## Patrick Honohan: Where did all the money channelled into property-backed lending go?

Article by Mr Patrick Honohan, Governor of the Central Bank of Ireland, originally published in the Irish Times on 31 January 2015.

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*Accompanying chart can be found at the end of the speech.*

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During 2002–2007 a vast sum in the order of twice annual GDP (much of it borrowed from abroad) was channelled by the banking system into property-backed lending.

Where did all this money end up? That was the question recently asked by Colum Kenny in this newspaper, and also addressed to me at the Banking Inquiry. As we take steps to ensure that there is no return to boom-and-bust conditions, it is indeed timely to revisit this question, which has puzzled many.

One approach to answering the question seeks to construct a kind of audit trail. Thus some of "the money" was paid out for construction work, wages, materials and profits – including bank profits. Some was received by those who sold property at high prices. These receipts were in part saved, and in part spent, by the recipients, either leaking out of the country in payment for imports or adding to tax revenue.

But that audit trail narrative misses a large part of the story. A fuller answer must take into account the damaging effects the spending of the money had on prices and wages; on investment patterns and the productive structure of the economy; on the Government's spending and tax rate decisions; and on the levels of indebtedness of households and firms.

The only way of getting to grips with the question from this deeper perspective is to pose it in terms of a clearly-defined counterfactual. Imagine how the Irish economy would have performed if the banks hadn't borrowed all that money to finance property-backed loans. Knowing this will allow us to restate the question "where did the money go?" in terms that, while complicated, are amenable to answer. For the difference between the actual and this counterfactual tells us where that money went.

Start with the capital gains and losses from credit-financed property transactions at what turned out to be evanescent bubble prices. The counterfactual economy would not have seen these transactions which left some sellers richer and many buyers poorer. Note that, in principle, the subsequent fall in prices did not affect these sellers: their gains were "in the bag". In contrast, the purchasers at bubble prices experienced losses when prices fell. As most of the purchases were funded by debt accumulation, many of these borrowers – whether household or corporate – found themselves with negative equity and, in the wider downturn, many soon also became unable to service their debt.

When borrowers defaulted, these transactions ultimately resulted in losses also for the banks' shareholders (and sub debt holders), and – notoriously – for the Government which stepped in to prevent other creditors of the banks losing. Naturally, much attention has rightly focused on the €40 billion or so of ultimate losses assumed by the Government under that heading. A broadly similar amount was lost by bank shareholders, etc. And there are two other big categories of capital gain and loss: I think the aggregate gains by Irish property sellers are plausibly of the same order of magnitude, as are the aggregate losses being nursed by borrowers.

But, large though these four categories of winnings and losses from property transactions at bubble prices are, they need to be considered alongside the even larger and still growing

accumulated difference between income in the actual Irish economy and that in the counterfactual scenario.

I won't pretend to have precise figures on how aggregate income and employment would have panned out in the counterfactual scenario of no property bubble, but the broad outlines are clear.

The counterfactual no-bubble Irish economy would have grown much more slowly than actual in the period up to 2007, and much faster in the post-crisis years. For example (according to one simulation) some 130,000 fewer houses would have been completed over that period, with total employment about 60,000 smaller by 2007, and despite less migration into Ireland, the unemployment rate would have drifted more than 2 percentage points higher than actual. Lower revenue would have pushed the Government accounts into deficit and a higher debt ratio at the outset of the global financial crisis. Household incomes would have been much lower too, with per capita personal consumption running about 8 per cent lower than actual in 2007.

Of course, different households were affected in differing degrees, resulting in large distributional shifts which are the subject of important ongoing research.

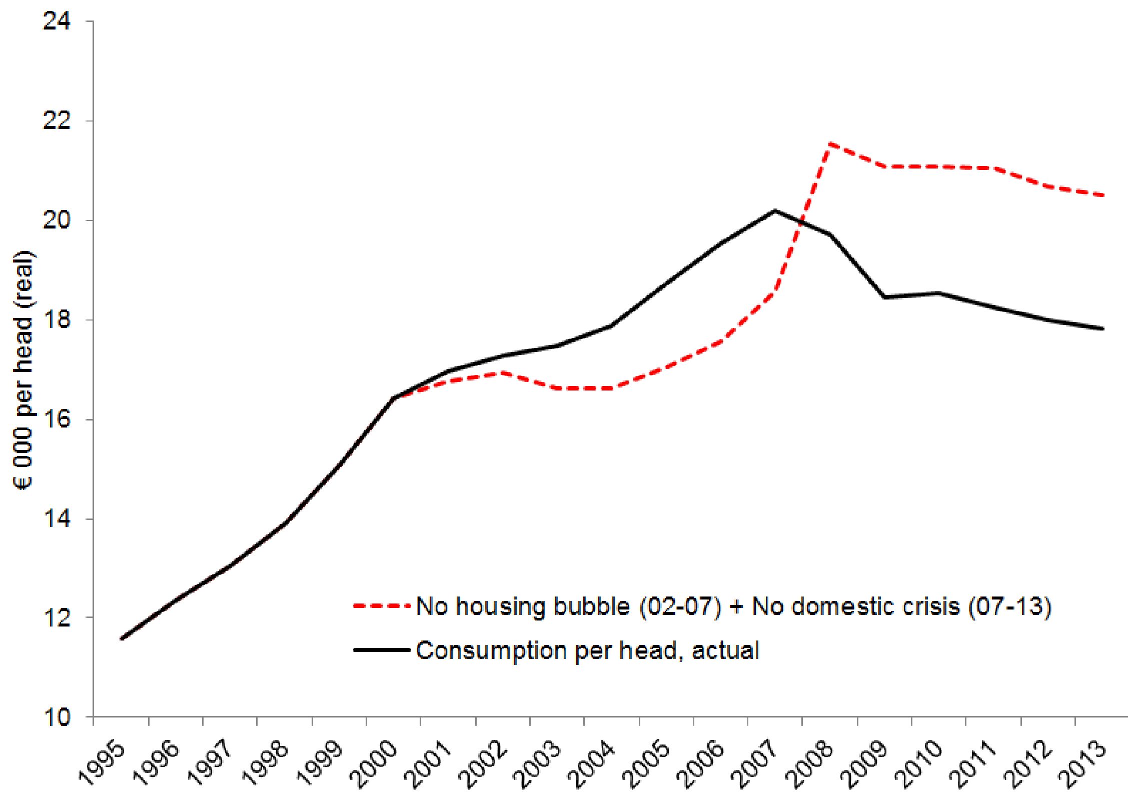
Heading into the global recession, then, the Irish economy would have been smaller, with more moderate wage rates and a somewhat higher Government debt and deficit. It would have been better placed to absorb what was coming. Ireland would have been hit by the global recession, of course, but our recovery would not have been held back by the implosion of a bloated construction sector, by the collapse in tax revenue and by excessive debt. And the Government would not have lost the confidence of the financial markets.

Without these burdens, it is plausible that Ireland would have done at least as well as the euro area's lack-lustre post-2008 performance. If so, by 2013, living standards would have been about 15 per cent above their actual level, and employment about 8 per cent higher. And this development would have continued into the years ahead, remaining well above what our damaged (albeit recovering) actual economy will deliver. The gap between actual and counterfactual is illustrated in the accompanying diagram.

The boom and the bust both damaged our economy. The boom, and the decisions that were taken during it, meant that Ireland had to adjust down from living standards that could never have been sustained, with sizeable and capricious shifts in the distribution of wealth. Despite the path of recovery, the economy still markedly underperforms relative to what could have been achieved had we curtailed the property bubble.

The Irish banking crisis, like so many others throughout history, illustrates why it is vital to act pre-emptively (as with the mortgage measures announced by the Central Bank this week), to ensure that we don't face such intractable challenges again.

With rising employment and a steady, albeit slow, working through of household and firm over-indebtedness, a gradual narrowing of the gap between what is and what might have been is in prospect, as long as we do not let borrowing – public or private – get out of hand again.


Consumption per head in Ireland with and without property bubble, 1995-2013
24
22
20
18
16
14
12
10
€ 000 per head (real)
No housing bubble (02-07) + No domestic crisis (07-13)
Consumption per head, actual
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013