

Debt

Riding the Tiger

By Richard Douthwaite

If it was a moral issue, you'd say we were all hypocrites. On the one hand, we love it when there is plenty of money about and the economy booms. On the other, we enjoy reading news stories about the unprecedented level of borrowing in Ireland and many other countries.

The fact is, the abundance of money and the depth of debt are two sides of the same coin. With the money creation system we've got, you can't have one without the other. For there to be any money in circulation, some people just have to be in debt. Those lucky enough to be completely debt-free and to have money in their bank accounts can only have that money because someone, somewhere, has borrowed it and is paying interest on it.

This will come as a surprise to most people. The common view is that the money we use is created by the government or, now that Ireland uses the euro, the EU. This is no longer true. Except for notes and coins, which are used to carry out only two or three per cent of transactions in value terms these days, all our money is created as a debt. The system works like this: you or I go into a bank and ask for a loan to buy a car. Once the loan is approved, we choose a car we like and hand over a cheque for the appropriate amount to the car dealer. The moment the car dealer accepts our cheque, money is born. He will lodge the €15,000 in his account, giving him money he didn't have before, and we get a £15,000 hole in our account that we'll have to fill up later. Money and debt are equal and opposite. The banks don't create money - we do, by spending the money they authorise us to create when they approve our loan applications.

This means that the money that financed the Celtic Tiger was all borrowed. The question is - who borrowed it? Who is struggling under a huge burden of debt as a result? Is it the government? No, it's us.

"...the amount we borrowed for housing alone in 2005 was 31 times higher than ten years earlier"

The reason the Irish economy has grown so rapidly over the past decade is that ordinary people have been borrowing more and more to buy houses and as a result are putting more and more money into circulation. The Tiger was conceived when Ireland decided to join the euro currency system. Many of those wanting to buy a house at the time realised that joining the Euro-zone meant that interest rates in Ireland would fall to something closer to the German level. Up to that time, German rates had been about 2 percent below those here. Because of the anticipated fall in interest rates, Irish house buyers felt safe offering - and thus borrowing - a little bit more



for the houses they were keen to buy. So property prices started to increase, putting more spending power into the hands of site owners and property developers. The higher prices made building housing estates very profitable. In the early 1990s, roughly 70 percent of the houses built in Ireland were built for the families which would occupy them. Now, about three quarters of all houses built are speculative developments.

While just under 20,000 houses were completed in 1991, the number of completions has climbed year by year since then, reaching 93,419 in 2006. It was not just the number of houses built which increased - their average price did too. In 1996, when 33,725 houses were completed, the average house price was £IR80,000, the equivalent of just over €100,000. Figures released in November 2006 put the national average price today at €310,000, although in Dublin the average is considerably higher, at €427,000.

As a result, the amount we borrowed - and thus the amount of money we put into circulation - grew considerably. In 1996 over 19,000 house loans were taken out, worth €692 million. In 2005, 107,680 loans were drawn down, worth €21,535 million. In short, the amount we borrowed for housing alone in 2005 was 31 times higher than ten years earlier.

Naturally, the increasing amount of money moving around the economy created a lot of work. Building trade employment expanded from 100,800 people in 1996 to 263,000 in 2006. This in turn created a lot of extra work for other people. House furnishers, tile superstores, pubs and restaurants all did well. So well, in fact, that many of them expanded too, borrowing to do so and thus putting yet more money into circulation and creating even more demand. The government got a lot more tax and spent that, plus some borrowings of its own, on capital projects like building more roads to cope with all the cars we'd bought. And we must not forget the people who, because the value of their house had gone up nicely, felt that they could take out a personal loan and use it for home improvements, a holiday or a new car.

A positive feedback set in, with more activity in the building trade leading to more demand in the rest of the economy and thus more construction activity. Even the increased employment in the building trade itself added to housing demand. After all, the



Eastern Europeans who now make up an estimated 12 percent of the sector's workforce need somewhere to live too. Positive feedbacks are always dangerous. They mean that the system in which they operate has inadequate checks and balances and is, essentially, out of control. In the days before Ireland adopted the euro, the Central Bank would have been able to limit the rate at which borrowing was increasing by raising interest rates. Once the decision to join the euro was taken, however, it lost that power. It was therefore unable to prevent a property bubble developing which everyone knows will have to deflate at some time. The only question is – will it deflate slowly and gently, or will it explode with a deafening, economically-destructive bang?



My money is on the bang scenario for the simple reason that the positive feedback operates more effectively on the way down than it did on the way up. All it takes to tip us into a severe economic depression is for the rate at which we are borrowing to slow down just enough to reduce the amount of new money we create each month to a level less than the amount of old money we destroy in the same period by repaying the loans we took out in the past. Too little borrowing means that there's less money in circulation and people's spending power is reduced.

As this makes it harder to do business, firms' investment plans are cancelled and redundancies occur. And that, in turn, destroys the optimism required for further borrowing.

For example, if enough people begin to fear for their jobs ('Perhaps I'd better not take out that car loan just now') or think that house prices are about to fall so that there's no need for them to rush to take out a mortgage to secure a place on the property ladder, they are collectively making self-fulfilling prophesies. If they defer borrowing, less money will be put into circulation, the property market will become less buoyant, and, yes, there was no need to rush to get into it after all. It's the same with business. If enough firms think that their future prospects are so doubtful that it would be better not to risk borrowing to expand, they will find that they were right and there really was no need for a loan to put in that extra equipment.

The modern economy therefore constantly moves between boom and bust because of the way the money system works. There are very few periods in which there is a happy medium, an in-between. In the booms, the economy experiences the positive feedback with

“
He that dies pays
all debts”

The Tempest Act 3 Scene 3

borrowing leading to more profits and therefore more borrowing. In the busts, cuts lead to further cuts and a vicious spiral down.

At present Ireland is riding a Celtic Tiger which will almost certainly eat us if ever the housing boom falters and causes us to fall off. But for how much longer can we keep the boom running by borrowing more and more? People living in Ireland are already investing almost a third of everything they earn. That's a very high figure by international standards – it's twice the level in Britain, for example – and can't be increased much more.

Looked at another way, ordinary people can't afford to take on much more housing debt – or indeed, debt of any sort. The average house now costs 12 times the average industrial earnings in the country and almost 16 times in the capital. Historically, this figure is very high indeed, as the affordability figures in Illustration 1 show. Affordability is taken as the annual cost of servicing a new twenty-five year mortgage relative to average income. This figure has averaged 28 percent over the past thirty years, with a high of 39 percent in the early 1980s (when mortgage rates were around 15 percent) and a low of 20 percent in 1994. Since then the figure has moved up steadily to 35 percent in 2006 and the Bank of Ireland thinks it could go as high as 37.8 percent this year as a result of the higher interest rates.

Another way of measuring housing affordability is to compare the median house price with the median income. Over several decades and in many countries, the median house has cost roughly three times the median gross income. Now, in Britain, Ireland and several other markets, house prices have risen sharply in relation to the median income with the result that *Demographia*, an organisation which tracks house prices using this measure, rates Dublin house prices as 'severely unaffordable' in its 2007 report. "The present extent of housing unaffordability is unprecedented, both historically and across markets" it writes. For the housing boom to continue, people have to be enabled to borrow more and more and new buyers have to keep entering the market. So far, the banks have been able to arrange things so that both can happen. As recently as 2002, they limited buyers to borrowing 2.5 times the primary income plus an amount equivalent to the secondary one. Now, borrowing of up to five times the joint income is common, which has pushed prices up.

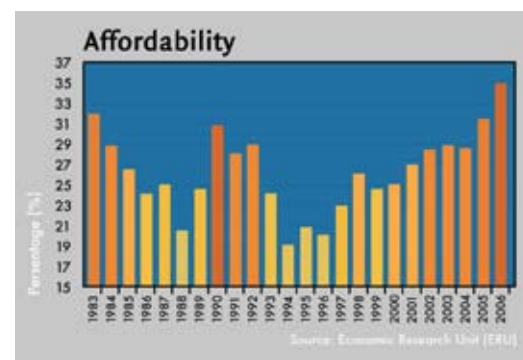
The trouble with this, though, is that higher and higher house prices make it increasingly difficult for young people to find the 10 percent deposit needed to get on the property ladder. For the country as a whole, the 10 percent deposit amounted to 38 percent of household disposable income in 1994-1995, but this ratio reached 63 percent in 2005. So the banks have intervened again. They have pretended to help buyers cope with the twin problems of affordability and finding the deposit by abolishing deposits by giving 100 percent mortgages and extending the mortgage period out to as long as 40 years.

The availability of these long mortgages at high multiples of the borrowers' incomes does not, of course, help the borrowers at all. It merely means that everyone has to borrow more, and for longer, to be able to compete on equal terms in the housing market. Even the banks are likely to come out of it badly. While they have been able to keep borrowing growing for the moment, their problems will be huge if the economy dips and house prices halve. The danger they face is that thousands of

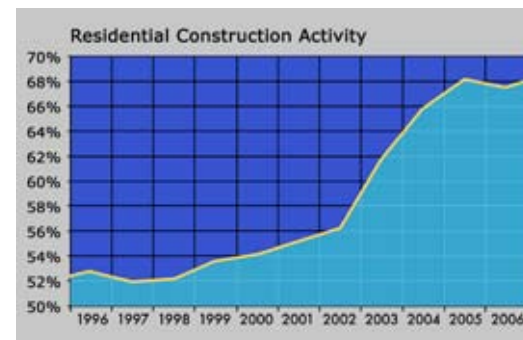
unemployed people with debts greater than their property's value will besiege their offices wanting to get out their situation by handing over their house keys.

This would be disastrous for the banks as it would mean that they had to register thousands of bad debts on their books, eroding their working capital and thus destroying their ability to lend. Their solvency might even be threatened. Moreover, they would have to sell the re-possessed houses by auction, which would drive down house prices even more. Mortgage lenders will therefore do everything they can to persuade people not to default on their payments. In particular, they will offer borrowers a new loan to enable them to continue to service the first one so that they can pretend that the mortgage is still valid on their books.

Forty-year mortgages are a warning that staying on the Tiger's back is becoming impossible. In Japan, just before the property market crashed in 1991, buyers could get 100 year or multi-generational mortgages. Prices there have dropped over 35 per cent from their peak and are still falling. Yet the rise in Japanese house prices in the seven years to 1991 was only 36 per cent, considerably less than the rise in the past seven years in Ireland. Many Japanese banks became insolvent and only survived because the central bank allowed them to pretend they weren't. Irish banks will try the same pretence if the boom ends with a bang. And what about us, the people who have borrowed for Ireland and made it one of the highest-income countries on Earth? Well, to put it simply, we will be in trouble. A radical restructuring of the way money is created will be required to get us out of our problems. But that's a story for another day.



These Bank of Ireland figures show the proportion of the average income required to service a new 25-year mortgage on an average-priced house. The current level is historically very high. Source: Economic Research Unit (ERU)



Residential Construction as a Percentage of Total Construction Activity (Ireland) Residential construction drove the boom. It took an increasing percentage share of all the construction activity in Ireland between 1996 and 2006 (The 2006 figure is an estimate) Source: Review of the Construction Industry 2005 and Outlook 2006 to 2008, DKM, Sept. 2006



Richard Douthwaite is an economist and writer with special interest in climate and energy issues, local economic development and rural sustainability.

His book *Short Circuit* (1996) gives dozens of examples of currency, banking, energy and production systems which communities can use to make themselves less dependent on an increasingly unstable world economy. He is one of the founder members of *Feasta*, the *Foundation for the Economics of Sustainability*, a registered charity which aims to establish the characteristics that an economic system would have to possess to be truly sustainable.

Richard lives near Westport with his partner Mary.

“Many people believe that providing they are never behind on their repayments, they are not in debt. This isn't true. A debt is when you owe someone [or an institution] money”.

The Money Doctor 2007 John Lowe

Editors note:

An article in the Irish Times (28/12/06) by Morgan Kelly, professor of economics at University College Dublin warned that house prices in Ireland could fall by 40-50 percent. He drew strong parallels between circumstances which led to property crashes which had occurred in Finland and the Netherlands and the situation in Ireland today. According to professor Morgan we can expect “the biggest [price] falls in apartments...and in ... outlying towns with long commutes to Dublin...”