particular) and swings in sentiment towards housing as an investment medium.

Investment Demand

Investment demand may be waning but little sign of significant withdrawal

Indeed, it was a strong revival of investor interest in the market, fuelled by the reintroduction of favourable taxation measures in Budget 2002, that has helped bolstered the housing market in the past couple of years. Estate agents Sherry Fitzgerald estimate that investors accounted for almost 30% of new house purchases last year while 21% of second hand purchases were to investors.

There have been some signs of waning investor demand in the light of lower rental incomes and difficulties being experienced in renting some properties. The private housing rents sub-component of the consumer price index has been in decline since May 2002 and was down some 4.5% year-on-year in February 2004. This has brought rental incomes down almost 7.5% from their peaks and they are now the lowest they have been since the start of 2001. Indeed, Sherry Fitzgerald also note that investors accounted for 27% of those who sold properties in 2003.



On balance, the Sherry Fitzgerald data imply that, while there is evidence of some investors leaving the market, there is still continued net investment demand. Despite some worries in the sector, the investment market is being supported by recent price rises and low interest rates which provide a significant cushion to investors. In particular, with interest rates so low, mortgage payments include a large proportion of principal repayment.

The other major factor underpinning the rental market is the level of government rental support in the absence of adequate state owned social housing. There have been some government moves to limit this support. Any significant further withdrawal of state support for private house rentals by social welfare recipients could damage an investment market already experiencing a fall in rental incomes.

Potential to put downward pressure on prices

We continue to believe that the combination of lower rental incomes and higher house prices is leading to a **reduction in investor interest, which has the potential to exert some downward pressure on house prices.**

Economic Outlook

Economic activity picking-up

The Irish economy has managed to weather the slowdown in global economic activity of the past couple of years relatively well and there are now some positive signs emerging. While the data, as yet, still paint a somewhat mixed picture of the Irish economy, there have been signs of pick-up in economic activity in recent months.

Overall, GDP growth in 2003 was sluggish, estimated at 1.4%. GNP growth was higher at 3.3%, but this reflected a decline in net factor income outflows last year.

GDP growth of 4% in 2004

Growth can be expected to strengthen this year in line with a much stronger performance by the world economy. This should boost exports. A continuing low interest rate environment should help stimulate domestic demand, while the savings ratio could decline from its current high levels. Spending power should also be boosted by lower inflation. Hence, we look for GDP growth to pick up to around 4% in 2004, with GNP increasingly by 3.5%.

	Real GDP %	Inflation Rate %	Avg Mortgage Rate %	Unemployment Level ('000)	Unemployment Rate %	Employment Level ('000)
1998	8.6	2.4	7.10	125	7.6	1,521
1999	11.3	1.6	4.93	96	5.6	1,616
2000	10.1	5.6	5.00	76	4.3	1,692
2001	6.2	4.9	5.49	71	3.9	1,742
2002	6.9	4.6	4.48	82	4.4	1,765
2003	1.4	3.5	3.66	89	4.7	1,796
2004 (f)	4.0	1.9	3.45	95	4.9	1,825

Source: CSO, AIB ERU

Employment Growth

Employment growth key for demand

Fundamental for housing demand is the strength of job creation. Sustained employment growth is vital if there is to be an increase in the pool of wage earners in a position to purchase homes either for their own use or for investment purposes. Furthermore, our assumption of further net inward migration assumes a significant level of job creation.

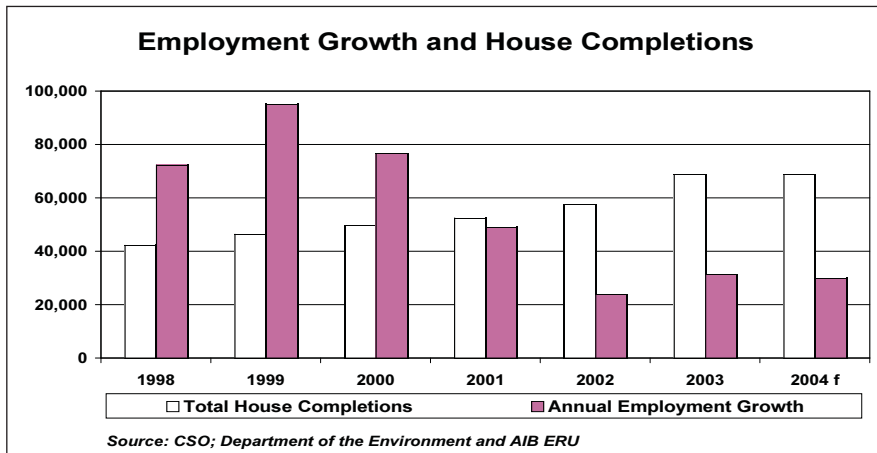
Job market holds up well

Encouraging for housing activity has been the fact that the labour market has held up better than anticipated during the downturn in activity in the past couple of years. Furthermore, the most recent data point to an improvement in labour market conditions over the course of last year. Employment rose by 1.8% year-on-year for 2003 as a whole, with the growth rate picking up to 2.5% in the final quarter of the year. Furthermore, while much of the employment growth in the early part of 2003 was due to part time employment, there was a notable pick up in full time employment in Q4 2003. It should be noted that, at the same time the unemployment rate has picked up only slightly to average 4.7% in 2003.

Low unemployment

The unemployment rate is likely to remain close to 5% in 2004. However, employment should continue to rise as the economic climate improves. We could see net job creation of the order of 30,000 for the year, broadly the same as the 31,000 increase in employment in 2003.

At such a level, job creation would still fall significantly short of estimated housing output. This is in contrast to the 1998 - 2000 experience when strong job creation substantially outpaced the level of housing completions. This was no doubt a contributing factor behind the strong 20% plus per annum house price gains in these years.



Interest Rate Outlook

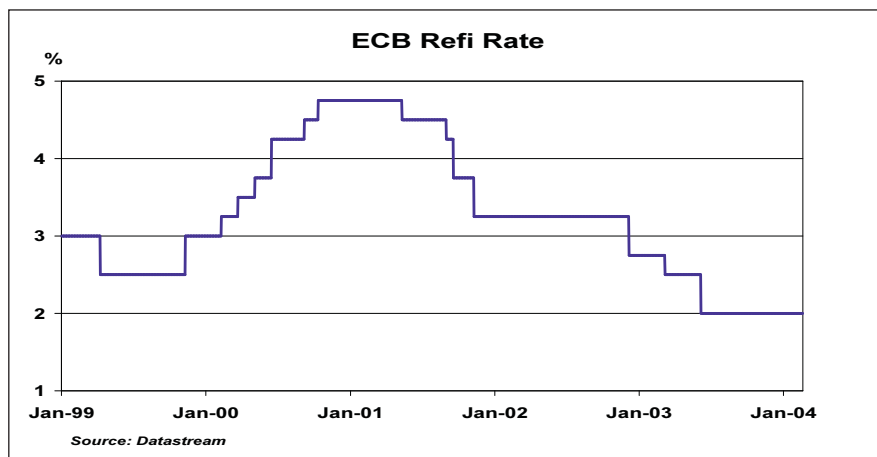
Interest rates to remain low and supportive

Interest rates in the eurozone have been on hold at 2.0% since June 2003. The latest indications from the ECB are that interest rates may remain unchanged for a considerable period of time. However, the chances of a further easing of policy have increased in recent weeks.

Average inflation in the eurozone is expected to average below 2% in 2004 for the first time since 1999. Meanwhile, economic activity in the area has not gained much momentum in early 2004. However, growth is expected to pick up pace over the course of 2004. Furthermore, the euro has appreciated sharply since last summer.

The ECB has so far dismissed calls from politicians for a further policy easing to weaken the euro and stimulate economic growth, arguing that interest rates are already at exceptionally low levels and that conditions are in place for a continued gradual strengthening of economic activity. However, if growth fails to pick-up then pressures for a rate cut will continue to grow. The ECB has indicated that it is closely monitoring the situation.

If there are no signs of a revival in consumer demand, then a rate cut towards the end of Q2 this year is quite possible. In any event, it now looks as if it will be 2005 before the ECB begins to increase interest rates. Even then, any increase would be modest.



Affordability

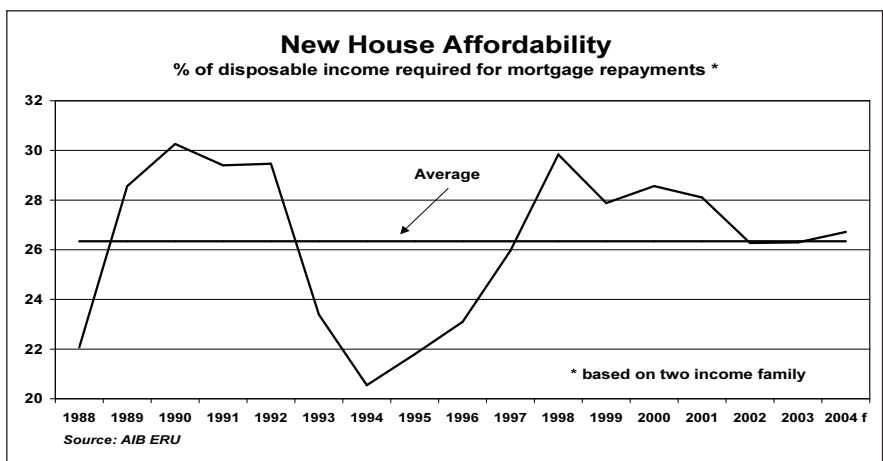
Despite rising house prices affordability has improved in recent years

The downtrend in eurozone interest rates over the past couple of years was a significant contributor to an improvement in housing affordability. Over the period 1998 - 2002, increases in disposable income (through both higher

wages and falling direct tax burden), on top of falling interest rates, outweighed the impact of rising house prices. As a result, house price affordability in 2002 was at its best level since 1997. The situation was more or less sustained in 2003 as mortgage rates fell further.

On a longer term view, new house affordability, as measured by the percentage of after tax income required to service a new 20 year mortgage, is now broadly in line with its average level of the past fifteen years.

For illustration purposes, the chart below shows the trend in affordability for a new 20 year mortgage based on a two income family, one receiving the average industrial wage and the other the average managerial wage.



The affordability trend is little affected by changes in the length of the mortgage contract assumed. Such changes, though, would have a substantial impact on the proportion of disposable income required to service mortgage repayments.

Longer term mortgages aid affordability

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. Indeed, the recent experience has been for overall affordability to be improved by extending the term of mortgages offered to first time buyers, in many cases to 35 years.

Improvement may be at an end

Any further improvement in affordability seems unlikely, in the absence of a marked fall in house prices. Disposable income growth looks set to moderate, with wage increases held back by low inflation, while budgetary constraints mean that significant reductions in the direct tax burden are very unlikely.

Only modest deterioration expected near term

Furthermore, a large part of the improvement in affordability in recent years has come from the downtrend in mortgage interest rates. Here too, the improvement looks set to be nearing its end. Eurozone interest rates may have troughed. However, with house price inflation expected to moderate and interest rates not expected to be increased until into 2005, **any near term deterioration in affordability is likely to be relatively modest.**

Other factors at work in ability to service a mortgage.....

The affordability ratio measures only the proportion of disposable income taken to service a mortgage. The actual ability to service a mortgage can depend on other factors such as changes in both the general cost of living and the actual level of disposable income.

... including parental support

Furthermore, there is considerable evidence that for young people affordability has been eased in recent years by considerable parental support towards the purchase price of a home.

Conclusions:

Transition To Sustainable Growth Pattern Possible

Housing market segmented and subject to different supply/demand factors

National house price inflation remains firm. However, within the overall picture, the diversified nature of the housing market and the different supply/demand characteristics affecting various sectors should not be forgotten.

Notably, the pace of new house inflation in 2003 was less than that for existing properties, no doubt reflecting the strong supply of new homes. Meanwhile, after a period of exceptional strength, the rate of price inflation within Dublin has moderated significantly, bringing it back down to slightly below the level of inflation outside the capital.

There is possibly a reluctance to chase Dublin prices higher after the further sharp price gains in the past couple of years and in the face of scare stories in the media about the risk of a housing market collapse. Looking forward, market segmentation should continue to be a major feature.

Rising supply should eventually impact on new house prices

Indeed, while 2004 has seen a strong start to the new homes market, the high level of supply is likely to eventually impact on new house prices. Prices, though, may well be held up near term by any pass through of higher development levies imposed by local authorities. Furthermore, in the event of any downward pressure on prices, after several good years, developers may well be in a position to hold on to completed or partially completed stock rather than releasing further phases of a development at lower prices.

Possibly lowering of quality

If supply levels do not moderate, though, this could eventually lead to a fall in the average absolute level of new house prices. Should this occur, though, it would not necessarily mean a fall in like-for-like house prices. Rather, developers have the option to reduce the size of homes, lower the quality of finish or build a higher density of development.

Output to remain high in 2004 but activity expected to moderate thereafter

As yet, though, there is no indication of any moderation in output. Even assuming that the level of housing starts begins to fall over the course of the year, completions could still come close to matching the 2003 record outturn of 68,819. Output levels, though, are expected to moderate from 2005 onwards.

Population trends supportive of demand

Meanwhile, long term factors are supportive of demand. Demographic trends and inward migration should help underpin demand in the coming years. Meanwhile, there has been no increase in household formation due to increased headship rates, which are low in Ireland compared to, for example, the UK.

Evidence of pent-up demand

The absence of any significant increase in households headed by one adult is particularly surprising given increased marital breakdown and a rise in the proportion of those who never marry. This implies a level of pent up demand for housing from household units headed by one adult, who are currently priced out of the market. Either a meaningful fall in price, appreciable gain in disposable income, or shift towards lower cost housing could be the key to unlocking this demand.

Current supply exceeding forecast demand

AIB has developed a housing demand model. It sees housing demand, running at close to 62,000 per annum for the period 2002 - 2006, before easing to 52,000 in the period 2006 - 2011. The ESRI have also produced demand estimates, which show a lower level of demand, running well below the current level of supply.

Risk of increasing number of vacant investment properties...

An increasingly large proportion of housing supply has been absorbed by second, vacant or replacement of obsolete homes, especially in the past couple of years. Looking ahead, though, demand for 'holiday homes' is likely to decline. Thus, it may well be that continued high levels of supply, in the absence of a rise in headship, could result in an increasing number of vacant investment properties.

... in the absence of sharply increased headship rates

It is only in the unlikely event that headship rates rise very sharply in the coming years that housing demand could be sustained at the current level of housing supply of 65,000 - 70,000 units per annum. This would require a change in the composition of supply towards smaller, more affordable housing units.

Transition to a more sustainable growth pattern possible

Overall, then, the AIB model suggests that a moderation in housing output is necessary if the housing market is not to become overly vulnerable to excess supply. Assuming that output levels do adjust downwards in line with our model, then the housing market should be able to achieve a transition to more sustainable growth patterns.

Meanwhile, in the short term, demand should be supported by a pick-up in economic growth and a continuing low interest rate environment. Furthermore, while the recent improvement in housing affordability may be at an end, any near term deterioration in affordability is likely to be relatively modest.

Employment growth the key

The prospects for employment growth are also key to housing demand. Without sustained job creation, purchases of new homes will inevitably decline from current levels. Furthermore, assumptions of continued net inward migration may not be fulfilled. Employment growth has held up well in recent years. We expect to see further solid growth in employment in 2004 and 2005 as the economic environment improves.

Investor demand needs close monitoring

The market remains vulnerable to any withdrawal by investors. As yet, though, while there are signs that investor interest is waning in light of lower rental incomes and difficulties in renting some residential properties, there is no evidence that on balance investors are leaving the market. This may well reflect the cushion provided to investors by recent price gains and the fact that interest rates are low.

However, given that any withdrawal by this sector has the potential to exert downward pressure on prices, one should continue to closely monitor anecdotal evidence of the strength of investor demand, the trend in rental income and state of the letting market for residential properties.

Mortgage growth can be expected to moderate also

It is hardly surprising that mortgage lending continues to grow strongly given the strength of gains in housing completions and prices. However, with more moderate price growth and no further increase in overall output levels expected, mortgage lending growth should also begin to moderate.

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