

Misjudging the Fiscal Stance: Lessons from Ireland's Boom and Bust



Alan Ahearne

NUI Galway, Bruegel and Central Bank of Ireland

Presentation at the Workshop organised by the Norwegian Ministry of
Finance's Advisory Panel

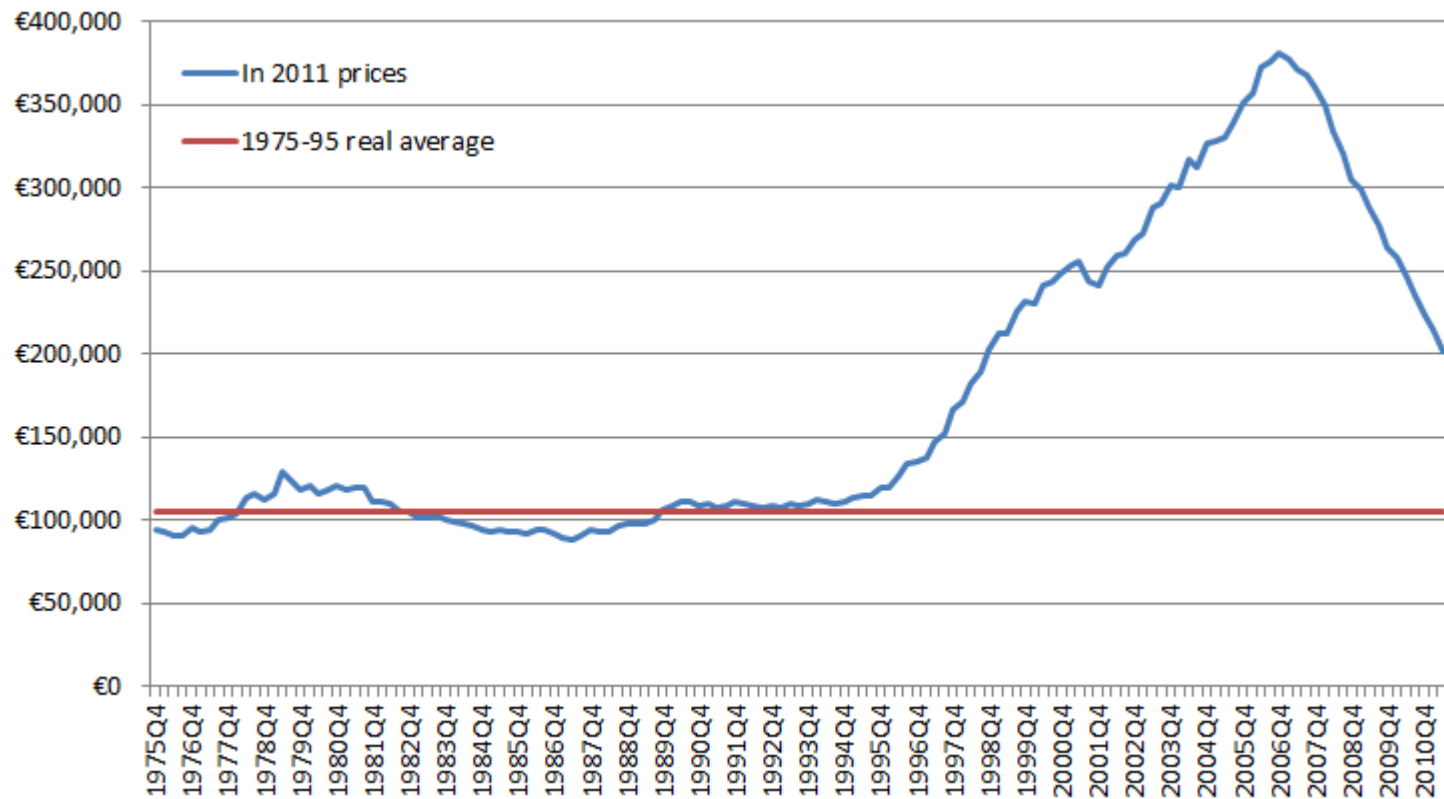
12 November 2012



Outline

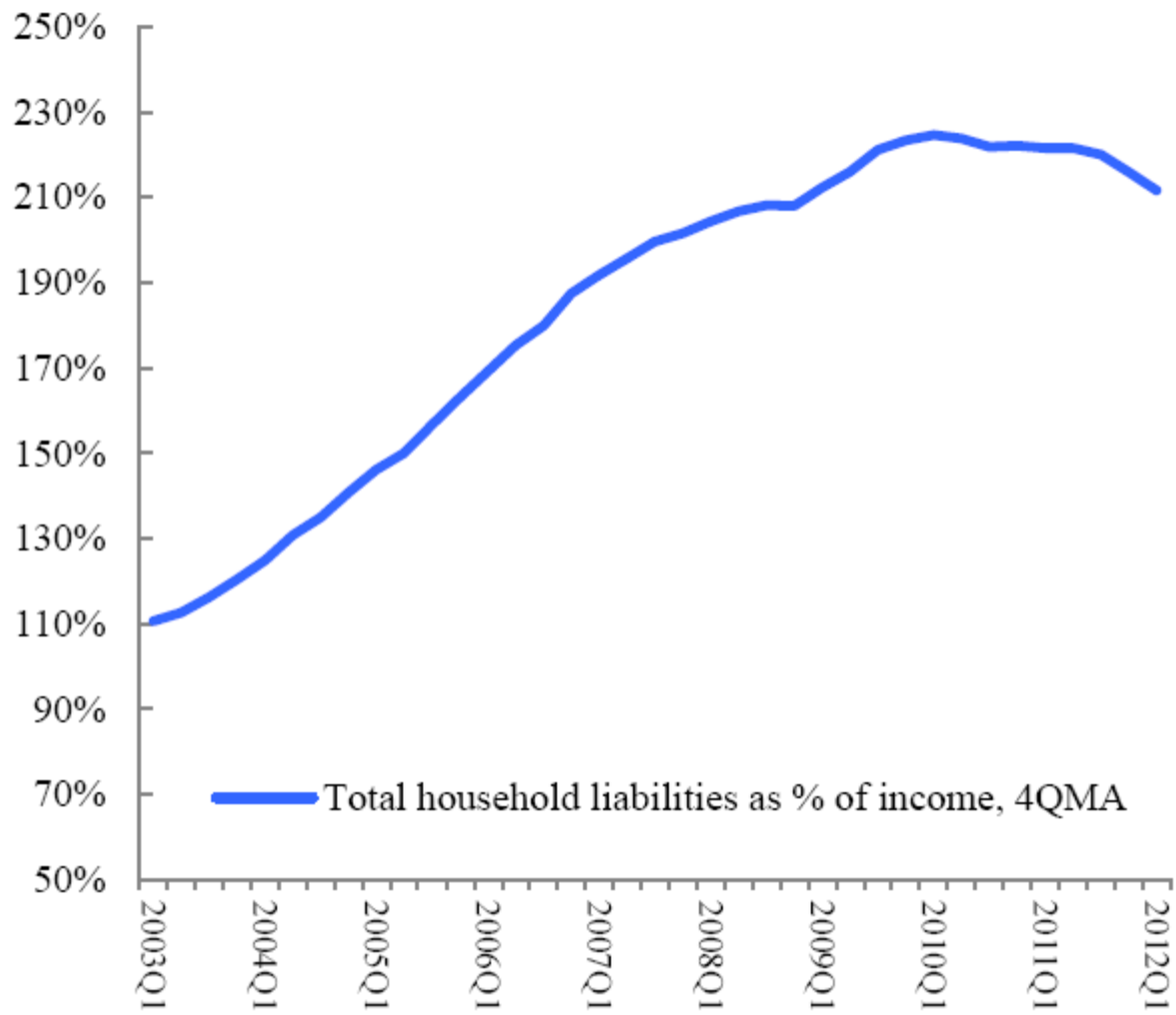
- Overview of boom and bust.
- Fundamentals or a bubble?
- The fiscal stance.
- Conclusions.

House price boom and bust



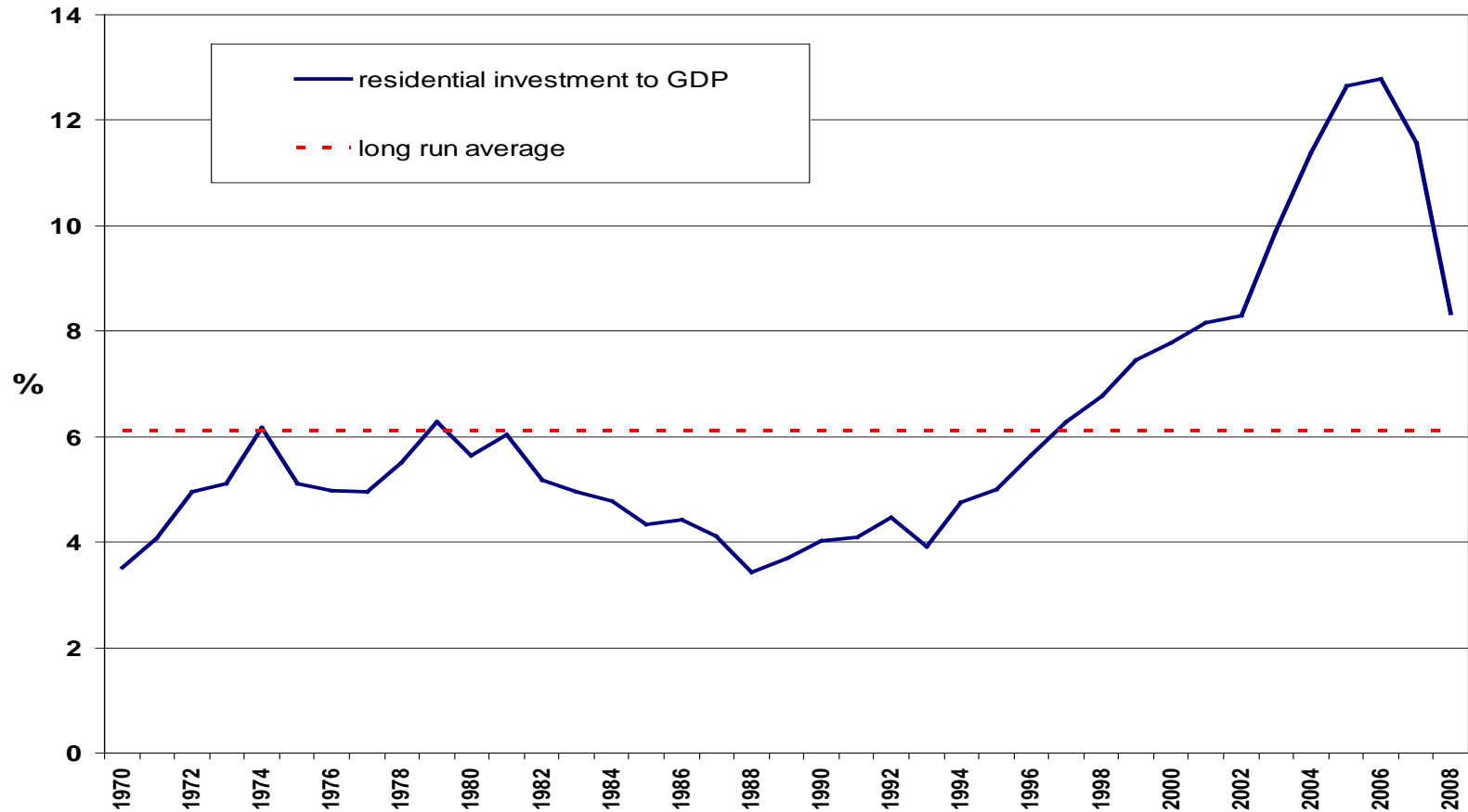
Source: Ronan Lyons, July 2011

Rapid increase in household debt



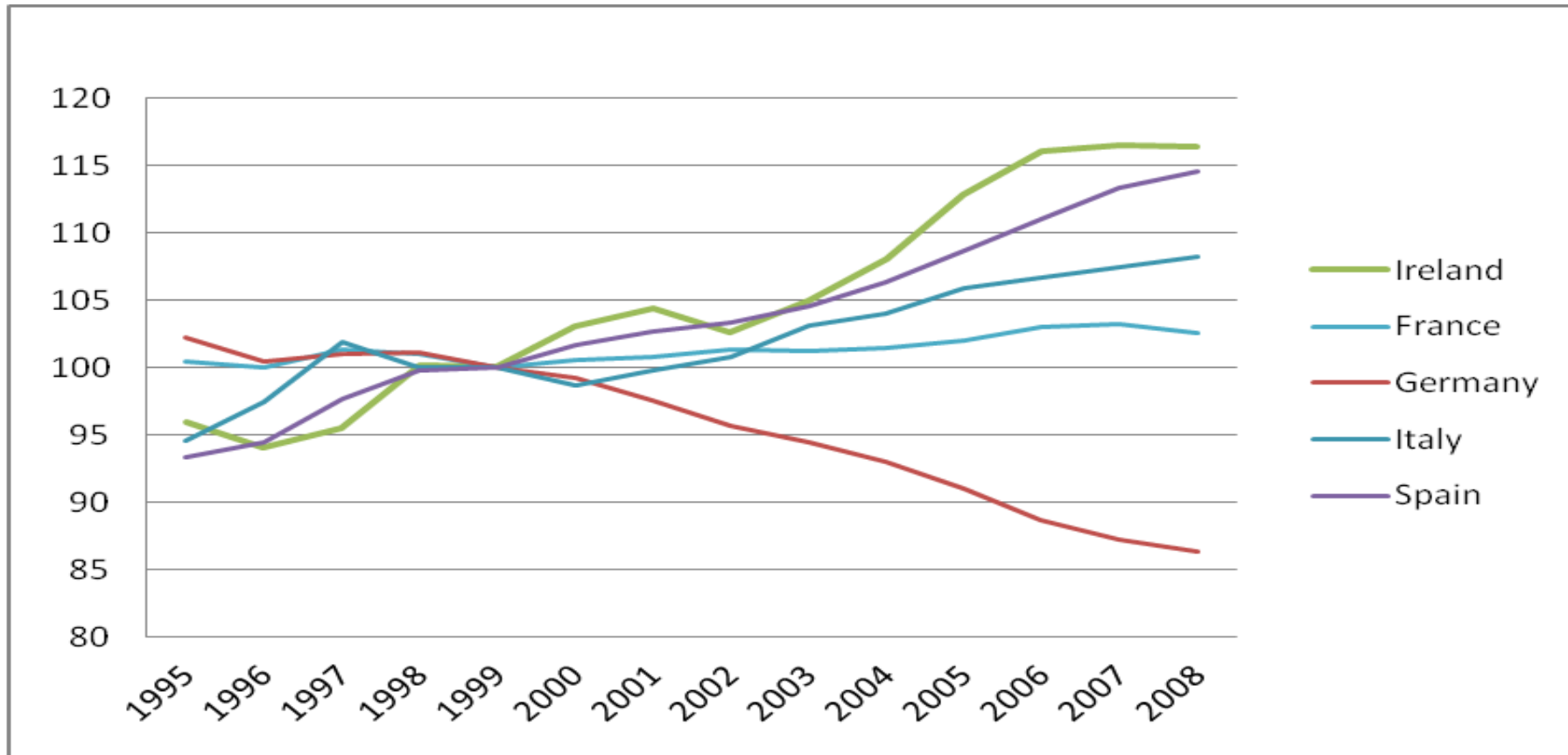
Bubble in construction sector

New homebuilding, share of GDP



Ireland lost competitiveness in euro area

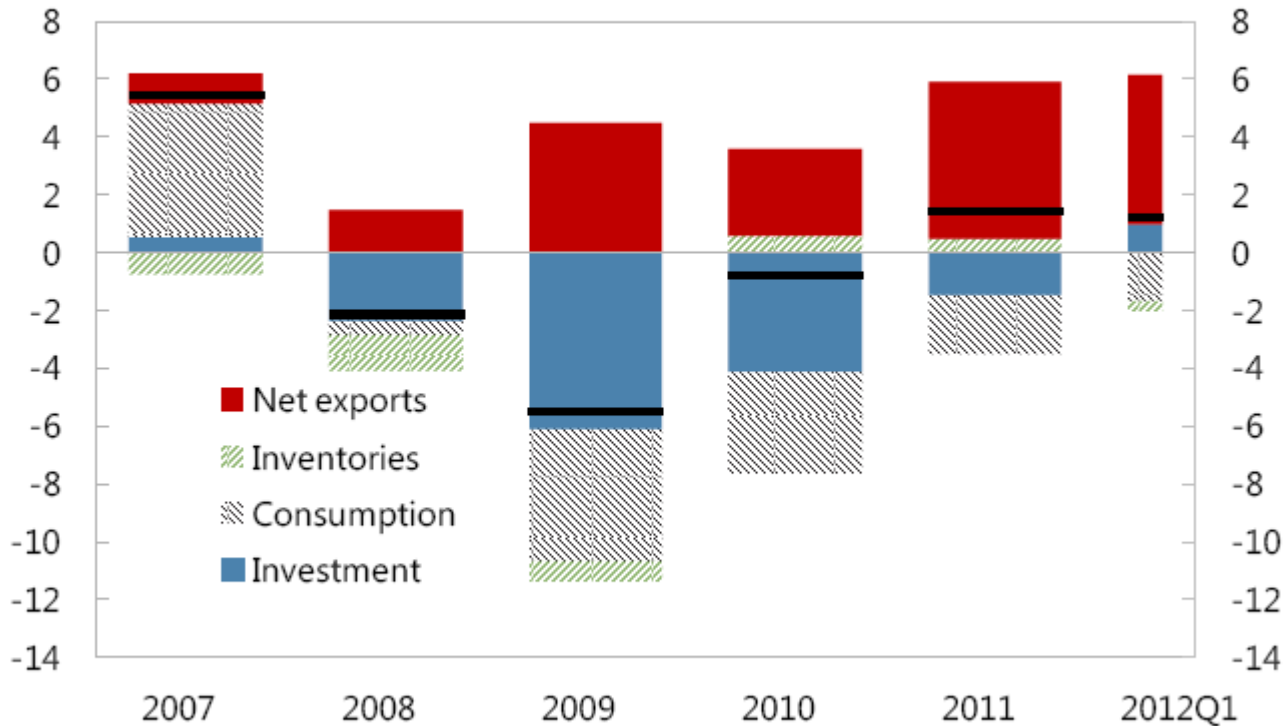
Relative unit labour costs



Source: Regling and Watson, 2010

Consumption and investment spending plunged after bubble burst

Contributions to Real GDP Growth
(Percent)

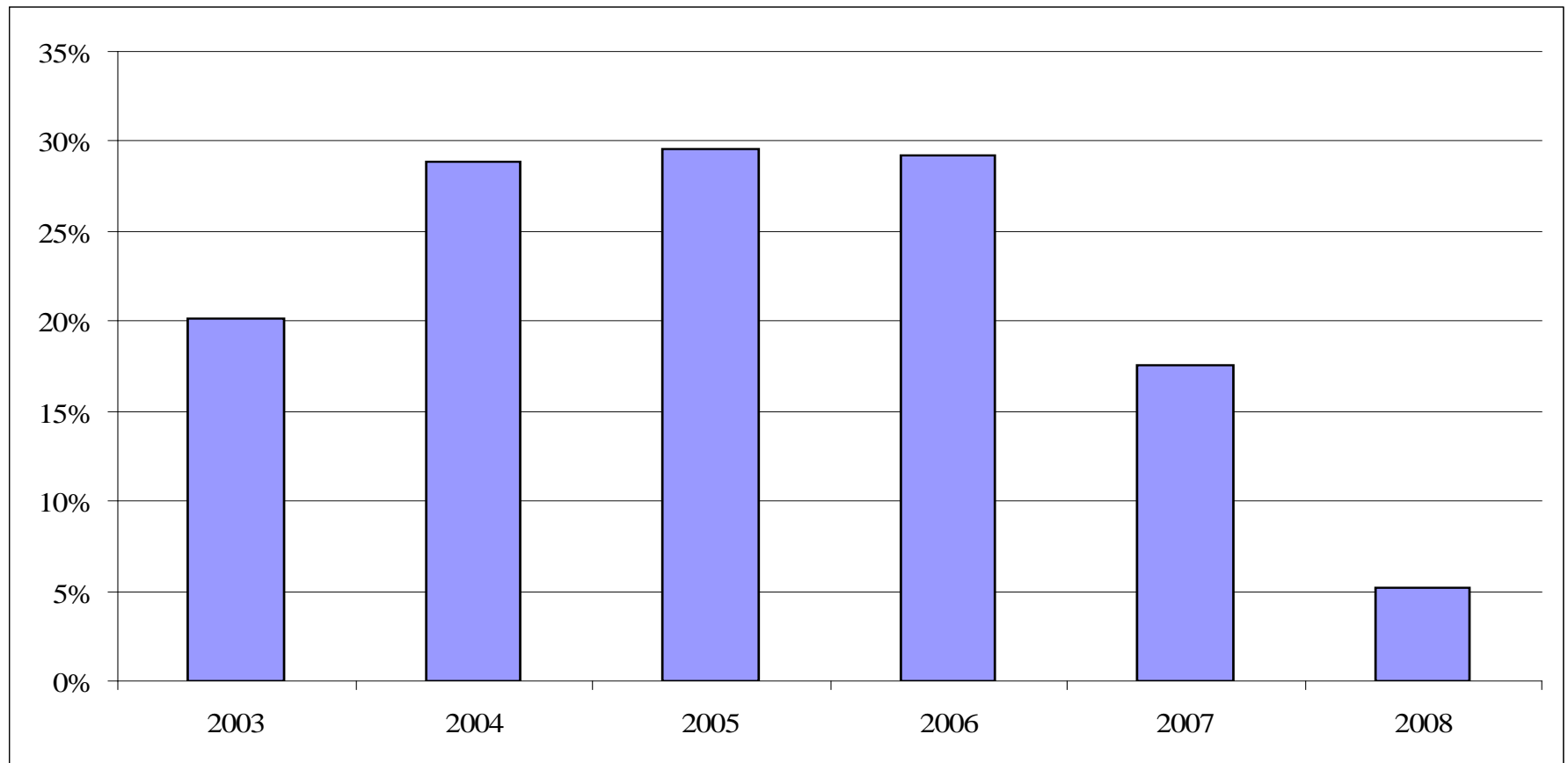


Sources: CSO; and IMF staff calculations.



Surge in lending by Irish banks...

Private sector credit growth of the Irish banking system

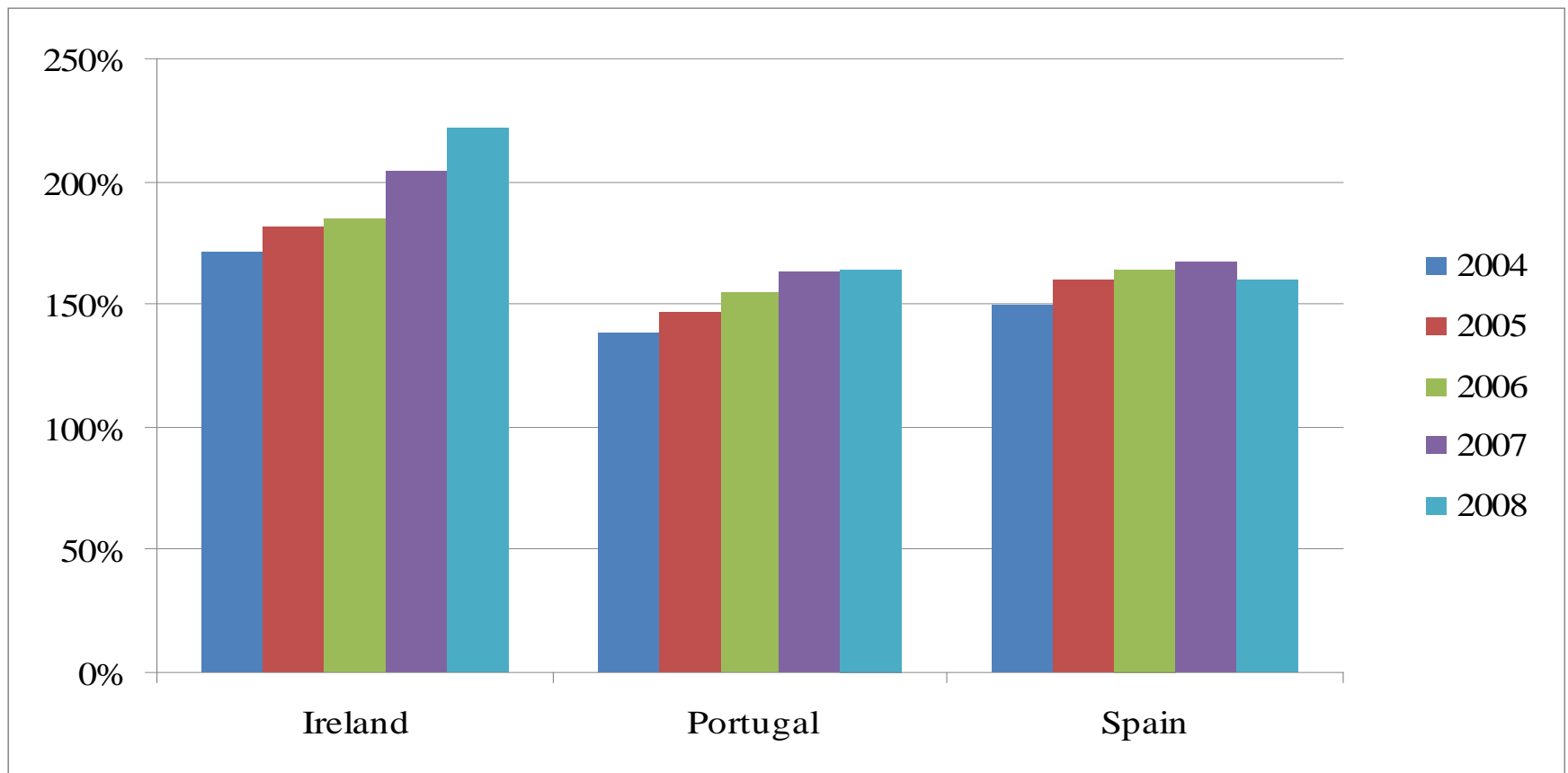


Source: Regling and Watson, 2010



...funded by international capital markets

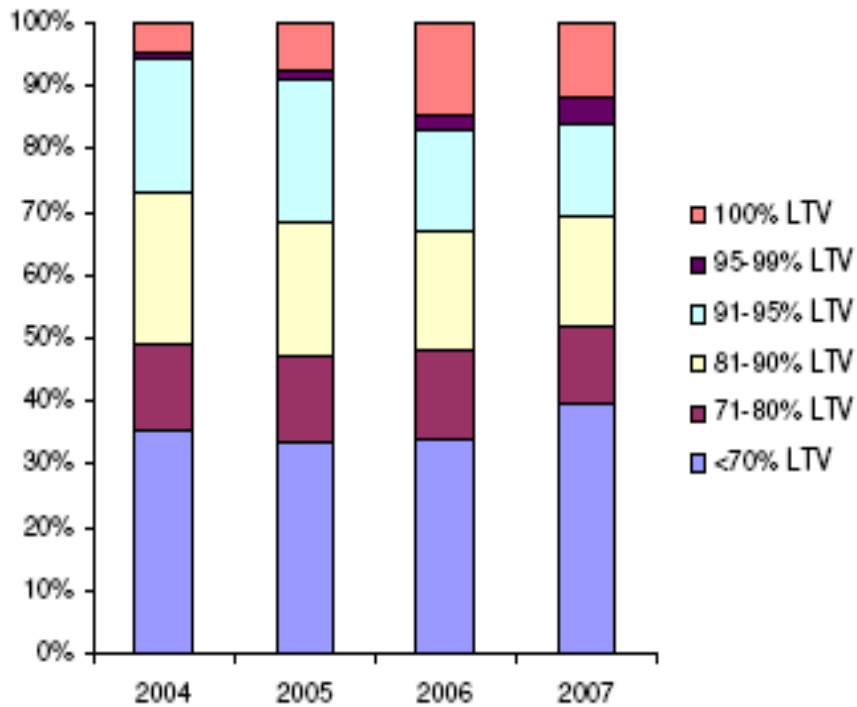
Loan-to-deposit ratios



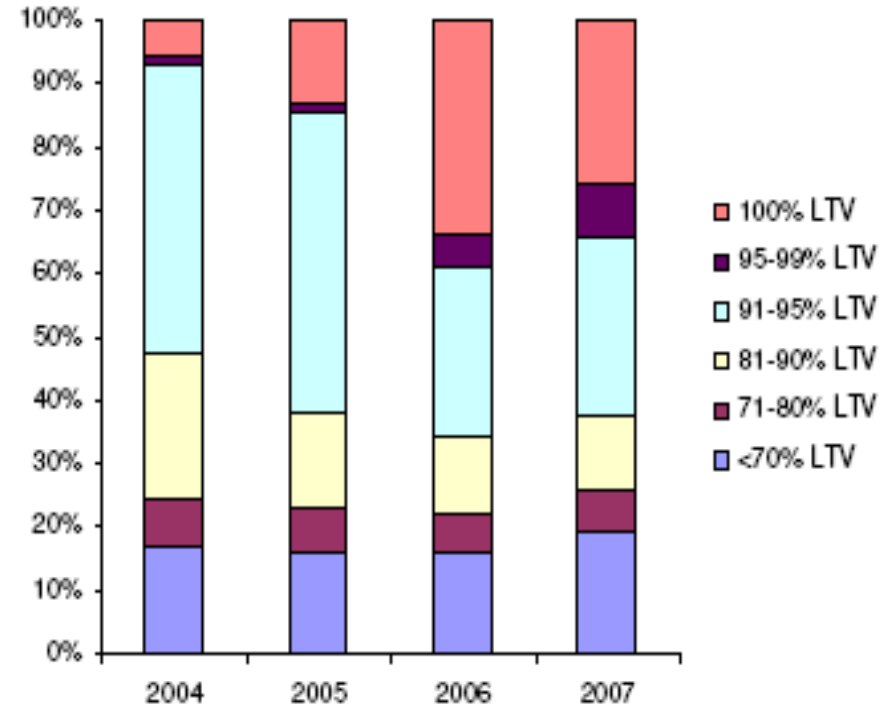
Source: Regling and Watson, 2010

100% loan-to-value common

LTV rates – all loans

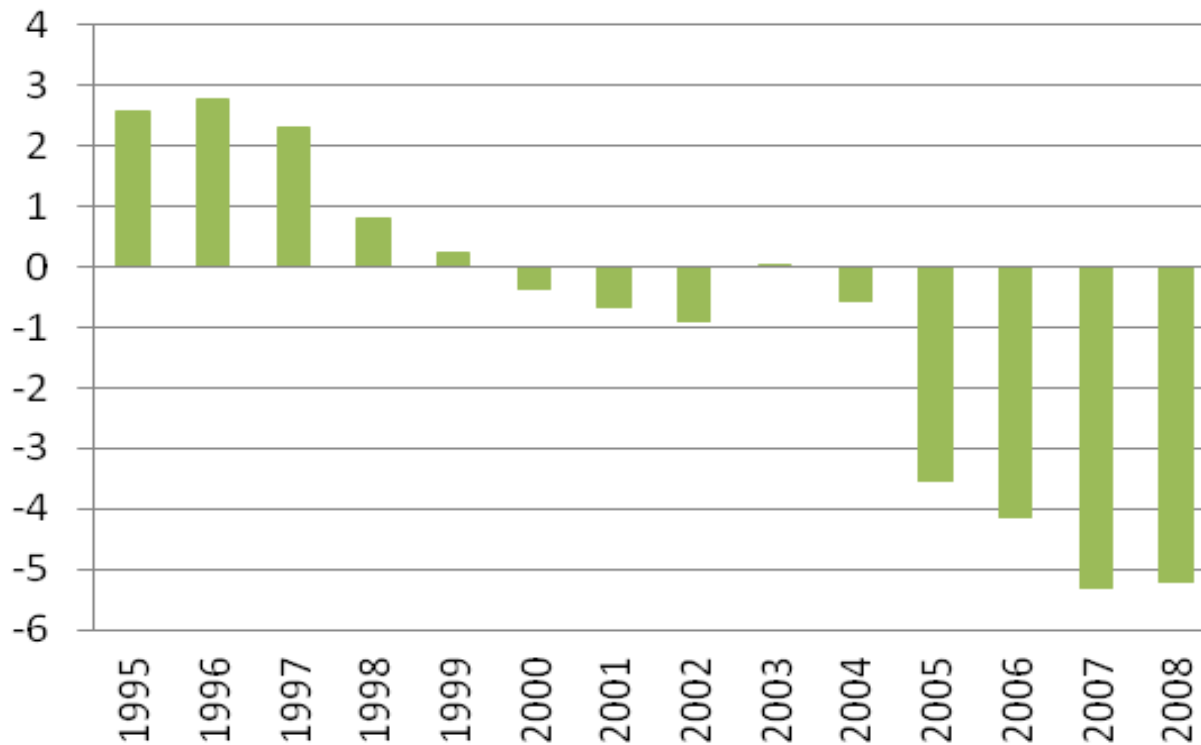


LTV rates -- first time buyers



Large external imbalances

Chart 3: External current account
percentage of GDP

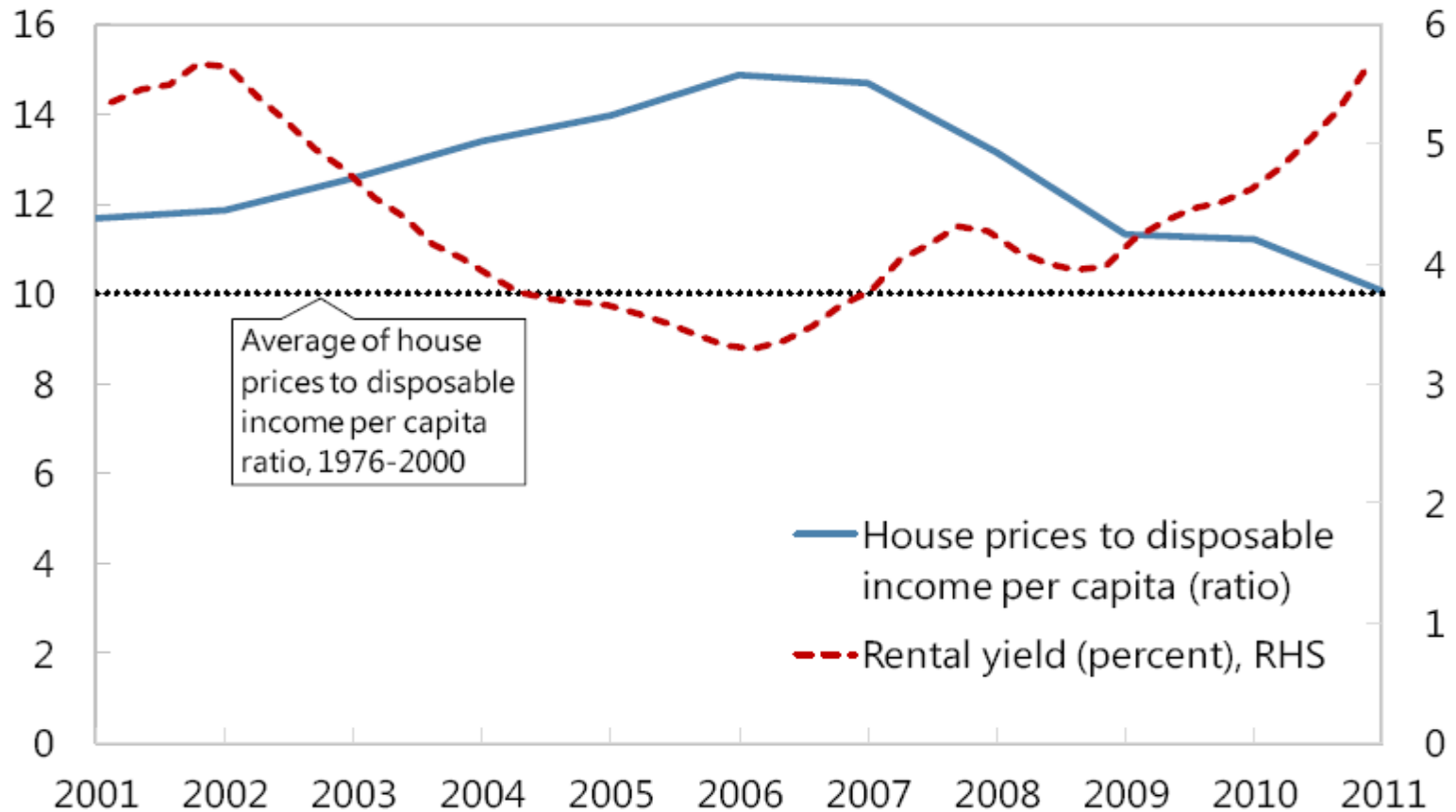




Fundamentals or a bubble?

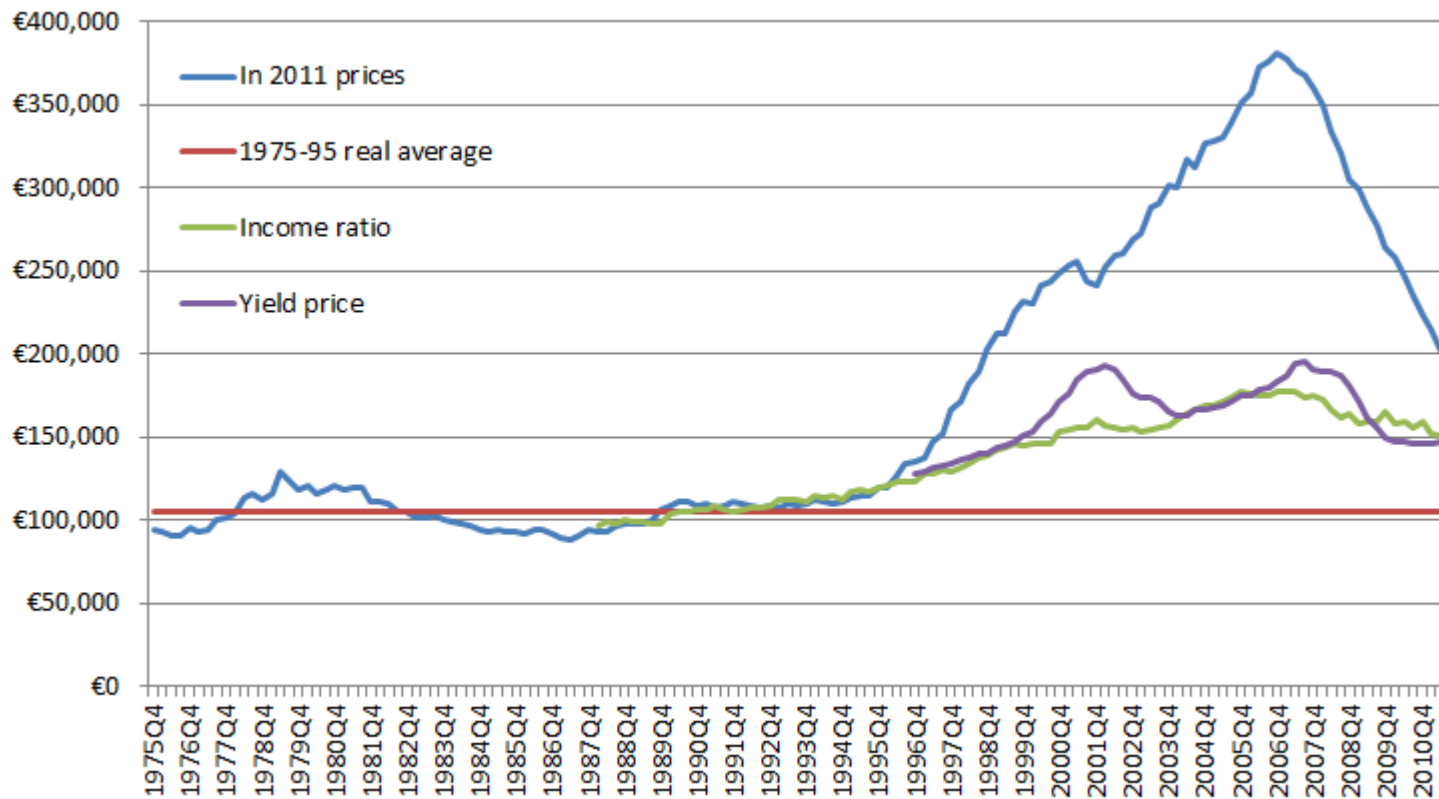
- How do we distinguish a bubble from a rational response to fundamentals?
- Plausible fundamental arguments:
 - Strong growth in GDP and incomes.
 - Low interest rates and financial integration.
 - Young population and immigration.
 - Profitable, well-funded banking system.

Measures of overvaluation



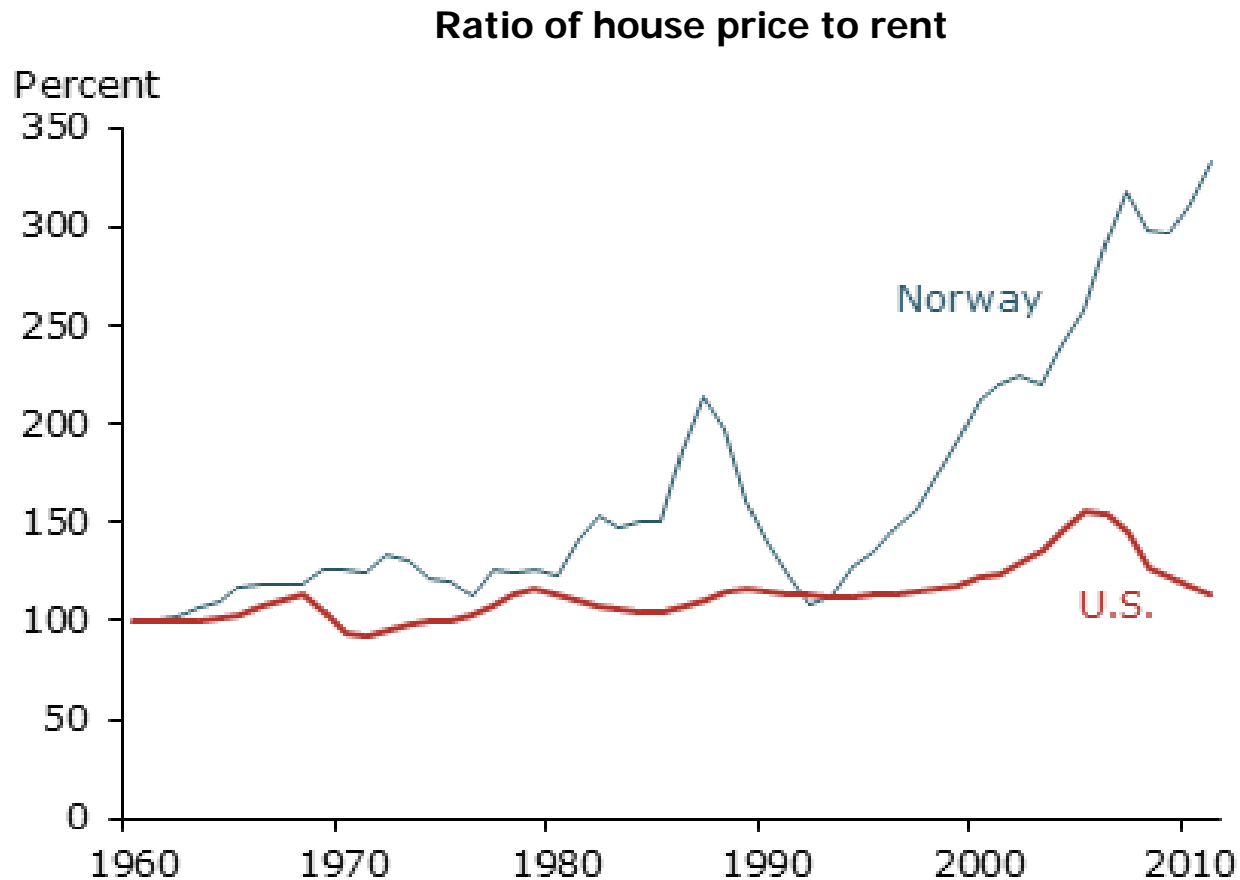
Source: IMF

Measures of overvaluation



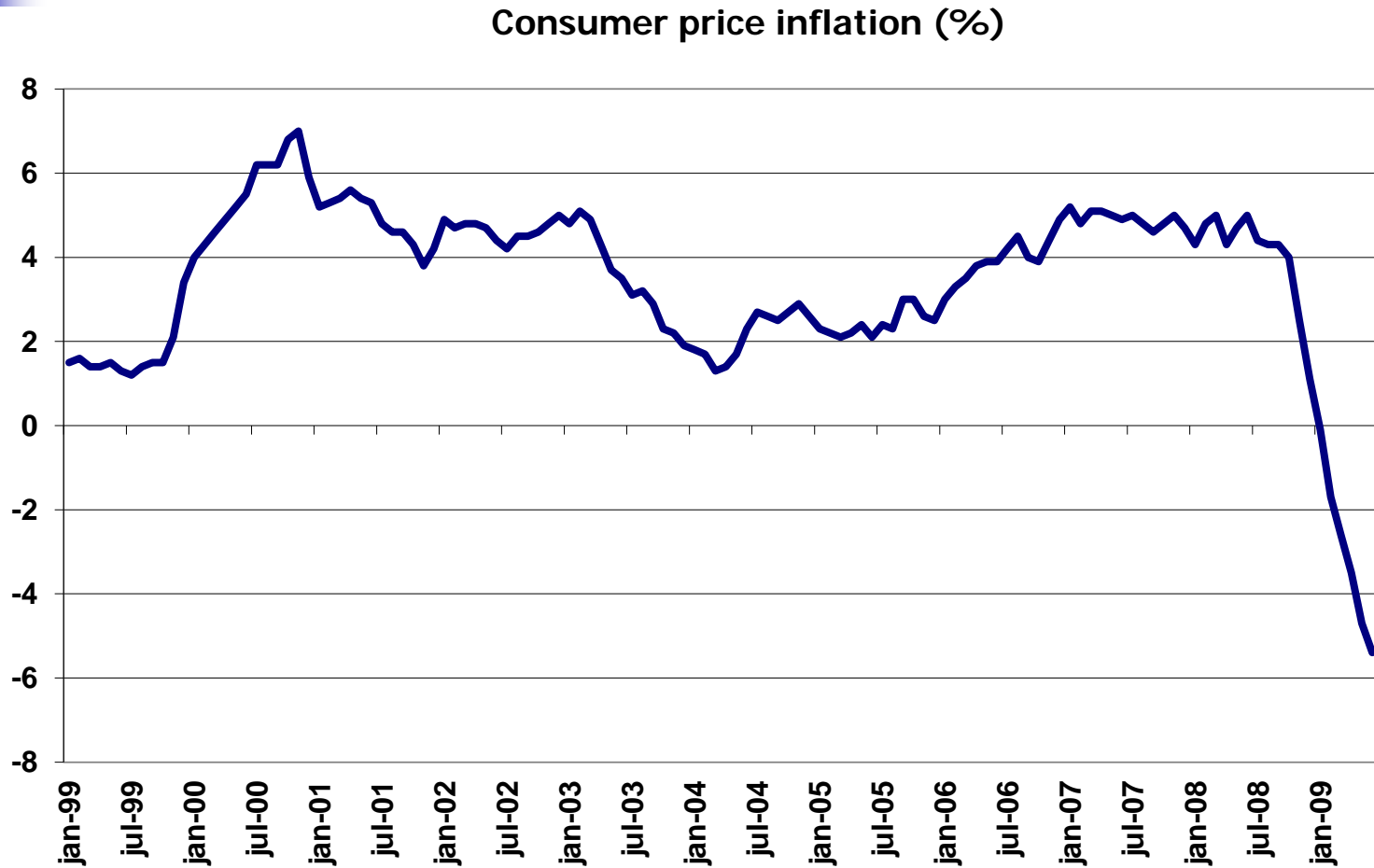
Source: Ronan Lyons, July 2011

Measures of overvaluation



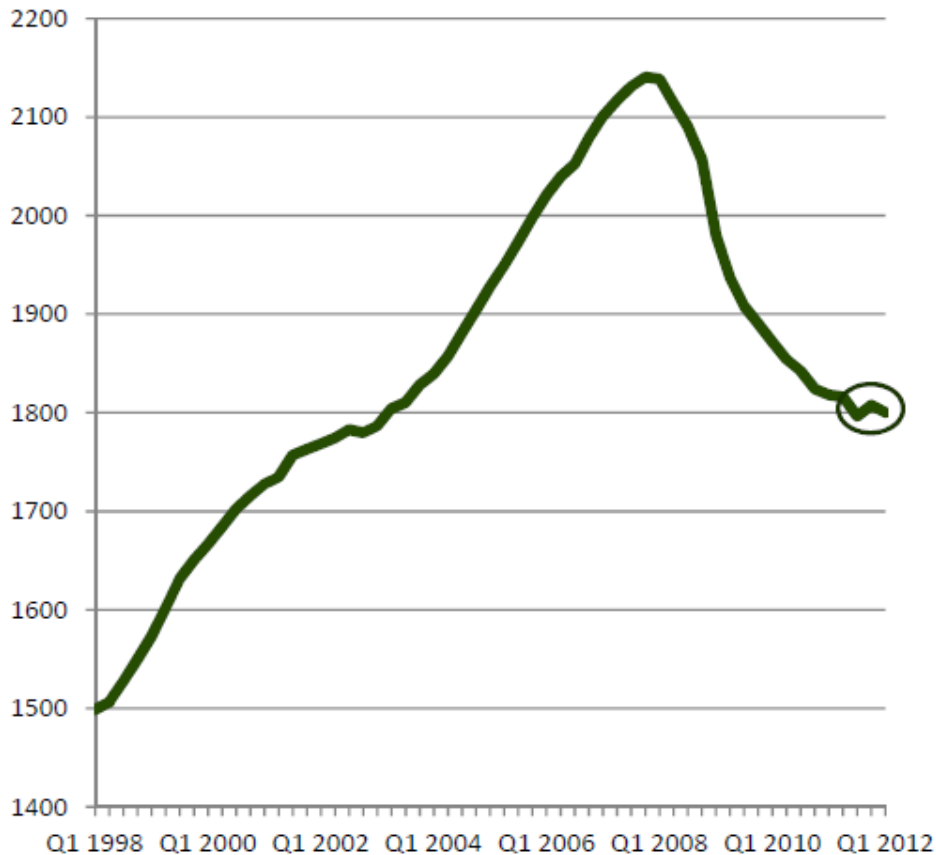
Source: Marius Jurgilas and Kevin J. Lansing, 2012

Consumer price inflation relatively low and stable...

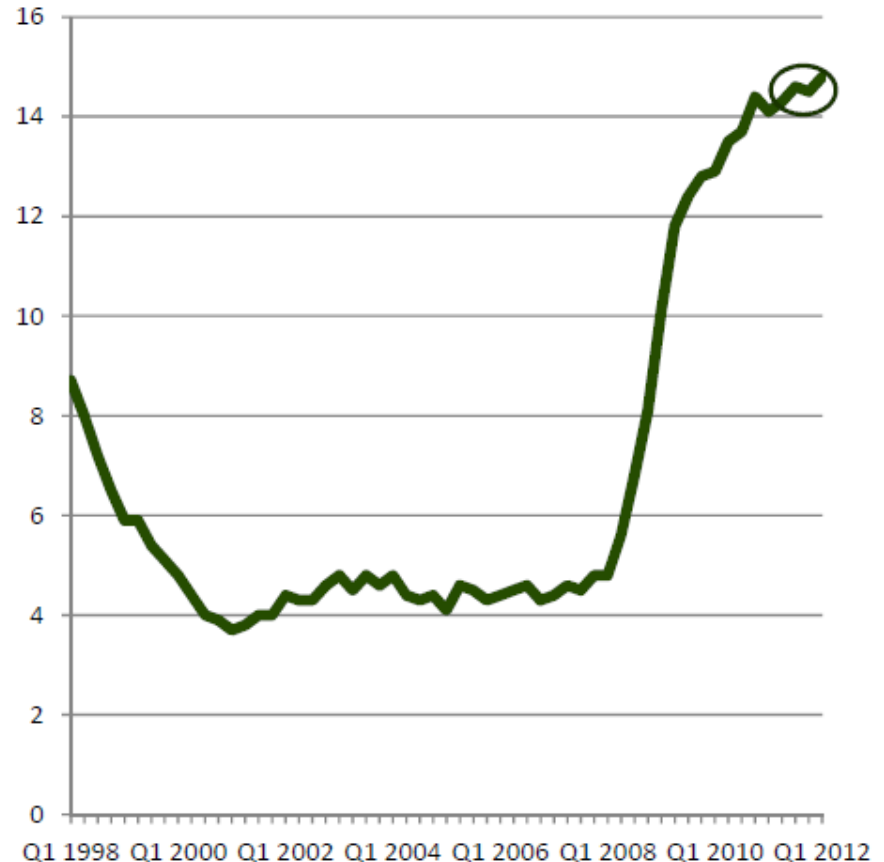


...with no clear evidence that unemployment was below NAIRU

Employment



Unemployment (%)





The value of anecdotes in diagnosing a bubble

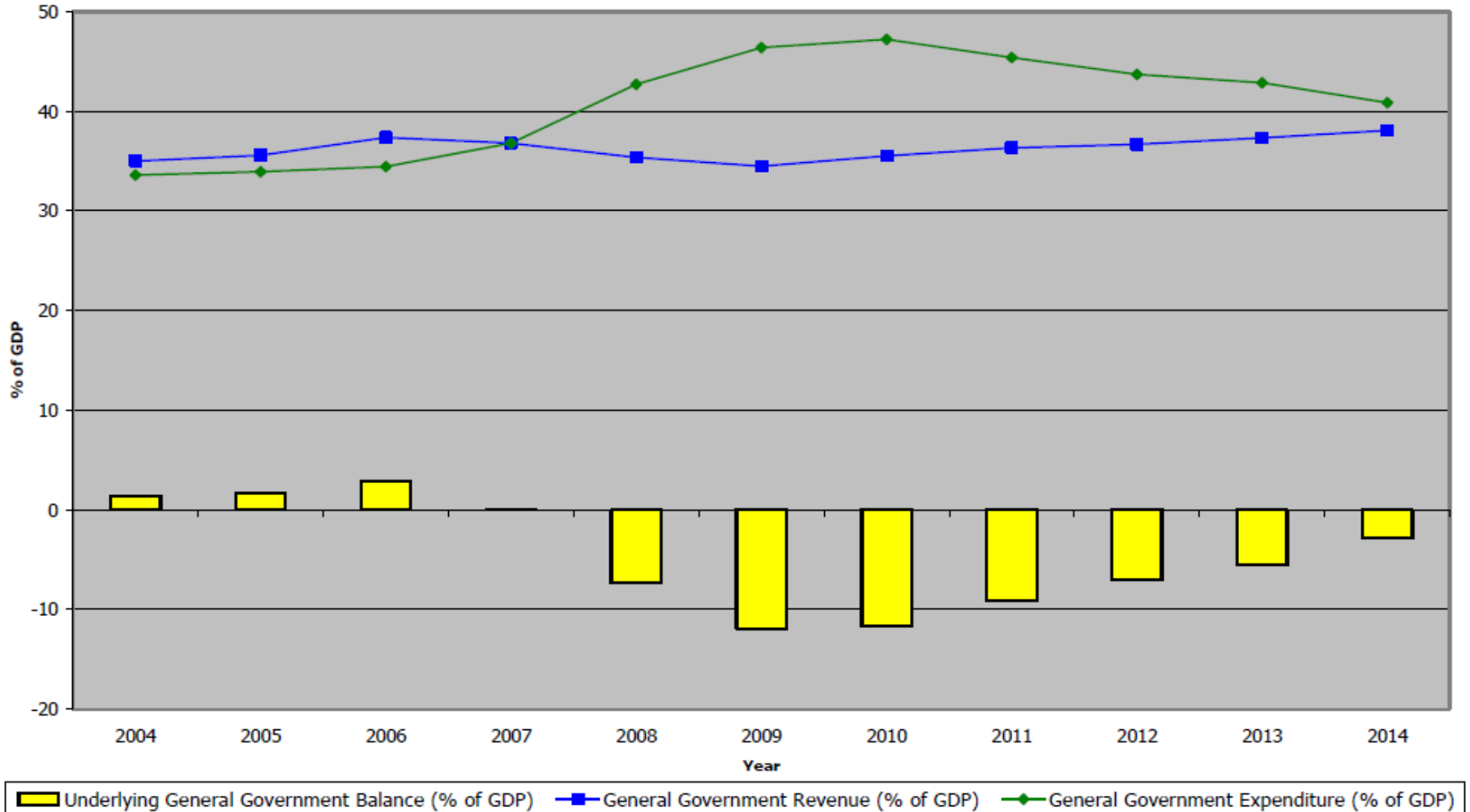
- Media's role in inflating the bubble.
- Tax breaks.
- Auctioneers & Valuers.
- Amateur real estate investors.
- Vacant properties.
- Joe Kennedy and the shoe-shine boy.



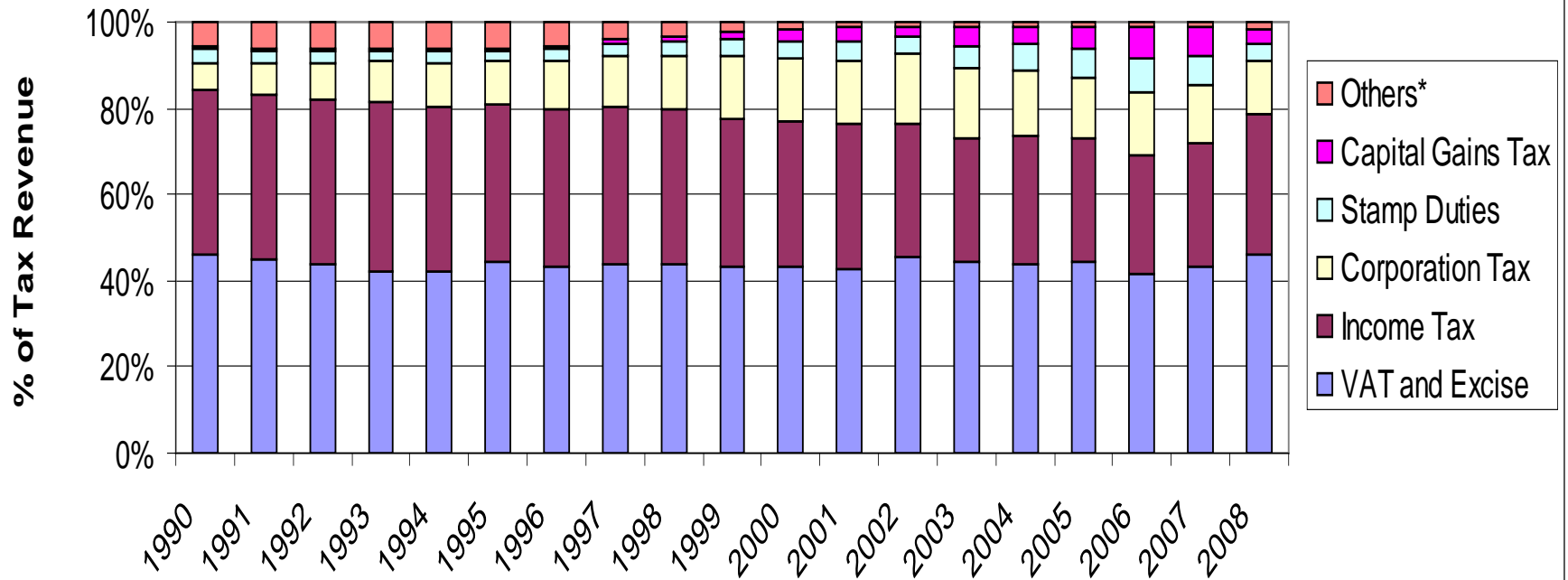
The fiscal stance

- Ireland ran headline budget surpluses during the boom.
- At the time, estimates for the cyclically-adjusted balance also looked benign.
 - Trends (H-P filter) missed bubble.
 - Estimates of output gap (and structural deficit) ignored financial imbalances.

Headline budget surpluses during boom



Bubble generated windfall tax revenues



*Customs, CAT, RPT, MVD, Ag. & Emp. Levies



Benefits of hindsight

		2006		2007	
		Seen then	Seen now	Seen then	Seen now
	Output gap	0.4		0.2	
	Structural Budget	2.7		0.7	



Benefits of hindsight

		2006		2007	
		Seen then	Seen now	Seen then	Seen now
	Output gap	0.4	2.8	0.2	6.5
	Structural Budget	2.7	-4.0	0.7	-7.2



Conclusions

- Fiscal stance was misjudged because financial imbalances were ignored.
- Something like “finance-neutral” output gap (Borio et al, 2012) would have been useful.
- Self-reinforcing spirals between economic activity and asset values.
- Asymmetric risks.