Patrick Honohan: The impact of the boom and bust on the capital of households in Ireland


* * *

Introduction

For me, a long-time admirer of Thomas Piketty’s work and a first-day-of-issue purchaser of Capital in the 21st Century (Piketty, 2014) there is much to enjoy and admire in this work, focusing as it does, not only on the distribution of income at a point in time, but in particular on the evolution of wealth or capital holdings over time, a topic neglected to a surprising degree in most analysis of economic statistics.

I especially like the historical sweep including the well-detailed comparison and contrast of the late 19th Century “gilded age” with the more recent “age of financialisation”. (We didn’t have much of a “gilded age” in Ireland, but we did have “financialisation” with a vengeance cf. O Riain, 2014).

I also was intrigued by the documentation of the destruction of wealth – and of wealth concentration – by war and depression in mid-20th century. (Resonances also here to Ireland’s current experience).

I appreciate the matter-of-fact concern with inequality – especially wealth inequality: I differ from those commentators who do not see the obvious policy relevance of these matters.

And I like the handling of the contrasting roles of inheritance and accretion through investment earnings versus “earned income” in generating wealth inequalities.

Finally, as someone who studied macroeconomic dynamics in graduate school, I was very struck by the neglected relevance of the $r - g$ dynamic (i.e. the dominance and concentration wealth will grow in the economy if the average rate of return on capital continues to exceed the rate of growth of economic activity) for interpreting and predicting trends in the concentration of wealth.

I have to disappoint anyone expecting a “however” at this stage, because (while such an ambitious book will continue to prompt many debates and questions) for me it is a tour de force.

Although much of the commentary around Piketty’s book has centred on his forward-looking analysis of the prospects for the size distribution of worldwide wealth in the decades ahead, other parts have greater immediate resonance for us here in Ireland. I am thinking specifically about the way in which many of the long data series in Capital show a pronounced decline in the mid-20th Century. Related to two world wars and the Great Depression which separated them, as well, perhaps, as to the rise of the “Welfare State”, these collapses occurred both in terms of the aggregate wealth-to-income ratio and to the concentration of wealth at the top end of the distribution.

If Capital convinces of anything, it surely establishes that looking at major historical transitions through the lens of data on wealth is very instructive. We also have had disruptive events in Ireland in the past decade somewhat comparable to the mid-century capital and wealth collapses in Europe documented by Piketty. As well as tipping the economy into a deep recession, triggering a surge in unemployment and emigration and crippling the public finances, our crisis has been associated with large losses in household capital and increases in indebtedness causing distress. These latter aspects have been the focus of a lot of work at...
the Central Bank in the past few years as we have used the limited powers at our disposal and sought to provide advice to Government to map the best available route to recovery.

Data on the distributional impact of recent economic developments in Ireland

*Capital in the 21st Century* shows the value of comprehensive data to understand trends in capital and debt. So, seen through such a data lens, how does the recent boom-and-bust experience of Ireland compare? Do we have the data? Well, for aggregate household wealth and indebtedness we do have many of the most important elements (Cf. Cussen and Phelan, 2010, 2011, Cussen, O’Leary and Smith, 2012), and I will speak about those aggregate numbers in a few minutes.

But for how that wealth and indebtedness is distributed, much less is known. To be sure, systematic collection of income inequality and poverty data in Ireland has been well established since the 1980s and is carried forward notably in the CSO’s SILC survey. The share of the top few percent of the income distribution has also been tracked over a long period of time in Ireland, and that data (Nolan, 2007) is part of the World Top incomes database employed by Piketty.

Using this and other sources there has been extensive work to understand the impact of the boom and bust on income distribution (cf. McGinnity et al. 2013) on the distribution of labour market effects of the bust (ibid.), on the distribution of economic stress and material deprivation (Maître, Russell and Whelan, 2014) and on mortgage distress (McCarthy and McQuinn, 2011). The question of mortgage distress has indeed been the subject of a large body of data-intensive analysis at the Central Bank, much of it published (cf. Kennedy and McIndoe, 2012).

The literature also has emphasised the role of the state in influencing the distributional impact on disposable income through tax and social welfare policy (Callan et al., 2013; Maître and Watson, 2013).

So we do know a lot about changes in living standards, loan servicing and economic stress resulting from the crisis. But the somewhat different dimension which Piketty has emphasised relates to assets and liabilities as distinct from income and expenditure – to stocks as distinct from flows: here we do have aggregate data, but little on its distribution.

We would like to have, as indeed Piketty includes in his book for many other countries and over a long time period, the size distribution of household wealth. In addition it would be valuable for the purposes of Government policy to know about the distribution of the different elements of household wealth as between different income deciles, age categories, social class, educational attainment, occupational category or economic sector.

But for Ireland, apart from the early work at the ESRI (Nolan, 1991; Honohan and Nolan, 1993), no really systematic nationally representative survey of the distribution of wealth has been published. There are, of course, various partial analyses, for example the wealth data from the TILDA survey of older people recently analysed by O’Sullivan and Layte (2011) and O’Sullivan, Nolan, Barrett and Dooley (2014), and the small 2012 Central Bank household survey focused on indebtedness (McCarthy, 2014; McCarthy and McQuinn, 2014).

Happily, we will soon know more about the distribution of assets and liabilities of households, with the data cleaning phase now nearing completion from the Household Finance and

---

1 Cussen and Phelan (2011) also discuss trends in the aggregate assets and liabilities of other sectors: Government and financial and non-financial corporations.

2 The latest data suggesting a broadly proportional impact of policy changes on all income groups, though with a somewhat higher adverse impact for top and bottom deciles, when the period 2009–14 is taken together.
Consumption Survey (HFCS), which was conducted for Ireland for the first time in 2013 by the Central Bank and the CSO.\(^3\)

This means that, when it comes to discussion of wealth distribution, we will not have the luxury of data-free speculation for much longer. So let me hasten to indulge myself!

**How did the main components of wealth change in Ireland in the boom and bust?**

The financial crisis had a dramatic effect on net worth of households in Ireland...as had the prior boom. As shown in the figure, measured aggregate household net worth peaked in Ireland in mid-2007 at €719 billion, up almost €300 billion from five years before. Just five years later, in mid-2012, it had fallen back to its mid-2002 level. From that trough there has since been a small net increase again.\(^4\) (I will not touch on the assets and liabilities of the corporate sector, an area which is greatly complicated by the large presence of multinational corporations; I think that omission does not much distort what I have to say.)

\(^3\) Like most such exercises, this survey may not throw light on the very top end of the wealth distribution.

\(^4\) A few points should be noted about this data. About two-fifths of the household financial assets represent insurance and pension fund assets held for the benefit of households, a further two-fifths represent currency and deposits. Quoted and non-quoted equities account for most of the remainder.
Households saved throughout this decade, and this tended to increase net worth. But the up-and-down swing in measured net worth was primarily related to changes in the price of land and housing.\(^5\)

The value of housing assets grew much more quickly than household net worth between 2002 and 2007; this was accompanied by a rapid increase in aggregate household debt. Indeed, by 2007 aggregate household debt represented the third highest ratio to disposable income among 24 European countries for which data is available (Cussen, O’Leary and Smith, 2012). The increase in household debt 2002–7 was about the same as the increase in aggregate household financial assets. But of course this would not be true of individual households: distribution matters. When the price of property fell back, the debt remained.

The two factors which have transformed what might seem a rather benign valuation blip into a crippling debt crisis are, of course (i) the distribution issue, namely the fact that different households were affected in dramatically different ways, depending mainly on whether they had borrowed to buy over-priced property and (ii) the fact that the Government’s net debt position has also deteriorated by about €150 bn since 2007: a third of it attributable to the bail-out of bank creditors\(^6\) and the rest resulting from the borrowing undertaken, especially from official sources, in the course of smoothing the transition to restoring budgetary balance.\(^7\)

---

\(^5\) The role of valuation changes is shown in Cussen and Phelan (2010, 2011). Aggregate equity withdrawal from mortgage lending in the boom years amounted to about €8 billion (Lydon and O’Leary, 2013).

\(^6\) Though not of bank shareholders, who lost essentially all of their investment; subordinated debt holders of the banks also lost heavily. Between them, these investors, mostly foreign, absorbed about half of the banking losses.

\(^7\) The latter need became evident after the automatic fiscal stabilisers (e.g. unemployment payments and reductions in tax revenue) kicked-in when the global and domestic economic crises coincided to erode employment and income levels.
If everyone’s assets and liabilities had been affected in the same way, then the return of net assets to their 2002 level might have seemed relatively painless. But the modest net change in aggregate household net worth between 2002 and 2012 should not mask an increase in aggregate indebtedness of over €100 bn. Not everyone borrowed. But for most of those who did at the height of the price bubble, the devastating effect on their net worth of the subsequent price fall is the most significant wealth outcome of the crisis. It has sent net worth into negative territory for many, especially before taking account of future earning potential (sometimes known as “human capital” in wealth analyses). Current and future earnings have also been damaged by unemployment. Migration flows are also a factor.

The whole size distribution of net wealth moved to the left: pushing those at the bottom into very negative positions.

While I cannot prove it, I think we may take it (based on what evidence we have) that there has also been a widening of inequality within the wealth distribution (using conventional measures of inequality) since the beginning of the millennium.

Furthermore, the churn within the distribution has been substantial. Clearly many people who had become rich lost all of their gains. Other rich people were relatively unaffected. But the sizable group which incurred heavy debts to acquire property close to the top of the market have seen their net worth (even if modest to begin with) wiped out entirely. It’s not just a question of analysing the relative impact of the bust on those who were rich before the boom versus those who were poor before the boom. Also striking is, for instance, the fact that the loss of net worth was concentrated mainly on those who borrowed in mid-century. This group was in turn concentrated in the age group 30–45, as is confirmed, for example, by the data of Duffy and O’Hanlon (2013).

While, as Piketty’s account well illustrates, many factors alter the net worth of different households over time – poor investment decisions; adverse shocks of one sort or another – this large movement strongly affecting a sizable fraction of society in a short period of time represents a huge shift in the distribution of household wealth, as well as an overall widening of wealth inequality. It constantly provokes the question: “what more, if anything, can or should Government policy do about this to alleviate the resulting stress?”

What can or should Government do?

In my experience, this question is inclined to elicit a wide range of responses displaying a wide range of fundamentally different approaches to questions of ownership and debt. There are, on the one hand, what may be called “contract fundamentalists” who disregard the extreme nature of the crisis that has occurred. On the one hand there are those who attach little importance to conventional principles of ownership and private property.

In practice – and this is part of the underlying mid-20th Century story shown by Piketty for Europe – sudden and major debt crises on this scale around the world have often been accompanied by a surge of inflation and currency depreciation. Such surges have had the effect of lowering the real burden of indebtedness and passing some of the real losses to the holders of monetary assets. Unanticipated inflation is a crude mechanism of redistribution, though, and typically results in output costs in subsequent years as monetary authorities struggle to bring it back under control. In any event, it is not an option for Ireland.

---

8 The burden of some of this debt has been partly mitigated by the low-for-long interest rate policy of the ECB – its policy rate has averaged well below 1 per cent for the past 5 years – which has brought the servicing costs of tracker mortgages well below where they were when the loans were contracted.

9 Another category often mentioned are retired persons whose wealth was concentrated as was traditional on long-standing holdings of bank equity.
Because it too reached the limit of its debt capacity (for the reasons mentioned above), the Government has little room left for policies involving net additional spending, so in practice it is limited to broadly cost-neutral adjustments to tax and spending. Along with this limited capacity, there has been little appetite for a transfer from taxpayers to those indebted households who can still afford to service their debts.

Personal insolvency legislation has, however, been modernised and streamlined, offering viable options for over-indebted borrowers. Ideally, though, lenders should be, and increasingly are, negotiating more favourable arrangements than bankruptcy that restore borrowers to a sustainable position, while husbanding (as is their responsibility) the capital of the bank and avoiding unwarranted losses from concessions to borrowers that can afford to pay – concessions that would largely fall on the banking system’s largest shareholder, the State. I need hardly recall that walking this tightrope has been a very slow process.

Some home-owners have seen their income situation deteriorate to the point where they can no longer afford to service the mortgage debt. Fortunately, the number of involuntary owner-occupier repossessions has so far remained low: given the sharp fall in property prices between 2007 and 2012, it can make sense for lenders to avoid repossession even for a homeowner who can no longer fully service the original debt.

Banks have been pressured by the Central Bank, within the limitations of prudential regulation and their constitutional property rights, to accelerate the conclusion of sustainable loan modification solutions where the existing contracts are no longer viable. Gradually – too gradually – we are seeing progress on this front. Banks are obliged to comply with the Central Bank’s code of conduct on mortgage arrears in arriving at sustainable solutions in a fair and transparent way. This remains a focus of our close attention at the Central Bank. Indeed, we have examined many options in the attempt to accelerate the process of achieving a return to sustainability.

Could a one-size-fits-all debt modification scheme be devised to deliver wholesale loan modifications speedily for unaffordable debt? Despite our best efforts at the Central Bank, we have had to conclude that no blanket scheme can be devised that would be both viable and effective in current circumstances. No workable schemes have been devised that do a good job at hitting the target of those who really need assistance; and blanket schemes would be extremely costly for the State (over and above the large injections which it has already made into the banks). Unfortunately, then, this work has not displayed a way forward.

To the extent that the lenders do not provide adequate workouts for unaffordable debt, it falls on the personal insolvency legislation to deal with this problem. The recent great liberalisation of this legislation was badly needed and it provides a benchmark context against which lenders must negotiate workouts. Is it enough? Clearly things are working slowly and too many creditors still adopt a “Victorian” approach to debt modification where the borrower cannot pay. On the other hand those debtors who can pay are beginning to realise that the State is not likely to impose on the rest of society the costs of investments gone wrong for those who can afford to take the losses.

The question of how best to deal with the overhang of household debt generated by the crisis has been extremely fraught. It involves political as well as technical decisions and judgment. The role of the Central Bank relates solely to the technical and here I hope we have provided advice that has helped maximise the overall room (in terms of aggregate economic resources available) for national political choices. We have contemplated many alternative approaches: While few people can be fully satisfied with the outcome to date, there do not seem to be any better paths.

Discussions about the distribution of household assets and liabilities has rightly focused on those with little or no net wealth, and also on middle-income householders who borrowed more than they can afford to acquire over-priced property. Still, there are also important questions about the wider economic impact of changes in wealth higher up the scale. Many Irish families of moderate wealth also saw their capital shrink dramatically in the crisis as
property investments made in the boom, and inherited bank equity investments, lost value. Given the traditional importance of family funds in underpinning start-up finance of small firms, will this loss of wealth have an adverse effect on investment by small firms now and in the coming years? Are alternative financing mechanisms, including those being put in place by Government, going to be enough to fill this gap?

Concluding remarks

Before closing, I need to emphasise that today’s discussion of assets and liabilities, prompted by Thomas Piketty’s work, should not allow us to neglect the other ways in which the crisis has had a severe effect – for example, through loss of employment or reduction of social benefits, to mention just the financial costs – on many households too far down the income scale to have accumulated any significant net assets. Indeed, some of the affected persons have emigrated and no longer show up in the national statistics.

As for the future, how important Piketty’s $r - g$ dynamic will be in coming years in Ireland is hard to know. Certainly for $r$ the return on bank deposits will remain low for the period ahead, and some of the bounce-back value of Irish property and business assets will accrue to the foreign buyers so much in evidence. The context for $g$ of this will, of course, be the growth recovery in the European Union and the euro area, underpinning employment and income growth in Ireland itself.

References


