The Global Financial Crisis: Impact on Property Markets in the UK and Ireland
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Report by the University of Ulster Real Estate Initiative Research Team

Alastair Adair
Jim Berry
Martin Haran
Greg Lloyd
Stanley McGreal

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The University of Ulster Real Estate Initiative (UUREI), based in the internationally renowned School of the Built Environment, brings together leading developers, investors and financiers across the island of Ireland to promote cutting edge research that informs the policy and practice agenda.

The Board of the Initiative recommended that research be undertaken to evaluate the impact of the financial crisis on both residential and commercial property markets in the UK and Ireland. This report forms the first in a series of reports to be published by the Initiative in pursuit of supporting the development of high quality, relevant research in areas related to the built environment.

Following the meltdown of the sub-prime mortgage market in the US the world’s financial markets have undergone a period of unprecedented turmoil. In turn, this has contributed to increased uncertainty in global economic conditions and heightened the volatility of investment markets including real estate. Currently property markets are undergoing a period of correction exacerbated by the global contraction in credit supply. There has been unprecedented government and central bank intervention. The transformed global financial landscape will have a major impact on economic growth, lending conditions and the operation of markets for years to come.

The report outlines a series of proposals on how the gridlock within the global financial system might be resolved to enable property markets to start functioning again. I trust that the outcomes of the research will stimulate debate which will be of benefit to the built environment professions, financial institutions and public sector decision makers.

Professor Alastair Adair
Pro-Vice-Chancellor
# The Global Financial Crisis: Impact on Property Markets in the UK and Ireland

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Executive Summary

Following the collapse of the sub-prime mortgage market in the United States the global financial system has undergone a period of unprecedented turmoil. As the implications of the crisis have become more transparent, confidence in financial markets has been severely eroded and remains fragile. The collapse or near collapse of high profile, and in some cases systemically important financial institutions along with unprecedented government intervention in the banking system has served to completely transform the landscape of global finance.

Initial government responses to the crisis were individualist, uncoordinated and lacked international cohesion. Whilst they have helped safeguard national economic interests, they have not restored confidence in global financial markets. In effect, governments have failed to understand the underlying fundamentals of the global financial crisis. Government interventions were primarily intended to stabilise the markets and support a more orderly de-leveraging process. As concerns continue to persist about the stability of some banks and their respective business models a deep rooted mistrust has engulfed the global banking system. This has further contributed to the contraction in interbank lending.

The ongoing uncertainty in the financial markets has fuelled turmoil in investment markets. Globally $7 trillion has been wiped off the stock markets over the course of 2008. New York’s S&P 500 fell 38.5% in the 12 months to the end of December. This was its steepest annual decline since the Great Depression. Japan’s Nikkei 225 fell 42% over the course of 2008, while in the UK the benchmark FTSE 100 index recorded the worst performance since its launch 24 years ago, closing at 4,434.17, down 31.3% on the same period 12 months ago. In Dublin, a turbulent year of trading was brought to an end when the ISEQ Index closed at 2,343.27, in total €61 billion was erased from the value of Irish shares over the course of 2008. The fall in the value of shares on both the London and Dublin exchanges were most acute among the banking and property sectors. This is a consequence of the steeper than anticipated downturn in the UK and Irish property markets.

In relation to property performance, the IPD All Property Total Return Index for the UK was -24% for 2008 and the SCS/IPD Index for Ireland was -34.2% for 2008. House prices have also fallen dramatically through 2008. According to Nationwide, for example, the average house price in the UK fell by 14.7% over the course of 2008 to £156,828. House prices in the UK are now at the same level as they were in the spring of 2005. In Northern Ireland the correction has been more evident, house prices have fallen somewhere between 28.2% (Northern Ireland Quarterly House Price Index) and 34.2% (Nationwide). In the Republic of Ireland the average house price fell by 9.1% year on year to the end of December 2008 according to the Permanent TSB/ESRI index. The average house price in the Republic of Ireland at the end of December 2008 was circa €261,500.

The downturn in both the commercial and residential markets allied with the limited availability of credit and tightened lending criteria have contributed to a dramatic fall in both transactions and development activity. UK and Irish banks have a high weighting of property exposure on their loan books and have attempted to contain and manage that lending, whilst improving their liquidity position and,

\(^1\) Nationwide calculations based on quarterly average figures.
as a consequence, are not in the market for new business. Market sentiment remains downbeat amongst the majority of banks with expectations that property prices are likely to fall further over the next few months. That perception allied with the outlook for the global economy, is not conducive to enhanced lending.

The contraction in credit supply has created an adverse feedback loop between the financial system and the real economy and has placed enormous downward pressures on global economic conditions. Emerging economies have had to respond to a major contraction in risk appetite as well as the fall in global demand whilst developed economies, heavily dependent on credit have all contracted simultaneously for the first time in history. The gravity of the situation is such that radical international intervention has been set in place.

It was the opinion of John Maynard Keynes, one of the most influential economists of the 1930s Great Depression “that an economy is not wholly a self-regulating organism; it cannot always be relied on to fix itself”. Keynesian style intervention is being held to offer what amounts to an historic solution to a modern day problem and reverses the neo-liberalism of the past three decades by advocating high levels of public spending to help “prime the pump” and provide the required stimulus to a stagnant economy. Historic reviews of recessions/incidents of financial stress highlight how such interventions have stood the test of time and acted as a stimulant to economic revival. Indeed, two of the world’s largest economies, the US and China have already put in place massive infrastructure proposals in a bid to spend their way out of recession.

The UK has advocated a similar approach, although constraints on public finances and concerns about the strains it will place on future tax revenues have delayed its effective implementation. Ireland’s proposed recovery plan “Framework for Sustainable Economic Renewal – Building Ireland’s Smart Economy, 2009-2014” sets out the strategic vision for Ireland as an ‘innovation island’ to ensure it is positioned to take advantage of a future economic upturn. Time is of the essence. Historic reviews of previous recessions highlight a need for clear and decisive action if long and protracted downturns are to be avoided. Counter intuitively, it is a good time to use debt to spend our way out of debt. What is irrational (indeed foolish) for an individual can be rational (and in fact crucial) for an economy (Oswald, 2009).

Central to the economic revival is the need to restore confidence in the interbanking system and the wider financial markets. International collaboration is the most effective way of tackling the ongoing problems within the financial markets, as invariably a crisis of global consequence will require global solutions. This will require time to co-ordinate and develop and in all probability will require further write downs within the banking system. The most effective way to manage so-called “toxic assets” remains a source of debate, but until clear and decisive action is taken to remove toxic assets from the balance sheets of financial institutions, uncertainty and fear will persist within the banking system elongating the lending freeze.

A more tightly governed and resilient financial system is likely to emerge as a result of the current financial crisis. The de-regulation of financial markets has been a key driver of global economic growth in recent years. On the whole such developments are considered to have been positive. It is important then that financial innovation should not be stifled or curtailed by overly bureaucratic legislation and intervention. That said, harsh but invaluable lessons should be learned as a result of the ongoing crisis and it is safe to say that due diligence and the regulation of international money markets will be relatively tighter in
the future. Governance structures have to be flexible enough to maintain functionality of the international monetary system but must also be stringent enough to control the pace of financial engineering and ensure that the appropriate infrastructure has been put into place to accommodate such innovation.
1.0 Introduction

This report by the University of Ulster’s Real Estate Initiative examines the effects of the global financial crisis on the world economy and identifies possible implications for property development and investment in the UK and Ireland in what has been a radically transformed financial landscape. The report has been compiled amidst unprecedented turmoil in the world’s financial markets, which in turn has contributed to increased uncertainty in global economic conditions and heightened the volatility of investment markets. Given the levels of instability within the macro environment, economic forecasts both national and international have in the main, concentrated on short term perspectives, and these have had to be revised downwards as the fallout from the crisis gathered momentum.

Section 2 of the report examines the demise of the sub-prime residential mortgage market in the US which triggered the global financial crisis and highlights how the de-regulation of financial markets and innovations including Asset Backed Securities (ABSs) and Collateralised Debt Obligations (CDOs) contributed to the crisis. As the fallout from the financial crisis gathered momentum it became clear that an adverse feedback loop had been created between the financial markets and the real economy. Section 3 examines the impact of the financial crisis on the global economy and identifies the extent of the contraction in economic output.

One of the ongoing debates of the financial crisis has been the swiftness with which governments have intervened to save banks, whilst other sectors of industry have been allowed to fail. Section 4 explores the role of the international monetary system within the global economy and highlights why a functioning banking
system is crucial to economic prosperity. The ongoing uncertainty within the financial markets and the widespread contraction in credit availability has had an adverse effect on property markets and has exacerbated the downturns in both the residential and commercial property markets in the UK and Ireland. Section 5 examines the extent of the downturn in the respective markets and brings together key interpretations on the future direction of the property market.

Section 6 explores events which have triggered incidents of financial stress and explores the actions that were taken to resolve previous financial crisis. Section 7 brings together the key messages emanating from the empirical phase of the investigation and highlights the inter-connectivity across financial market functionality, economic prosperity and property market performance as well as identifying the options required to stimulate interbank lending.
The term “credit crunch” emerged into common parlance in the autumn of 2007 following the demise in global financial markets. In the period since hardly a day passes without reference to the implications that the “credit crunch” is having on the global economy, property prices, stock market values and consumer confidence. In order to understand the full implications of the credit crunch it is first necessary to comprehend the origins of the financial crisis and to examine the factors which contributed to the collapse of international money markets.

The demise of the sub-prime mortgage market in the US was the catalyst for the credit crunch, but as news of the sub-prime crisis broke in August 2007 the effect it would have on global money markets was not immediately apparent. When the Bank of England in April 2007 drew comparisons between the US sub-prime debacle and the commercial property market in the UK, no one took much notice (Bourke, 2007). In many European countries the collapse was initially dismissed as a US problem, fifteen months later and the global implications have become all too apparent. Wall Street has come in for heavy criticism both in the US and internationally for encouraging profligate lending practices and for developing financial vehicles which circumvent financial regulation.

Financial engineering has played an important role in the globalisation of money and property markets. In recent years the growth in new finance vehicles such as derivatives and asset backed securities has exploded. The financial innovations have improved liquidity and enabled investors to spread risk through international diversification. The downside – as highlighted very acutely following the collapse

2.0 Origins of the Credit Crunch:
Understanding the Sub-Prime Crisis in the US
of the sub-prime mortgage market in the US - is that by spreading risk so well it has implications for all corners of the world, unsettling hedge funds, banks and stock markets as far away as Asia, Australia and Europe. In effect reducing global risk appears to have increased national uncertainty with many countries surprised to find that problems with homeowners in the US could have had such a profound knock-on effect on their own economic prosperity (Anderson and Timmons, 2007).

The credit crunch is often attributed to the collapse of the sub-prime mortgage market in the US – and while this may have been the catalyst, it is a symptom of a deeper rooted and complex condition. The origins of the crisis are firmly embedded in the deregulation in financial markets which began in the US in the 1970s and the subsequent innovations in financial structures, particularly Asset Backed Securities (ABSs) and Collateralised Debt Obligations (CDOs). Asset Backed Securities and Collateralised Debt Obligations were enormously profitable for Wall Street firms but in order to produce these products, Wall Street needed a lot of income producing loan product – mortgages were an easy and readily available source, but the incessant demand was a key driver in the decline in lending standards (McCoach, 2008).

The incentives to provide loan products coupled with low interest rates meant that lenders became much less prudent in their lending practices. This fuelled a lending boom to borrowers with poor credit ratings2. To enhance their lending capacities further banks also began to explore new ways to package these loans, so they could sell more. A central building block to offsetting the risk was Asset Backed Securities, which are bonds backed by assets such as student loans, car loans or credit pool of mortgages or other income producing card receivables.

Banks and other financial institutions pooled these asset backed securities into new units, dividing them up again and issuing securities against them, creating Collateralised Debt Obligations (CDOs). The idea took off, with new combinations that were further removed from the asset. New vehicles included CDOs of CDOs, called CDO-squared. There is even CDO cubed (Anderson and Timmons, 2007). J.P. Morgan estimate that there are about £0.8 trillion (US$1.5 trillion) in global CDOs of which around £300 billion are structured finance CDO’s made up of bonds backed up by sub-prime mortgages, slightly safer mortgages and commercial mortgage backed securities.

Funds and banks around the world have been adversely affected by the collapse of the sub-prime mortgage crisis in the US because they had purchased bonds, or risk related to bonds which in many cases were backed by sub-prime mortgages. The collapse of the sub-prime market revealed serious weaknesses in how this debt had been structured, including dangerous amounts of leverage that had not been accurately reflected in risk assessments. The products into which investors had bought were often so complex and far removed from the original asset that it has taken over a year for the severity of the financial crisis to become apparent.

Prior to the sub-prime mortgage collapse in the US, the International Monetary Fund, the Bank for International Settlements and the Bank of England had all expressed concerns about the fragility of many of the securitised products on offer, highlighting that investors were not taking the downside risks of such products seriously enough. The biggest risk was a steep fall in house prices, since securitisation was based on an assumption that any problems faced by squeezed borrowers would be massaged

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2 Mortgages were often approved on the pretence that house prices would continue to rise. It was only when house price values began to fall and mortgage default rates increased dramatically that the true consequences of such extravagant lending practices began to unfold.
away by rising property markets (Elliot, 2008). However, by August of 2007, it was clear that the residential property market in the US was in free-fall. As property values plummeted and default rates soared, suddenly the asset backed-securities which were tied to the US residential sector were worth much less than the investors holding them had anticipated.

The collapse of the residential property market in the US in effect created a global balance sheet problem. There is $900 billion (out of a total of $9 trillion in mortgage debt) in sub-prime paper on the balance sheets of world banks, investment houses, hedge funds and mutual funds. In total there are 2,500 different sub-prime bond issues – not all of them are bad. The problem is that no one will know for several years how good or how bad some of this sub-prime paper is, pending a better track record on defaults. The average sub-prime issue has 2.5% of its mortgages repossessed; another 5% in foreclosure and another 12% are 60 days overdue. Some sub-prime issues are doing better, others are doing worse. The major concern as identified by Steidmann (2007) was that falling house prices will take away any incentive to continue to pay a mortgage, leading to a dramatic increase in the number of defaults.

As the consequences of the collapse in residential property values in the US were laid bare, markets around the world abruptly lost two ingredients which are vital to their vibrancy – confidence and trust. Banks and lending institutions had been left exposed and would have to absorb huge losses, although it was unclear which banks’ balance sheets would be most affected. The uncertainty fuelled suspicion among the banking world and prompted banks to stop lending to one another as they could not guarantee the quality of each other’s balance sheet. As financial institutions attempted to de-lever and reduce risk, their willingness and ability to continue to extend credit was curtailed, resulting in tightened monetary and financial conditions. Liquidity in the financial markets deteriorated further in September 2008 as the crisis entered a new phase following the bankruptcy of Lehman Brothers and the near collapse of insurance conglomerate AIG. The problems within AIG raised fresh concerns about the scale and spread of default risk as well as the credibility of financial product insurance but it was the collapse of Lehman Brothers that sent shock waves through the global banking system, destroying confidence in the financial markets. The collapse was highly symbolic, not just because of Lehman Brother's position within the global financial markets but because it revealed the levels of integration that exist within the global banking system and confirmed what many within the financial markets had suspected – that the current financial crisis was greater than anything previously witnessed.

The market response to the Lehman collapse was swift, intense and broad based. Prime money market funds, which invest in corporate debt and asset backed securities, experienced some $320 billion redemptions in one week. As a result they were unable to provide the nearly $2 trillion of credit they typically extend daily, leading to difficulties for financial institutions dependent on wholesale funding and nonfinancial corporations needing refinancing (IMF, 2008b). With traditional sources of finance unavailable banks sought to repair their financial liquidity by cutting back on lending to their customers. As a result borrowing became harder to arrange and more expensive - the classic definition of a credit crunch (Elliott, 2008).
Key Point Summary

- The origins of the financial crisis are firmly embedded in the deregulation in financial markets and the innovations in financial structures including Asset Backed Securities and Collateralised Debt Obligations.

- Financial innovation has improved liquidity and enabled investors to spread risk through international diversification. The downside is that the global implications of the current downturn are more profound than anything previously witnessed.

- The collapse of the subprime residential mortgage market in the US was the catalyst for the financial crisis. There is $900 billion in sub-pime paper on the balance sheets of the world’s financial institutions – not all are bad, but pending a better track record on defaults, it will take several years to establish the true extent of the collapse.

- As the consequences of the sub-prime collapse in the US transpired, financial institutions have attempted to de-lever and reduce risk. As a result their willingness and ability to extend credit has been curtailed resulting in tightened monetary and fiscal conditions.
In October 2007, finance ministers from the G7 nations gave reassurances that the global economy was in good health, having just experienced its fifth straight year of robust growth. Despite the fact that the credit crunch had already started to bite, financial leaders gave assurances that they had acted resolutely to protect the systemic stability of the global financial markets concluding that the outlook was one of “strong global fundamentals” and “well capitalised financial institutions”.

Just over a year later these same financial leaders were forced into a series of crisis meetings in Washington to try and devise an agreed plan of action to prevent complete meltdown of the global financial system. The optimism of October 2007 was replaced by a realism that many financial leaders were either unwilling to contemplate or simply chose to ignore. In the midst of the confidence and euphoria that had characterised global economic conditions pre-credit crunch it is easy to see where such optimism had materialised. Early warning signs, including the collapse of Northern Rock were dismissed, but even these gave little indication to the scale of the crisis that was to unfold and the dramatic affect it would have on global economic conditions.

As the scale of the financial crisis has broadened and intensified global economic growth has stagnated. The International Monetary Fund’s (IMF) World Economic Outlook (October 2008) outlined how the global economy had “entered a major downturn” in the face of “the most dangerous shock” to rich-country financial markets since the 1930s. In the October report the IMF expected global growth, measured on the basis of purchasing-power parity (PPP), to fall to 3% in 2009 and on the verge of what the IMF considers a global recession3. That forecast

3The IMF definition of global recession takes many factors into account, including the rate of population growth.
has subsequently been revised downwards to 2.2% in November 2008, whilst a further revision in January of this year indicated that global growth was likely to contract to just 0.5% in 2009.

The IMF revision comes despite wide-ranging policy actions by governments and central banks around the world, and is based on the premise that the downturn is likely to be much deeper than initially feared and that a sustained economic recovery will not be possible until the banking sector is restructured and credit markets are unclogged. In January of 2009, the IMF estimated that losses on mortgage write downs on US originated securities were in the region of $2.2 trillion as a result of increased defaults on prime mortgage loans and corporate debt, the estimate was only $945 billion in April of 2008. Both high and low level corporate debts have been significantly weakened by the ongoing developments within the financial sector whilst falling house prices and an increase in unemployment have further dented consumer confidence and affected economic prospects more broadly (IMF, 2008b).

Hopes that continued growth in emerging economies, in particular the BRIC nations (Brazil, Russia, India and China) would cushion the global economy from the effects of the credit crisis also diminished over the course of 2008. China, in particular, has shown strong resilience in the midst of the global economic downturn over the last twelve months. As the financial crisis unfolded, economists believed that one of the few positives in the global economy would be the ability of China to maintain double-digit growth figures. However, clear signs have emerged to show that even the Chinese economy is beginning to slow, prompting many analysts to re-evaluate their growth projections to around 8% (Dyer, 2008). While many countries around the world would welcome domestic growth of 8%, this represents a significant downturn for the Chinese economy which had previously enjoyed five years of turbo-charged growth.

Emerging markets have to face up to new challenges. The pronounced reduction in investor’s risk appetite has resulted in a retrenchment in short term capital flows, exerting pressure on local markets and significantly raising the cost of credit. Analysts at Morgan Stanley estimate, for example, that capital flows to emerging economies could fall to $550 billion in 2009 from around $750 billion in 2007 and 2008. Together with the slowing global economy, this creates a very challenging environment for emerging economies that rely heavily on foreign finance to sustain their growth projections. In spite of this, growth in most developing countries is expected to remain above historical averages, and prospects are good that their robust growth can be sustained over the long term. Positively, emerging economies are much less exposed to leveraged banking systems and in many cases have sizable reserve cushions and favorable external balances which should continue to provide resilience to global stress (IMF, 2008b).

The contraction in GDP output will invariably be sharpest amongst the advanced economies. The US economy, temporarily buoyed by fiscal incentives and strong exports had grown at a solid 2.8% annualised rate between April and June of 2008. However, over the summer the stimulus given by the tax rebates began to wear off, with severe consequences for the “real” economy. Unemployment began to rise significantly – the US economy lost over one million jobs in November and December making 2008 the worst year for job losses since 1945 (Cohen, 2009).

Tightened credit availability meant that consumer spending also fell dramatically. Car sales fell to a 16-year low as would-be buyers were unable to get credit. In the first week of October 2008 the Dow Jones, a key measure
of the financial strength of the US economy dropped by 18% - the worst fall in its 112 years history. Significantly this fall came just days after US Congress passed the $700 billion Troubled Asset Relief Programme (TARP). More than $8.4 trillion has been wiped of the value of American stocks over the course of 2008 (Dey and Rushe, 2008).

Much of the contraction in the US economy can be explained by the uncertainty and ongoing de-leverage within the financial sector as well as the protracted downturn within the housing sector. The S&P/Case-Shiller Home Price Index shows that house prices in the twenty largest metropolitan areas in the US have fallen on average by 18.2% in the twelve months to the end of November 2008. The latest figures mean that house prices in the US have fallen on average 23.4% from their peak in 2006⁴ (S&P/Case Shiller, 2009).

As a consequence of the dramatic downturn in house prices, more than 10 million households in the US now owe more on their mortgages than the market value of their homes (IMF 2008b). Housing-related activity has also plummeted. New starts in the US have fallen 60% from their peak, although a correction was needed after a period of excess. The inventory of unsold new homes stood at 374,000 at the end of November 2008, a figure which is considered by many analysts to be disproportionately high (Rappeport, 2009).

House builders, in spite of significant discounts on developments have struggled to secure sales as they are unable to compete with the mark down in prices within the highly distressed resale market. One third of house sales in the US now involve foreclosure, a sign of continued market weakness, indeed foreclosures are now such a dominant feature of the limited market activity that they are increasingly being utilised as the benchmark to establish market value. Baseline projections indicate however that the housing cycle in the US will eventually find a floor in 2009 following four years of decline (IMF 2008a).

In Japan, which experienced three recessions in little over a decade, there is increasing signs of vulnerability. Although growth in Japan held up well through the first quarter of 2008 weakening external demand has started to weigh on economic activity (IMF 2008a). Economic output in Japan contracted at an annualised rate of 3% in the second quarter of 2008 as exports fell, investment slowed and high food and fuel prices dented consumer confidence. Fortunately, Japanese banks had been too busy rebuilding their balance sheets to participate wholeheartedly in the derivatives market and as a result are less embroiled in the financial crisis than their US and European counterparts (Nakamoto, 2008).

However, by the end of October 2008 it became clear that the Japanese banking system was also in crisis – not the victim of toxic derivatives and swaps but as a result of the rapid depreciation in ordinary shares held by banks in Japanese companies. These cross-shareholdings, a peculiar feature of Japanese capitalism, has had pernicious effects on the capital ratios of Japanese banks. By late October the Nikkei 225-share index had fallen by almost 30%, to 7,162.90, its lowest level for 26 years. As share prices tumbled, Japanese banks have been forced to revalue their assets, which in turn has reduced their capital ratios – the net result has been a need to raise capital quickly. Japan’s biggest bank, MUFG, plans to raise as much as ¥990 billion ($10.6 billion) through the issue of new shares and preferred securities. Other banks including Mizuhu Financial Group and Sumitomo Mitsui Financial Group are also in the process of capital raising (Economist, 2008a).

The European outlook is equally grim. The credit crunch may have originated in the US but

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⁴There is an element of variance in the peak prices across the twenty metropolitan areas.
many analysts are predicting that the European economy could be its biggest victim. Figures compiled for the IMF show that the Euro zone economy is now officially in recession for the first time in its ten year history after growth of -0.2% in the second and third quarters of 2008 (IMF 2008a). Economic forecasts from DG ECFIN for the European Commission have predicted that the Euro zone economy will contract by 1.9% in 2009. The contraction has been attributed to the continued turmoil in the financial markets, the correction in housing markets and the dramatic increase in energy prices (European Commission, 2008).

Whilst some European countries have seemingly managed to resist global conditions, most notably Poland and the Netherlands, the results for the third and fourth quarters of 2008 show that GDP has contracted across Germany, France, Italy and Spain – the four largest economies in the euro zone. The fact the Italian economy has slipped comes as no surprise as it had struggled to maintain growth even during periods of buoyancy within the global economy, while the property market collapse has, as expected, had severe implications for Spanish GDP.

The contraction in the German and French economies is more alarming, given that their respective government leaders had publicly condemned Wall Street for engineering the financial crisis, rebuffing suggestions that their financial institutions would become embroiled in the credit crisis. Indeed there was a widely held belief that the German economy, not having experienced the boom-bust scenario in its housing market and which remained comparatively free of debt, would make up for weakness in debt-laden Euro economies such as Spain and Ireland. However, household spending in Germany fell steadily over the course of 2008. There are also clear signs that exports which drive the German economy are struggling. Orders for German engineering goods fell in June by 5% from a year ago, according to VDMA, a Frankfurt-based industry group whilst foreign orders fell by 7% (The Economist, 2008b). German GDP contracted by 2.1% in the fourth quarter of 2008. This is the largest quarterly contraction ever recorded in united Germany.

In truth the financial crisis offers few silver linings for the EU economy. Inflation may be at a turning point, with figures compiled by Eurostat highlighting that twelve month inflation in the Euro zone fell to 1.6% at the end of December 2008, its lowest level since October 2006. However, business and consumer confidence have been severely dented, whilst the slump in housing markets appears to be spreading to the real economy, with Ireland the first Euro zone economy to go into recession.

The Irish economy had for the best part of a decade been bolstered by unprecedented house price growth. The Permanent TSB house price index shows that average house price in Ireland increased by 51% between 2002 and 2006. Prior to the housing boom the Irish economy had grown systematically. In 1998 GDP growth stood at 8.7%, interest rates meanwhile were at over 6% and on the rise, ensuring inflation remained at a very manageable 2.2%. Ireland relinquished its independent monetary policy and joined the Euro in 1999. Interest rates, now determined by the ECB were much lower than had been the case in Ireland and by 2000 stood at 4.5%. The low interest rates were intended to stimulate economic prosperity within the stagnant German economy but for economies such as Spain and Ireland, which had been prospering prior to joining the euro, they help fuel an economic and housing bubble.

House prices in Ireland soared on the back of the cheap and readily available finance. This in turn gave rise to a construction boom within the housing sector. House building accounted for 6% of Irish economic activity in 1998, and by 2006 residential development activity
accounted for 13% of Gross National Product (GNP). Between 1998 and 2006, when new housing supply peaked, the total number of completed dwellings more than doubled from 42,349 in 1998 to 93,419 in 2006. Whilst social housing provision increased periodically from 3,256 in 1998 to 5,208 in 2006, completions within the private sector soared from 39,093 in 1998 to 88,211 in 2006, an increase of circa 126%.

Commentators argued that such a dramatic increase in output was simply unsustainable. Whilst the benefit of hindsight has proven such observations to be correct, in the midst of the euphoria that surrounded the construction boom rational thinking was on too many occasions a distant second to market sentiment. The downturn in the residential property market, which has been compounded by the ongoing crisis within the financial markets, has highlighted the imbalance of the Irish economy.

As the downturn in house prices continued over the course of 2008 residential development activity has all but ground to a halt putting severe downward pressure on economic output. Figures compiled by the Central Statistics Office (CSO) show Irish GDP at -2.4% for 2008, GNP is calculated at -2.6%. The contraction in the economy has meant that employment figures have fallen dramatically over the course of 2008. The total number of people in employment fell by 25,200 (1.2%) year-on-year to the end of September 2008, the first annual decline in employment since 1991.

Whilst females in employment increased by 7,000 over the year to the end of September 2008, male employment levels fell by 32,000, with the construction sector most adversely affected. Employment within the construction industry has fallen progressively in Ireland since March 2007; however the pace of joblessness within the sector sharpened dramatically over the final quarter of 2007, a momentum that was sustained throughout the course of 2008. The number of males employed in the construction sector decreased by 27,000 in the 12 month period to the end of September 2008, 10% of the working male population in Ireland (CSO, 2008).

The Economic and Social Research Institute (ESRI) forecast for the Irish economy for 2009 reflects an expected downturn in both private and government consumption along with a further contraction of 26% across both commercial and residential development activity. As a result GNP is expected to contract by 4.6% in volume terms. External demand is unlikely to fill the void caused by falling internal consumption with Ireland's key trading partners, the UK and US already in, or likely to fall into, recession. The unfavourable exchange rate which has seen the value of the Euro climb against both the US dollar and sterling will also impact negatively on exports. Employment is expected to contract by 117,000 over the course of 2009, the result of ongoing job losses and an expected outward migration of circa 50,000.

Forecasts for the United Kingdom economy are equally downbeat. Economic activity in the UK had slowed sharply over the first half of 2008, reaching standstill by the end of the second quarter. The weakening was broad-based, driven by a fall in both residential and business investment. Government investment had initially provided some stimulus but as the fallout from the financial crisis gathered momentum the previously strong labour market weakened dramatically, leading to a significant increase in unemployment.

The number of unemployed people increased by 290,000 over the year to the end of November 2008, to reach 1.92 million, the highest figure since the three months to September 1997. Redundancy levels also increased significantly. There were 225,000 redundancies in the three
months to November 2008, an increase of 78,000 over the quarter and 101,000 over the year. The widespread contraction in output across all sectors of the economy has meant that job vacancies are at their lowest levels since records began. There were 530,000 job vacancies in the three months to December 2008, 153,000 less than the same period last year (Office of National Statistics, 2009).

The latest figures come on the back of a sharp decline in production activity. In the three months to the end of November 2008 the seasonally adjusted chained volume index for the output of the production industries decreased by 2.7% compared with the previous three months. The manufacturing sector was worst affected with a 2.9% fall in the level of output between October and November (Office of National Statistics, 2009). The figures confirm what survey data had been predicting – that manufacturing activity is shrinking fast amidst widespread reports of prolonged shutdowns, shortened working weeks, as well as the laying off of significant numbers of workers.

Figures compiled by the Office of National Statistics confirm that the UK is now officially in recession. The UK economy contracted 1.5% in the fourth quarter of 2008, the second successive quarterly contraction following a fall of 0.6% in the third quarter. The 2.5% contraction in the three months to the end of December 2008 is the greatest contraction over a three month period since the spring of 1982 and underlines the speed and ferocity of the downturn that has gripped the UK economy. The latest figures mean that national income contracted by 2.1% over the last two quarters of 2008. In the early 1990’s recession the economy shrank 2.5%, peak to trough, but took six quarters to do so (Cohen, 2009).

The recession in the UK has had four key drivers. They are the housing market, the price of oil, a loss of confidence in the financial institutions and a contraction in bank lending (Oswald, 2009). In large part the contraction in the wider global economy has its origins in the housing market and the misconceived view of western society that house prices would only ever go up. Just as in the earlier dot-com bubble, some analysts constructed complicated stories in their minds to rationalise what was fundamentally impossible. The sense of well-being and satisfaction that homeowners derived from the rising housing market meant that such interpretations were perfectly palatable; hindsight has shown that they defied rational thinking and ignored the cyclical nature of property markets. The dramatic fall in house prices has made almost everyone feel worse off, even in cases where the losses are never likely to be crystallised.

The second trigger for the recession was the exceptional rise in oil prices from the middle of the decade. Ten out of the eleven postwar economic downturns have been preceded by a spike in the price of oil. Fossil fuel is the central ingredient of modern life, as a result expensive energy costs cause slow-acting but corrosive increases to business costs which erode profit margins and contribute to unemployment as much as two, three or even four years later (Oswald, 2009). The third stimulus for the current recession, and the one that has captured the most headlines and features heavily in this report has been the evaporation in trust in banking institutions. The fourth recessionary influence has been has been the dramatic contraction in bank lending. Government intervention may have pulled the UK banking system back from the brink but the availability of credit will improve only very slowly. Unfortunately in terms of an economic recovery this is the stimulant that is likely to have the most protracted consequences. Entrepreneurs and small businesses are the heart beat of the UK economy and are vital to its economic revival due to their dynamism and creativity. However, tightened lending criteria is likely to mean that small businesses will find it increasingly difficult to secure credit, which
for many is fundamental to their existence.

Business confidence is at its lowest level since the 1990s and further widespread reductions in investment and employment are inevitable over the course of 2009. The UK has been gripped by recession sentiment pushing consumer confidence to historically low levels. After a decade of debt fuelled consumption, household savings ratios started to increase over the third and fourth quarters, albeit from historically low levels. Reduced interest rates and the fall in commodity prices have enhanced the levels of disposable income.

Allied with the VAT stimulus, government had hoped that consumers would be encouraged to spend. Initial trends suggest however that rather than spend surplus income consumers have decided to save it. Whilst savings ratios in the UK needed to be enhanced over the long term, in the midst of a recession, and with little incentive to save due to the poor saving rates, it is important that consumption levels are maintained. Removing money from the economy in the current economic climate could trigger unwanted deflationary pressures. The IMF expects the UK economy to contract by a further 2.8% over the course of 2009, the worst of any large industrialised nation. The IMF forecast for the UK has been revised downwards as result of a deeper than expected downturn in the housing market, the contraction of the financial sector, and the impact on UK exports of weaker growth in the US and Europe.

In Northern Ireland the contraction in economic output has not been as marked as in other regions of the UK. This is partly attributable to the high level of public sector and public sector related employment. In addition to this a further buffer to the Northern Ireland economy, and to the retail sector in particular, has been the dramatic increase in cross border trade due to the favourable exchange rate and the reduction in VAT. That said, the Northern Ireland economy is now more outward looking and in this respect is not immune to the contraction in global output.

In the absence of regional Gross Value Added data for 2008/09, it is not possible to state whether Northern Ireland is technically in recession. However, there has been a marked increase in the level of unemployment and output across the private sector with construction, financial and business services and manufacturing the worst affected. Figures compiled by the Department of Enterprise Trade and Investment (DETI) reveal that 5,540 jobs were lost in the private sector in Northern Ireland in the third quarter of 2008. Unemployment has increased by 51.5% over the course of 2008 to stand at 36,000 at the end of December (DETI, 2008). While the increase is significant in percentage terms, an increase of this magnitude has not been seen since 1971, the rise is from historically low levels and in that respect somewhat distorts the regional picture. The number of claimants remains well below the level of ten years ago when 56,000 people were listed as unemployed (DETI, 2008).

In truth, there has been little to celebrate in the global economy over the last year. In some respects, however, the contraction in global output is to be welcomed, coming as it does on the heels of several years of rapid expansion. Global demand growth had far exceeded world supply potential as illustrated by the dramatic increase in international commodity prices and by excessive inflationary pressures in both developed and emerging economies in recent years. The contraction in the global economy has resulted in a marked reduction in commodity prices, which in turn has helped relieve inflationary pressures.

Oil prices peaked in mid-July 2008 at $150 a barrel, but by the middle of November had more than halved to $70 a barrel. Pre-credit crunch the International Energy Agency (IEA) had warned that global demand for oil was
simply unsustainable, in the IEA Oil Market Report (October 2008) they outline that while prices have been reduced in the wake of the contraction in the global economy, over the medium term they expect prices to rebound to at least $100 a barrel when growth returns to the global economy (IEA, 2008)\(^6\).

The price of steel, which had risen to record levels in the first two quarters of 2008, has since fallen sharply due to weakening demand as major construction and infrastructure projects around the world are put on hold in the wake of the uncertain financial climate. Demand from China in particular has fallen dramatically attributed to the contraction in construction activity as well as reduced demand from car manufacturers. The fall in steel prices has prompted suppliers to reduce production levels, global output in September 2008 fell by 3.2 per cent, the biggest year-on-year fall since March 1999 (Marsh, 2008). Even when the dramatically reduced levels of output are taken into account, steel prices look set to continue to fall until at least the middle of 2009 (Song-Jung, 2008).

The contraction in the global economy has also helped to reduce the long-standing trade imbalances, most notably between China and the US. The Chinese government has purchased dollars and held them in the form of US treasury securities – this intervention has funded a large share of the US deficit and has meant that China now hold in excess of $1.4 trillion of foreign currency reserves. For the US government, being able to fund budget deficits by selling bonds to a foreign government, had enabled them to hold down long-term interest rates, but this had also generated a very large external deficit which would have been unsustainable over the long-term (Deloitte, 2008). However, the slowdown in domestic demand, along with the depreciation of the dollar, is helping to resolve the long-standing global financial imbalances. The US current account deficit has narrowed from 6.2% of GDP at the end of 2006 to 4.9% of GDP at the end of 2007 which bodes well for longer-term prospects, once the current cyclical adjustment comes to closure.

\(^6\)Reduced oil prices whilst helping reduce inflationary pressures has in itself contributed to the slowdown in the global economy - oil producers have reduced output in the wake of weakening global demand and have put on hold plans to increase production, whilst for investors the volatility in oil prices has increased the risks of associated investments.
The global economy in recent years has been driven by the widespread and cheap availability of credit, without it both developed and emerging economies around the world have stagnated. The IMF forecast that global growth in 2009 is likely to contract to 0.5%.

Hopes that continued growth in emerging economies and in particular the BRIC nations would offset the contraction in global demand all but disappeared over the course of 2008. Emerging economies have to face up to new challenges as the pronounced reduction in investor’s risk appetite has resulted in a retrenchment in short term capital flows, exerting pressure on local markets and significantly raising the cost of credit.

The IMF has predicted that Europe could be the biggest victim of the financial crisis. The Euro zone economy has officially fallen into recession for the first time in its ten year history following growth of -0.2% in the third and fourth quarters of 2008. The UK and the Republic of Ireland are both officially in recession after posting successive quarters of negative growth over the course of 2008.

The positive outcome of the contraction in the global economy is the reduction in the long standing trade imbalances, most notably between China and the US. The reduction in global demand has also eased inflationary pressures that had become a feature of both developed and emerging nations.
In analysing global economic conditions it is apparent that an adverse feedback loop has been created between the international monetary system and the global economy. Weakening economic conditions around the world have contrived to reinforce credit deterioration, which in turn has compounded stress on mortgage, credit and funding markets. In order to understand this relationship, as well as the potential implications, it is important to explore how financial systems contribute to economic growth and to identify previous episodes of financial stress that share similarities with the current crisis.

A major source of debate surrounding the 2007-08 financial crisis has been the speed with which national governments have intervened to protect banks and other high-profile financial institutions from collapse. This intervention is all the more profound when, in essence, it was the profligate lending policies of these same institutions which fuelled the financial crisis. However, the reason that banks and other key lending institutions have been rescued while other troubled industries are allowed to fail, is attributable to the important intermediary role they play in the wider economy.

The role of banks has evolved significantly over time in response to globalisation and the de-regulation of financial markets. However, their symbiotic relationship with securities markets remains an essential feature of many financial systems. To understand the important role of banks in stimulating economic growth it is revealing to explore the pro-cyclical behaviour of bank leverage around financial cycles and in particular to identify how banks manage leverage during upturns and downturns.
Financial systems are inherently pro-cyclical, with growth in credit, leverage and asset prices often reinforcing the underlying economic dynamic—and in some cases leading to financial imbalances followed by a sharp correction (Borio, 2007). Whilst financial cycles have been a consistent feature of the economic landscape their impact on the ‘real economy’ remains a subject of debate. One strand of research emphasises the role of the financial accelerator in amplifying the effects of financial cycles on the real economy through its effects on the value of collateral and thereby on the willingness of the financial system to provide credit to the economy (Berenake et al, 1999). In this view, shocks that affect the creditworthiness of borrowers tend to accentuate swings in output. An alternative interpretation on the impact of financial cycles focuses on lenders balance sheets and the relationship between bank capital and aggregate credit, the so-called bank capital channel (Kashyap and Stein 1995). In the main, evaluations of financial stress have relied heavily on historical narratives of well known banking crises, when bank capital was eroded and there was often need for significant public intervention (Kindleberger & Aliber, 2005). Although such narratives are useful in identifying a rich database of episodes of financial stress they often fail to relate these events to changes in economic conditions. To overcome these limitations the IMF developed the Financial Stress Index (FSI) which was constructed using market based indicators in real time and of high frequency within developed economies. The FSI index for each country was calculated using a number of variables from the banking, securities and foreign exchange markets (Table 1).

The IMF research identifies over 113 incidents of financial stress for advanced economies in the last 30 years. Twenty-nine of the 113 incidents of financial stress identified where followed by

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<td>Banking Related Variables</td>
<td>The “beta” of banking sector stocks which measure the correlation between the total returns to the banking sector stock index and the overall stock market index. Accordingly incidents on high stress are reflected by an unusually high drop in the value of banking stock prices relative to overall market prices. The spread between interbank rates and the yield on treasury bills- the so-called TED spread, which measures the premiums that banks charge each other over treasury bill rates. The slope of the yield curve.</td>
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<td>Securities Market Variables</td>
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Source: International Monetary Fund (2008)

Altunbas, Gambacorta and Marques, 2007). When bank capital is eroded, banks become more reluctant to lend and may be forced to de-leverage, leading to sharper economic downturns (IMF 2008b).

The study included Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, Norway, Spain, Sweden, Switzerland, United Kingdom and United States.
economic slowdowns, while a further 29 were followed by a recession. Forty-three of the incidents of financial stress identified were driven mainly by stress in the banking sector, the banking sector was also partly responsible for a further 17 incidents of financial stress.

The findings of the IMF study are significant as historic reviews of the advanced economies demonstrate that where economic downturns are preceded by financial stress, and as has been the case in the current contraction in the global economy, they have tended to be more severe and protracted. Medium cumulative output losses (relative to trend or until recovery) were about 3% of GDP for slowdowns and about 4.5% of GDP for recessions following financial stress, significantly greater than slowdowns and recessions that were not preceded by financial stress in which GDP contracted by 1.5% and 2.25% respectively (Figure 2).

The IMF research highlights the global implications of the 2007-2008 financial crisis – with virtually all the countries in the sample affected by the current constraints in the global money markets. Previous episodes to have affected the majority of countries in the sample over the last 30 years include the 1987 stock market crash, the Nikkei/Junk bond collapse in the late 1980s, the Scandinavian banking crisis in 1990, the European Exchange Rate Mechanism (ERM) crisis of 1992 and the collapse of LTCM. None of the previous incidents, however, have had the profound impact of the current crisis. The research highlights that, whilst the origins of the crisis may have been in the banking sector, by early 2008 the crisis had broadened significantly to affect the securities and foreign exchange markets as well (IMF, 2008b).

A further significant finding of the IMF investigation was that whilst only 58 of the 113 incidents of financial stress have been followed by a recession or downturn, about 60% of the downturns/recessions were the result of stress in the banking system. In general slowdowns tend to be associated with a fall in the demand for credit; however during slowdowns/recessions associated with banking-related financial stress, the cost of capital is significantly higher. The findings support the view that a reduction

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7 An economic slowdown occurs if the level of real GDP falls below trend within six quarters of the onset of financial stress. A recession occurs if a peak to trough business cycle occurs within six quarters of the onset of financial stress.
in credit supply is a key factor associating banking-related financial stress episodes with economic downturns (IMF, 2008).

The IMF study revealed that credit and asset price dynamics and the financial position of households and firms preceding the incident of financial stress are important determinants in evaluating the impact of a financial shock. Statistical analysis conducted by IMF reveals that incidents of financial stress are more likely to be followed by economic downturns or outright recessions when they are preceded by a rapid expansion in house prices or by higher borrowing ratios among firms and households. Indeed incidents of financial stress that are followed by recessions are characterised by a more exposed household sector in terms of a reliance on external financing.
An adverse feedback loop has been created between the international monetary system and the global economy. Weakening economic conditions have contrived to reinforce credit deterioration, which in turn has compounded stress on mortgage, credit and funding markets.

There have been over 113 incidents of financial stress for advanced economies in the last 30 years. Fifty-eight of the 113 incidents identified have been followed by an economic slowdown or recession. Stress in the banking sector has been responsible for over 60% of all incidents of financial stress identified.

Historic reviews of advanced economies demonstrate that where economic downturns are preceded by financial stress, economic downturns have tended to be more severe and protracted.

Incidents of financial stress that are preceded by rapid expansion in house prices or by higher borrowing ratios among firms and households are more likely to be followed by economic downturns or outright recessions.
Prior to the financial crisis, the UK and Ireland (North and South) had experienced housing booms. Historic reviews of incidents of financial stress highlight that where an economic downturn is preceded by a housing boom the downturn tends to be more protracted. This section of the report examines the characteristics of the residential property markets in the UK, Northern Ireland and the Republic of Ireland, highlighting the factors which fuelled the respective housing booms as well as examining the extent of the subsequent market corrections.

5.1 United Kingdom Residential Property Market

Following more than a decade of unprecedented growth many property analysts had been forecasting a downturn in the UK housing market citing that the rise in house prices was unsustainable. Between December 1999 and December 2007 the average house price in the UK increased by £107,000 or £119,000 depending on the index used (Figure 2).

Figures compiled by Nationwide show that the average house price in the UK increased from £75,000 at the end of December 1999 to just over £182,000 at the end of December 2007. The Halifax House Price index shows the rate of growth over the same timeframe to have been even steeper with the average house price increasing from £77,000 at the end of December 1999 to circa £196,000 at the end of December 2007. Although the figures do not account for regional variations in house price growth they
were representative of the underlying national trend prior to the downturn.

The extraordinary levels of house price growth can be explained by a number of factors, including low interest rates and strong levels of employment as well as the constraints in housing supply. However, central to the growth was the wholesale availability of credit. The incessant demand amongst many lending institutions to enhance their share of the residential mortgage market meant that lending criteria was often not as stringent as it should have been. The extensive range of mortgage products available during the housing boom, including self certificate mortgages and products with loan to value ratios in excess of 100% meant that home ownership had been opened up to a much wider percentage of the population. Loan to income ratios were also extended allowing borrowers access to larger volumes of mortgage finance (Figure 3). This is particularly apparent in the period 2005 to 2007, coinciding with the rapid expansion in credit availability globally.

In addition to the broader homeownership demographic a further dimension of the house price growth has been the dramatic expansion of the buy-to-let sector. Figures compiled by the Council of Mortgage Lenders (CML) show that the number of buy-to-let mortgages increased by 21% in the 12 month period to the end of December 2006. Over the course of 2006, banks, building societies and other lenders approved more than 330,000 buy-to-let loans worth a total of £38.4bn. The figures represent a 48% increase in volume and a 57% increase in value of buy-to-let mortgages over 2005 levels. At the end of 2006 the buy-to-let sector accounted for 9% of all outstanding mortgages in the UK by value. In addition to the mortgaged acquisitions large volumes of equity were also being channelled into buy-to-let properties, collectively this investment put severe pressure on housing stocks and added to house price growth.

As the gap between supply and demand widened, the misguided belief that property prices would grow indefinitely gathered momentum with increasing numbers of investors speculating based on short term capital appreciation. Property trading became a feature of the market and meant that investors

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* Figures to the nearest 000's

**Source:** Nationwide/Halifax (2009)
were no longer concerned about securing tenants for their properties. The net result was that large volumes of newly developed property, particularly apartments throughout the UK were purchased from developers but have remained unoccupied. The downturn in the property market has exposed the true extent of this problem with large volumes of new build apartments in major cities such as Birmingham, Leeds, Liverpool, Manchester and Sheffield currently vacant. NHBC statistics show that apartments/flats and maisonettes made up 44% of new homes started in the UK in the first quarter of 2007, double the percentage seen in 2000.

The overhang in supply within the apartment sector has been fuelled by government housing targets, demand for affordable housing, as well as the dramatic increase in the value of development land. The UK Government’s housing targets required a dramatic increase in the number of residential units being developed – the solution has been a widespread increase in apartment provision. Developers were, in the main, happy to conform as the dramatic increase in the cost of land during the property boom meant they were required to maximise the number of units that they could develop on acquired sites.

The changing population demographic of the UK may have supported such rapid expansion within the apartment sector but the underlying demand which has contributed to the overhang in supply was artificially enhanced by investors with short term investment horizons. Following the downturn in the market many of these investors have been left with properties lacking an income stream and with no identifiable exit strategy.

The momentum of the UK housing market was dampened by a series of interest rate increases introduced by the Bank of England in the period between November 2006 and July 2007*. The interest rate rise was a necessary intervention to arrest CPI inflation which had

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* Chart shows the proportion of mortgages with loan to income ratios greater than 2.5, 3.5 and 4.5.

Source: FSA, Survey of Mortgage Lenders and University of Essex
risen in response to soaring global commodity prices. The initial 0.25% rise in November 2006 had limited effect on house price growth but three further incremental rises of 0.25% began to take effect as house price inflation started to stagnate before falling slightly between July and August 2007 (Figure 4).

The monthly fall in August 2007 was dismissed as seasonal and indeed in September and October 2007 prices continued to rise. According to Nationwide figures the UK market reached the peak of the growth cycle in October 2007 when the average house price stood at £186,044 before entering into a period of significant correction in November 2007. Figures compiled by the Halifax identify that the correction in the market actually began in September. The Halifax index shows the growth cycle to have reached its peak in August 2007 when the average house price stood at £199,612.

In the main a ‘soft’ correction had been predicted, after all interest rates, in spite of the 1% increase remained comparatively low, especially when compared to the previous housing market crash in the UK when interest rates peaked at 15%. Employment levels remained strong and the economy continued to grow – albeit slowly. A report for the National Federation of Housing published in August 2007 highlighted that whilst the rise in interest rates would dampen house price growth over the short term, the expanding gap between supply and demand would see house prices recover strongly, with growth of 40% predicted over the five years to 2012.

Upbeat forecasts such as this were commonplace in the early part of 2007 and may well have been realised; but what these projections had not anticipated nor had they factored in, was the crisis within the global financial system. Significantly, a house price expectations survey conducted by the Building Societies Association (BSA) in May 2007 highlighted that if house prices in the UK were to fall, it was likely to be the consequence of a factor or factors beyond the housing market itself.

As fallout from the financial crisis intensified, the impact on both developed and emerging economies around the world has been profound. The UK officially fell into recession following successive falls in GDP output in the third and fourth quarters of 2008. The economic downturn allied with rising
unemployment, concerns over job security and tightened lending criteria have combined to undermine confidence in the UK housing market. As a result the correction in the market has been relatively steeper than most analysts had forecast.

The Nationwide Monthly House Price Index shows that house prices in the UK contracted for fourteen consecutive months between November 2007 and December 2008. According to Nationwide figures the average house price in the UK has fallen from £184,099 in November 2007 to £150,501 at the end of December 2008 (Figure 5), a fall of £33,598 or 18.2%. Figures compiled by Halifax confirm a downward trend of similar magnitude. The Halifax monthly House Price Index recorded price declines in fourteen of the sixteen months between September 2007 and December 2008, including ten months of consecutive decline between March 2008 and December 2008. According to Halifax figures in the sixteen month period September 2007 to December 2008 the average house price in the UK fell from £184,723 to £153,048, a decline of £31,675 or 17.1%. While it is important to acknowledge that too much weight should not be attached to monthly variations in house prices, quarterly figures which give a much greater indication of the underlying market trend reinforce the severity of the downturn (Figure 6).

As the disruption in financial markets gathered momentum over the course of 2008 the depth of the decline in UK house prices continued apace and has already surpassed the falls experienced in the previous property crash of the 1990s. The Halifax House Price Index shows that in the previous downturn average prices peaked at £70,247, in May 1989, and then a long run of monthly losses and stagnation ensued until the market eventually bottomed out, in July 1995, at £60,965, a peak to trough loss of 13.2% covering a period of over six years. In the current downturn the Halifax House Price Index shows the average price peaked at £199,612, in August 2007, but by the end of December 2008 the average house price had fallen to £160,861, a fall of 12.7% in a period of sixteen months.

Whilst comparisons with the 1990s house price crash are useful in that they help contextualise the severity of the market correction, they are meaningless as a barometer for predicting the possible duration of the current downturn or for anticipating a potential recovery. The principal reason for this is that the downturns have had
very different underlying fundamentals. The 1990s crash was triggered by a rapid increase in interest rates following the UK decision to join the ERM. A succession of interest rate rises may have taken the heat out of the growth cycle which preceded the current downturn, but it has been the lack of liquidity within the global financial markets and the subsequent contraction in mortgage lending which has exacerbated the current downturn.

Liquidity within the global financial markets improved dramatically in the period December 2003 and June 2007 as a result of innovative financial engineering. However following the collapse of the sub-prime mortgage market in the US there was a marked contraction in financial market liquidity. The liquidity index fell to -0.25 in September 2007 before contracting further to -1.55 in September 2008 as renewed uncertainty gripped the financial markets following the collapse of Lehman Brothers and the near collapse of insurance conglomerate AIG (Figure 7).

The lack of liquidity within the global financial markets has put a significant strain on the resources of lending institutions leading to a major contraction in mortgage lending (Figure 8). Between 2002 and 2007 annual gross mortgage lending in the UK had grown by circa 65% from £220.7 billion in 2002 to just over £363.4 billion in 2007. As the implications of the financial crisis widened and the downturn in the housing market gathered momentum gross mortgage lending has fallen dramatically. Gross mortgage lending in 2008 amounted to circa £257.6 billion, 29% less than in 2007 (Figure 9). In total 516,000 loans were approved for house purchases in 2008, 501,000 less than in 2007 (CML, 2009).

The UK mortgage market had total outstanding balances of circa £1.2 trillion at the end of December 2008. The market is dominated by three lender types, banks, building societies and Other Specialist Lenders (OSLs). Historically banks have been the dominant lender within the residential market sector but that dominance has diminished in recent years (Figure 9).

At the end of December 2002 banks held £467.6 billion (69.3%) of the outstanding balances in the residential mortgage market in the UK. By the end of December 2008 banks held outstanding balances of £586.2 billion (47.9%) of all outstanding balances. The decline in the banks overall market share is attributable to the dramatic growth in OSLs. At the end of
December 2002 OSLs had outstanding balances of $467.6 million, equating to 12.1% of the overall market share. By the end of December 2008 OSLs had outstanding balances of £426.8 billion representing 34.9% of the overall market share.

The greatest contraction in overall gross lending in 2008 was amongst the OSLs, many of whom depend on the wholesale money markets, and the banks. The UK banking system in recent years has also become increasingly dependent on international wholesale markets due in part to the dramatic fall off in the customer deposit base. In 2001, UK customer lending was comparable with customer deposits, but by the first quarter of 2008 the surplus of lending over deposits – the customer funding gap, was £700 billion. Much of the additional funding had been sourced overseas, with the

US a predominant intermediary attracting capital inflows from the rest of the world and exporting these funds to other countries (BOE, 2008). Figure 10 illustrates the growth in interbank deposits into the UK banking system from abroad in the period 2001 to 2008, which in turn has widened the customer funding gap.

The downturn in house prices, allied with the ongoing uncertainty in the financial markets, has had a negative impact on the volume of sales transactions and in the level of residential development activity. NHBC figures show that the total number of applications to start new homes in the calendar year 2008 was circa 103,000, almost 50% less than for the calendar year 2007 when 200,697 applications were submitted. Not surprisingly the decline in new build applications has been most acute within the private sector. In the three-month period September to November 2008, NHBC received a total of 18,675 applications to start new homes in the UK. Whilst the private sector accounted for over half (10,718) of the total applications in the three months to the end of

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Liquidity index shows the number of standard deviations from the mean. It is a simple unweighted average of nine liquidity measures, normalised on the period 1999-2004. The fall in the indicator in the period Sept. 2007 - Sept. 2008 is largely due to the sharp decline in the interbank liquidity measure.
November, this represented a 73% decline on the same period last year (NHBC, 2008). The number of applications to start new homes from Housing Associations has also fallen, but at a more moderate level. Applications for the three months to the end of November totalled 7,957, 9% lower than the same period last year (NHBC, 2008).

NHBC statistics reveal that new build completions have also fallen dramatically over the course of 2008. Completions were down 13% over the first half of the year compared to the same period in 2007. The decline steepened as the year progressed with new build completions in the three months to the end of November 31% lower than the same period a year ago (NHBC, 2008). The contraction in development activity has fuelled unemployment within the house building sector putting further downward pressure on the UK economy.
More than 5,500 redundancies were announced by volume house builders Persimmon, Taylor Wimpey, Barratt and Redrow over a four week period between June and July of 2008, setting the tone for a systemic shift in unemployment levels within the construction industry. In addition to the widespread redundancies many house builders have introduced shortened working weeks as well as suspending activity on a number of development schemes. These radical decisions have been taken in response to the dramatic fall off in demand for new build properties. Daily sales of new homes in the UK in the three months to the end of November 2008 stood at 378, 22% lower than the same period a year ago (NHBC, 2009).

Rising unemployment across the UK in tandem with tightened lending criteria\(^{10}\) has created high levels of distress within the residential mortgage market. Figures compiled by the

\[^{10}\text{Tighter lending criteria has created problems for people wishing to re-mortgage when their existing deal expires.}\]

CML show that 11,300 homes were repossessed in the third quarter of 2008, up slightly from 10,100 in the second quarter. The numbers are alarming, but in percentage terms the number of homes repossessed in the third quarter equates to 0.1% of all mortgaged properties in the UK. The CML expect the total number of repossessions to be around 45,000 for the whole of 2008, although this figure looks set to rise into 2009, with the number of households in arrears by the end 2008 likely to exceed 170,000.

\begin{figure}
\centering
\includegraphics[width=\textwidth]{figure10.png}
\caption{Major UK Banks’ customer funding gap\(^{(a)}\), household saving ratio and foreign interbank deposits \(^{(b)}\)}
\end{figure}

(a) Customer funding gap is customer lending less customer funding, where customer refers to all non-bank borrowers and depositors. (b) Data exclude Nationwide. (c) UK household savings as a percentage of post-tax income.

\textbf{Source: } Bank of England, Dealogic, ONS, published accounts and Bank calculations.
of 2008 11,300 buy-to-let properties were repossessed, 12% higher than the 10,100 in the second quarter. The Council of Mortgage Lenders (CML) have warned that the period of adjustment within the UK residential market is likely to be extended by the weak economic backdrop and the lack of available finance. The CML envisage market activity to remain subdued over the course of 2009 with transactions forecast to fall to around 700,000, down from around 900,000 in 2008 (CML, 2008).

The obsession with global financial crisis and the depth of the property market downturn has meant that very little attention has been given to the conditions that are likely to exist when the market recovers. Property markets are cyclical by nature and although the current downturn may be elongated by the global credit crisis, the market will recover. Jones Lang LaSalle’s Residential Market Forecast (November 2008) has projected that UK house prices will fall between 13% and 15% on average over the course of 2009. The fall is forecast to continue into 2010 were falls of between 1% and 3% are forecast.

Encouragingly, Jones Lang LaSalle has predicted the second quarter of 2009 will be a watershed of sorts for the UK housing market and could provide the first signs that house price falls are beginning to diminish, although they do not expect the trend to become established until later in the year. House prices are forecast to fall in the region of 2% in the final quarter of 2009, but the overall decline for the year has been eased from -20% to circa -15%. Transaction levels are expected to pick up in the first quarter of 2010 but confidence is likely to remain low and will take some time to fully recover. In tandem with the overhang supply, it is unlikely that there will be any positive growth in house prices in 2010. Jones Lang LaSalle predicts that house prices will fall between 1-3% in 2010, although the market is likely to reach its bottom between the third and fourth quarter of 2010, at which point UK house prices will have fallen an aggregate 29% from their peak in the third quarter of 2007.

The housing recovery in the UK will be led by London. It will outperform the rest of the UK throughout 2011, with growth projected at 7-9% in greater London and 8-10% in the run up to the 2012 Olympics (Jones Lang LaSalle, 2008). In terms of the overall UK housing market, growth is projected at 4-6% in 2011, before increasing to 8-10% in 2012 and 2013. The market will then gather momentum, not least because of the highly publicised gap between supply and demand which will have widened significantly during the downturn due to the dramatic contraction in residential development activity. The Jones Lang LaSalle forecast highlights that the change in the population demographic, constraints on supply, along with escalating construction costs will result in house price growth of 20%+pa within the next ten years (Jones Lang LaSalle, 2008).

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11 Halifax and Nationwide have refused to provide house price forecasts for 2009 stating that it would be impossible to accurately predict house price movement over the next twelve months, and that to provide a forecast that was subject to constant review would only add to market uncertainty.
5.2 Northern Ireland Residential Property Market

The downturn in the Northern Ireland Housing market has been the most pronounced of any UK region. Market sentiment in the wake of the downturn has at times bordered on hysteria. House prices are projected to fall by as much as 50% depending on the objectiveness of the source. The sense of panic has been intensified by the realisation that this is the first down phase of a property cycle that the Northern Ireland housing market has experienced. The Halifax House Price Index shows that Northern Ireland house prices have by and large followed an upward curve between 1984 and 2007 (Figure 11). As a result, the ongoing correction in the market is the first time that the majority of home owners in Northern Ireland will have experienced first hand the downward phase of a property cycle.

Naturally, after such a sustained period of growth, and following swiftly on the back of five years of double digit price increases, it is easy to become pessimistic about the current plight of the Northern Ireland housing market.

Various commentators had forecast the demise of Northern Ireland housing prices well before the correction unfolded – even though the downturn arrived much later than many of their forecasts projected and was fuelled by circumstances that had not been foretold.

Given the attention grabbing headlines that preceded the downturn, in which Northern Ireland achieved record levels of house price growth, it was conceivable that any downturn would be greeted in a similar fashion. Figures compiled by Nationwide show that the average house price in Northern Ireland at the end of the second quarter of 2005 was £117,149, £40,345 or 34% below the UK average. By the end of the third quarter of 2007 following a period of phenomenal growth the average house price in Northern Ireland was £227,970 or £43,839 (23.8%) above the UK average (Figure 12).

The UK market as a whole experienced a period of robust growth between 2005 and 2007. The average house price in the UK rose...
by 16.9% between the second quarter of 2005 and the third quarter of 2007. However, within that same timeframe house prices in Northern Ireland soared, with growth of circa 95%. The dramatic growth over such a short period of time was attributable to a culmination of factors, including the constraints placed by the planning system, the relaxation of lending criteria, the widespread availability of debt, the high inflow of investment from the South of Ireland as well as the rapid expansion in the buy-to-let sector.

The availability of cheap finance acted as a stimulus to the buy-to-let market which ultimately became the key driver of house price growth in Northern Ireland. Investors with varying motivations, some long term, others more opportunistic in nature, ploughed vast sums of money into buy-to-let properties. Between 1996 and 2001 the number of private rented dwellings in Northern Ireland increased at an annual average rate of 2,300 dwellings per annum. Between 2001 and 2004 this figure increased to 4,400 dwellings per annum, but between 2004 and 2006 the private rented sector grew rapidly with an average increase of 9,200 dwellings per annum. At the end of 2006 there were more than 80,000 dwellings in the private rented sector in Northern Ireland, representing 11.5% of total housing stock. If dwellings that were privately rented when last occupied are taken into account the figures rise to 94,600 dwellings or 13.4% of total housing stock (NIHE, 2008).

The investor appetite placed irrepressible pressure on housing stocks. As the gap between supply and demand widened the housing bubble went into overdrive. Significantly lending capacities were relaxed further to facilitate purchase, adding further fuel to an already overheated market. Growth of 95% in little over two years was unsustainable. By the third quarter of 2007 tangible evidence began to emerge that the market was cooling as transaction volumes declined and properties ‘time on the market’ began to extend significantly (University of Ulster, 2007).

The global financial crisis has exacerbated the downturn and as a result the market is currently enduring a difficult period of correction. In the midst of that correction, market sentiment has been decidedly downbeat. Whilst there is no denying these are challenging times for
the housing market in Northern Ireland, it is important to gain a sense of perspective, to provide an objective evaluation and to quantify the true extent of the downturn.

Figures compiled by the Nationwide Building Society show the average house price in Northern Ireland at the end of December 2008 to be £147,833 (Figure 13). According to the Nationwide, the average house price in Northern Ireland fell by £76,983 over the course of 2008, a year-on-year fall of 34.2%. The latest figures mean that the average house price in Northern Ireland has fallen circa £80,000 or 35.2% from the peak of the market (£227,970) in the third quarter of 2007. The Nationwide statistics confirm the average house price in Northern Ireland has now returned to a level comparable with the second quarter of 2006.

The Halifax House Price Index confirms a similar downward trend. According to the Halifax figures the average house price in Northern Ireland at the end of December 2008 was £153,299 (Figure 14). The figures for the fourth quarter of 2008 mean that the average house price in Northern Ireland has fallen by £70,646 in the calendar year 2008, a year on year fall of 31.5%. According to the Halifax figures the average house price in Northern Ireland has fallen circa £84,651 or 35.6% from the peak of the market (£237,950) in the second quarter of 2007.

The overall correction in the Northern Ireland market has been much steeper than the UK average (Table 2). One of the principal reasons for this is that income growth in Northern Ireland did not support such a dramatic increase in house prices. Figures compiled by the Department of Enterprise, Trade and Investment show Northern Ireland has the lowest gross weekly earning for full time employees of any region in the UK (Figure 15). Northern Ireland house prices peaked in the third quarter of 2007 when the average house price stood at £227,970\(^{12}\), the highest of any UK region outside London. Consequently Northern Ireland was the lowest ranking region in the UK in terms of affordability.

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\(^{12}\) Nationwide House Price Index
The growth in house prices relative to income levels created an affordability gap in Northern Ireland. In a review into affordable housing published in Spring 2007, Sir John Semple outlined the extent of the affordability gap across Northern Ireland with 22 of the 26 district councils identified as having an affordability gap based on income relative to house price. Semple's review was based on first quarter 2006 data. However, as house prices continued to grow across Northern Ireland, by the first quarter of 2007 the affordability gap extended to include all 26 district council areas. The mean affordability gap across all 26 district councils in the first quarter of 2007 stood at £98,975. In 2003 the mean affordability gap was -£1,482.

Figure 14  Northern Ireland Average House Price and Percentage Change (Halifax Figures)

* House Prices to the nearest 000s

Source: Halifax

Table 2  Northern Ireland Residential Property Market Key Statistics

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<thead>
<tr>
<th></th>
<th>Halifax</th>
<th>Nationwide</th>
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<td>Market Cycle Peak</td>
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<td>Qtr 3 2007</td>
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<tr>
<td>Average Price Q4 2008</td>
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<td>£147,833</td>
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<tr>
<th></th>
<th>Halifax</th>
<th>Nationwide</th>
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<tbody>
<tr>
<td>Peak – Q4 2008 Change</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Northern Ireland</td>
<td>-35.6%</td>
<td>-35.2%</td>
</tr>
<tr>
<td>UK</td>
<td>-23.3%</td>
<td>-14.8%</td>
</tr>
</tbody>
</table>

* Compiled Using Quarterly Data

Source: Halifax/Nationwide
As house prices continued to rise, First Time Buyers (FTBs) increasingly found themselves priced out of the market. In the four year period December 2003 to the December 2007 the house price to earnings ratio for FTBs in Northern Ireland more than doubled from 3.6 at the end of 2003 to 7.6 at the end of 2007 (Figure 16). As a result of the downturn in the housing market, at the end of 2008 the house price/income ratio for FTBs has eased to 5.0 for Northern Ireland, the UK average is 4.4.

During the boom cycle, and because of the affordability issues highlighted in Figure 1 there was a marked reduction in the number of loans to FTBs (Figure 17). There were 3,000 loans made to FTBs in Northern Ireland in 2008, down from 5,200 in 2007 and over 15,000 less than the number of first time buyer loans approved in 2001. The 2008 figures were the lowest since 1974, when 3,300 loans were approved to FTBs (CML, 2008).

**Figure 15**  
UK Regions - Median Gross Weekly Earnings for Full-Time Employees

![UK Regions - Median Gross Weekly Earnings for Full-Time Employees](image)

*At April 2008*

**Source:** Department of Enterprise, Trade and Investment (DETI)

**Figure 16**  
First Time Buyer Gross House Price to Earning Ratio for NI (1999-2008)

![First Time Buyer Gross House Price to Earning Ratio for NI (1999-2008)](image)

**Source:** Nationwide
Mobilising FTBs will be an important step to breaking the current gridlock in the housing market. The Social Development Minister has introduced a number of innovative schemes across the province, including the ‘Own a Home Scheme’ in Portadown, and a scheme in the North West of the province which will see the North and West Housing Association commit to providing £4 million to help up to 100 FTBs get onto the property ladder. Whilst the numbers are small in relative terms, this is undoubtedly an encouraging step in helping FTBs onto the property ladder and the roll out of schemes of this nature is to be encouraged.

Other equity sharing arrangements have been put in place in conjunction with the banks to enhance affordability and to entice first time buyers back into the market. The £35 million private finance deal secured between Bank of Ireland and Co-Ownership will enable an additional 200 people onto the property ladder. The new initiative has been capped at £175,000 in line with the increased stamp duty exemption band. Whilst exemption from stamp duty in itself may not be a justifiable reason to enter the property market, in tandem with the dramatic fall in interest rates and the huge discounts being offered by developers, the market should be more attractive for first time buyers.

Market sentiment however remains downbeat and there are widely held views that house prices are likely to fall further over the course of 2009. The wider economic conditions and the restrictions on lending suggest that this is likely to be the case. With the market having already undergone a correction of circa 35% in a period of 15-18 months, further declines are likely to be less marked. In this respect the innovative equity sharing arrangements which have been set up between the banks and local developers are to be encouraged as these will shelter first time buyers should the market continue to decline. In the case of the new build sector, house prices are already likely to have reached their base when developer discounts are taken into account. Therefore, an opportunity exists for FTBs to enter the market and to capture true value, whilst safeguarding against the prospect of negative equity.

Confidence in the Northern Ireland housing market is at its lowest point for more than a decade and the buoyancy, so evident over the last number of years, has been replaced by uncertainty and doubt. For many homeowners the ‘downturn’ is a new experience. ‘Bricks and mortar’ was supposed to be a ‘safe’ investment and a widespread consensus had emerged that house prices would grow indefinitely. More mature residential markets such as the

![Figure 17: Loans to First Time Buyers in Northern Ireland (2001 – 2007)](image_url)

Source: Council of Mortgage Lenders (CML)
US and mainland UK illustrate that this was never likely to be the case. Property markets are inherently cyclical. There will inevitably be peaks and troughs as the market moves through that cycle and responds to changes in micro and macro economic conditions and other externalities which influence supply and demand.

Much of the sentiment that accompanied the correction in house prices in Northern Ireland has been unjustifiably hyped by the media, as indeed it had been during the boom cycle. The majority of home owners in Northern Ireland view their house firstly as a home and not as an investment in the purest sense of the word. The majority of homeowners in Northern Ireland are not any worse oﬀ in ‘real terms’ by the correction in the housing market as they are unlikely to realise any tangible loss. Nevertheless, sentiment will dictate that homeowners will feel relatively worse oﬀ, but in real terms they have not really lost anything. The downturn has created paper losses, just as the upturn generated ‘paper gains’. Unless these gains or losses are crystallised householders financial liquidity or disposable wealth remains unchanged.

The inevitable questions posed in any downturn relate to duration and depth of correction. The global economic climate makes accurate forecasting diﬃcult, but if we examine market fundamentals at the micro level then there is certainly cause for optimism in terms of market recovery. House prices in Northern Ireland have already fallen circa 35% from their peak in 2007. The speed of the correction has been alarming but as the housing market in Northern Ireland was the most heated of any UK region, it was forecast to undergo the deepest correction. On the positive side, the quicker that the market corrects itself, the closer the market moves towards recovery. House prices in Northern Ireland are likely to fall further over the course of 2009, but the worst of the correction is already likely to have taken place.

In the case of new build property, when developer discounts are taken into account, there is unlikely to be any signiﬁcant further price correction. The secondary market has not experienced the same level of correction; it is conceivable that if existing homes on the market are to be sold they will have to adjust to the price base being set in the new build sector. The majority of sellers in the secondary market are not in a position to oﬀer the discounts currently available from developers; as a result many existing homes are likely to be withdrawn from the market, with only those households that have to sell, likely to fall into line with the price base being set in the new build sector.

Many home owners in Northern Ireland remain in a relatively strong position as they have high levels of equity in their homes and are unlikely to see this eroded completely unless things take a dramatic turn for the worse. Only those who entered the market post 2006 are in immediate danger of realising negative equity. The reduction in commodity prices and the dramatic fall in interest rates have eased the financial commitments of existing homeowners and will ensure that the residential market is unlikely to experience the levels of distress that some analysts had predicted in early 2008. Distress levels will ultimately increase on the back of rising unemployment levels, and whilst those ﬁgures may cause alarm, it is important to remember that any rise will be from historically low levels.

Tighter lending criteria has constrained activity within the housing market, but changing sentiment and restoring market conﬁdence is key to any market recovery. Whilst registered interest with estate agents has improved in recent weeks, potential buyers continue to adopt a “wait and see” attitude. There are two principal reasons for this. First is the fear of committing to a market that could fall further. In this respect many of the equity sharing arrangements that protect buyers from the falling market need to be promoted.
Second and probably of more significance, are concerns over job security. As the economic downturn gathers momentum, unemployment levels have risen dramatically, albeit again from historically low levels. Potential purchasers are unwilling to make a commitment if they are fearful for their employment prospects. Whilst this is perfectly understandable and justified, sentiment has also played a key role. The Northern Ireland public have been gripped by recession sentiment, and as a result even those in secure employment positions are affected by mood and are stalling on major financial commitments.

The correction in the Northern Ireland property market will over time bring greater stability to a market that was in danger of self imploding. The competition to secure property at the peak of the market had reached the point of hysteria. Much of the growth in Northern Ireland was fuelled by investors. However, the financial crisis has ensured that lending criteria has been tightened and many of the freely available buy-to-let mortgage packages have been withdrawn from the market. The buy-to-let sector is currently the domain of the equity rich investor and with buy-to-let products in the immediate term likely to be confined to those with substantive deposits; this should relieve some pressure from housing stocks and ease affordability pressures when the market does recover.

5.3 Republic of Ireland Residential Market

The correction in the Republic of Ireland (ROI) housing market pre-dates that of the UK and Northern Ireland. According to figures compiled by the Permanent TSB/ESRI, house prices in the ROI peaked in January 2007 at €311,078. Prior to the downturn the ROI economy had been bolstered by unprecedented house price growth. In the 10 year period from January 1998 to the market peak in January 2007 the average house price has risen €216,533 or 129%. House prices in the late 1990s soared on the back of Ireland’s decision to join the Euro. In the period December 1999 to December 2006 house prices in Ireland increased on average 12.5% pa. (Figure 18).

Figure 18 ROI National Standard Price and Percentage Change

<table>
<thead>
<tr>
<th>Year</th>
<th>Std Price €000s</th>
<th>Percentage Change</th>
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<tbody>
<tr>
<td>Dec-99</td>
<td>143</td>
<td></td>
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<tr>
<td>Dec-00</td>
<td>174</td>
<td></td>
</tr>
<tr>
<td>Dec-01</td>
<td>17.9</td>
<td></td>
</tr>
<tr>
<td>Dec-02</td>
<td>21.3</td>
<td></td>
</tr>
<tr>
<td>Dec-03</td>
<td>182</td>
<td></td>
</tr>
<tr>
<td>Dec-04</td>
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</tr>
<tr>
<td>Dec-05</td>
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</tr>
<tr>
<td>Dec-07</td>
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<tr>
<td>Dec-08</td>
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<tr>
<td>Dec-12</td>
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</tbody>
</table>

Source: Permanent TSB/ESRI

13 Standardised Price.
The increase in house prices in Dublin was even more dramatic, but significantly the correction in the capital lagged that of the rest of the country. The average house price in Dublin peaked in April 2007 at €429,754. In the ten year period from April 1998 to April 2007, coinciding with the peak of the market, the average house price in Dublin increased by €303,175 or 240%. In the period December 1999 to December 2006 house prices in Dublin increased on average 1.3% pa. (Figure 19).

In the view of many leading economists the rate of house price growth in ROI could have been justified up until 2005. It was towards the end of 2005 that evidence began to emerge that the market was in danger of overheating, but rather than undergoing the minor correction that many had anticipated, further relaxation in lending criteria meant that house prices actually increased by a further 16% over the course of 2006. The underlying fundamentals of the market did not support such a growth spurt and it became increasingly likely that the market would endure a much steeper correction than had previously been anticipated.

In January 2007 the standard house price in Ireland peaked at €311,07. The price remained stagnant through February before starting to contract (Figure 20). By the end of December 2008 house prices in the ROI had fallen for twenty-two consecutive months. In that time the standard price has fallen €49,505, to €261,573. This equates to a fall of 15.9% from peak to the end of December 2008. In Dublin the market peaked in April 2007 at €429,754 before experiencing a turbulent period of

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**Figure 19** Standard Price and Percentage Change in Dublin

![Graph showing standard price and percentage change in Dublin](image)

**Source:** Permanent TSB/ESRI

The housing boom in Ireland was driven by a culmination of factors. Firstly there was the transformation from a traditional to service based economy which caused GDP output to double between 1995 and 2007. Employment levels were at a record high, while the economy was bolstered by a young, dynamic and well educated work force. Secondly, there was a strong inward migration into Ireland from 1997 onwards. This along with the changing household demographic, put added pressure on housing stocks, but without question the biggest contributor to the housing bubble in Ireland were low interest rates and the wide spread expansion in credit.
The standard house price in Dublin fell twenty consecutive months to the end of December 2008, at which point the standard house price stood at €351,096. Over the twenty month period the standard house price in Dublin contracted €78,658 or 18.3%.

Prior to the downturn the dramatic growth in house prices had fuelled a construction boom within the residential sector. Between 1998 and 2006, 569,119 new dwellings were completed across the private and social housing sectors (Figure 21). Whilst social housing provision increased periodically from 3,256 in 1998 to 5,208 in 2006, completions within the private sector soared from 39,093 in 1998 to 88,211 in 2006, an increase of circa 126%. To put the magnitude of development activity into perspective, figures compiled by Communities and Local Government show that in the same time period the number of new dwellings completed in England was circa 1,500,000, and yet England has a population more than ten times that of Ireland.

The downturn in the housing market witnessed a major contraction in residential development activity. House completions in the Republic of Ireland, as measured by ESB connections, totalled 48,090 in the eleven months to the end of November 2008 according to figures released by the Central Statistics Office (CSO). Whilst this represents a 33% decline on the same period last year, a much greater deficit had been anticipated. The figures are partly attributable to the lag between development activity and the contraction in market demand with a number of residential schemes which had commenced prior to the downturn being built out. In addition to this, a high volume of completions were single private dwellings, a sector of the market which has been less affected by the ongoing market sentiment. The higher than anticipated figures caused Ulster Bank to revise their completion projection for 2008 upwards from 49,000 to 51,000 (Ulster Bank, 2009).

Whilst completion levels were better than expected for 2008, development activity is anticipated to contract further over the course of 2009 and into 2010, in response to the lack of confidence in the residential market and the lack of underlying demand. Planning permission for residential units in the first three quarters of 2008 totalled 37,431, a decline of...
12,262 on the same period in 2007 when 49,693 residential applications were approved. In addition to the decline in planning approvals, new house registrations, which are the proxy for future completions have fallen dramatically. According to CSO statistics, a total of 12,711 registrations were made in 2008, compared with 37,878 in 2007, a decline of 66%. As a consequence of the fall in planning approvals and registrations, completion levels for 2009 and 2010 are likely to be subdued.

The Ulster Bank Housing Market Update forecasts that completions for 2009 are likely to be around 20,000 units with a further 20,000 units completed in 2010 as the market responds to the overhang in supply (Ulster Bank, 2009). Fiscal incentives meant that in many towns and villages throughout Ireland residential developments were undertaken where underlying population growth did not support the level of housing supply. Estimates suggest there are circa 200,000 housing units vacant throughout Ireland. In a best case scenario, and when market confidence is restored, there is possible demand for about half of these. However, there will remain huge volumes of vacant new build houses/apartments in locations were there is simply no underlying demand. The solutions to the overhang in supply in these areas remains a source of debate, but what these developments highlight is that much of the residential boom in Ireland was driven not by housing need but by financial gain.

There is a tangible lack of confidence in the Irish housing market at present. On the positive side the ongoing fall in house prices have eased affordability enabling first time buyers to enter the market. The additional tax relief granted to first time buyers in the recent budget, which extended mortgage interest relief from 20 to 25% will act as a further incentive and in tandem with the reduction in interest rates mean that affordability levels have returned to 1990s levels (Ulster Bank, 2009).

In spite of the fiscal stimulus, sentiment remains downbeat, while the general tightening of lending criteria means that larger deposits may be required. The transition from 100% mortgages will take time to filter through into the market but for many, particularly first time buyers, this will prolong entry into the property market. The Irish Government views the mobilisation of first time buyers as fundamental to stimulating market activity.
An equity share scheme has been introduced, in which government take an equity share in properties purchased and in an attempt to overcome the gridlock in the banking system first time buyers will be able to secure mortgage funding through the Housing Finance Agency.

Figures compiled by the Irish Banking Federation (IBF) show an ongoing increase in first time buyer's share of the market, from 15% in the first quarter of 2008 to 20% in the third quarter. Overall lending however remains subdued, IBF figures highlight that 27,937 new mortgages were issued in the third quarter of 2008, a decline of 31.8% on the same period in 2007. Whilst tighter lending has acted as a constraint, restoring market confidence will be key to any housing market recovery. At the moment perspective buyers anticipate lower prices. Their pessimism is compounded by the outlook for the economy and the labour market and until those expectations change perspective purchasers will not be willing to enter the market.
Towards the end of the third quarter of 2007 conclusive evidence began to emerge that the longest cycle of growth in the history of the UK commercial property had come to an abrupt end. The IPD Quarterly property index posted negative returns for the first time since its inception in 2000. The slowdown although forecast has been more dramatic than expected and has been extenuated by the ongoing turmoil within the global financial system.

Prior to the downturn the UK commercial property market had enjoyed more than fourteen years of robust performance in terms of total return (Figure 22). Following on from the previous property crash in the early 1990s the commercial property market recovered strongly achieving total returns of 20.2% in 1993. From the period of recovery up until end the end of December 2006 commercial property in the UK posted double digit returns in eleven out of the fourteen years.

In the period 1992-2006 property was the top performing asset class in the UK outperforming both equities and gilts over 3, 5, 10 and 15 year timeframes (Table 3), whereas, theory suggests that property returns lie between those of equities and gilts. Property was also the least volatile investment option over the 15 year timeframe. Risk measured as the standard deviation in total return for property in the period 1992-2006 was 6.1% compared to 15.8% and 10.2% for equities and gilts respectively.

The relatively robust performance of the commercial property market in the UK between 2004 and 2006 was driven by strong capital growth (Figure 23). Between the second quarter of 2004 and the final quarter of 2006
commercial property in the UK appreciated by 32.9%. The capital returns being achieved attracted a strong weight of money into the real estate sector, most notably from investors outside the UK, through limited investment opportunities and the intensity of competition added to the price inflation. In the three months to the end of December 2005 commercial property in the UK appreciated by 4.8%.

The inflow of Irish investment was a prominent feature of the UK commercial market in the period 2004 to 2006. Buoyed by the phenomenal economic growth in Ireland and keen to diversify their investment portfolios, Irish investors were the dominant ‘foreign’ investor grouping in the UK commercial property market between 2004 and 2006 (Figure 24). Substantive levels of Irish investment continued to flow into the market until the end of 2006, but by the first quarter of 2007 the level of investment started to ebb and by the second quarter of 2008, Irish investors started to withdraw from the market. There was an outflow of more than £129 million of Irish investment in April 2007 (Capital Economics, 2007).

In addition to the major inflow of foreign investment, the strong performance of property relative to equities and fixed income caused a dramatic shift in the weight of capital towards real estate within the UK. There had been a dramatic re-weighting of capital to the real estate at the start of the decade following the collapse of the dot-com bubble in 2001. This trend continued throughout the growth cycle. Research by O’Roarty and Hobbs (2007) suggests that the inflow of capital brought a new investor audience to the property sector. Unfamiliarity with the asset class meant that initial investment activity had been largely confined to prime income producing assets, but as their experience of the sector grew and the competition for core style investment opportunities intensified the appetite for risk among this investor grouping increased, motivated by the prospect of enhanced levels of return.

The search for higher returns acted as a catalyst for financial innovation and contributed to a rapid growth in securitised activity and in the development of increasingly sophisticated property investment vehicles. In Europe the unlisted property funds sector more than doubled from 205 in 2000 to 427 at the end of 2005. In this period the GAV of property held by the unlisted funds sector increased from

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**Figure 22**  All Property Total Return (1992 - 2006)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Return (%)</th>
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</thead>
<tbody>
<tr>
<td>1992</td>
<td>-1.6</td>
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<tr>
<td>1993</td>
<td>11.9</td>
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<td>3.6</td>
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<tr>
<td>1996</td>
<td>16.8</td>
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<td>1997</td>
<td>11.8</td>
</tr>
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<td>1998</td>
<td>14.5</td>
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<tr>
<td>1999</td>
<td>10.5</td>
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<td>2000</td>
<td>6.8</td>
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<tr>
<td>2005</td>
<td>18.3</td>
</tr>
<tr>
<td>2006</td>
<td>19.1</td>
</tr>
</tbody>
</table>

**Source:** Investment Property Databank (IPD)
<table>
<thead>
<tr>
<th>Year</th>
<th>All Property</th>
<th>Equities (All Share)</th>
<th>UK Bonds</th>
</tr>
</thead>
<tbody>
<tr>
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<td>-1.6</td>
<td>20.5</td>
<td>18.4</td>
</tr>
<tr>
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<td>3.6</td>
<td>23.8</td>
<td>19.0</td>
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<tr>
<td>1996</td>
<td>10.0</td>
<td>16.7</td>
<td>7.7</td>
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<td>16.8</td>
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<td>15.0</td>
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<td>11.8</td>
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<td>19.4</td>
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<td>2003</td>
<td>10.9</td>
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<tr>
<td>2004</td>
<td>18.3</td>
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<tr>
<td>2006</td>
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<td>16.8</td>
<td>-0.1</td>
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</table>

**Annualised Over:**

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<th>Equities (All Share)</th>
<th>UK Bonds</th>
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</thead>
<tbody>
<tr>
<td>3 Years</td>
<td>18.5</td>
<td>17.2</td>
<td>4.6</td>
</tr>
<tr>
<td>5 Years</td>
<td>15.2</td>
<td>9.9</td>
<td>5.2</td>
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</tr>
<tr>
<td>15 Years</td>
<td>12.0</td>
<td>11.7</td>
<td>8.9</td>
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**Standard Deviation Over:**

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<th>Equities (All Share)</th>
<th>UK Bonds</th>
</tr>
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<tbody>
<tr>
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<tr>
<td>15 Years</td>
<td>6.1</td>
<td>15.8</td>
<td>10.2</td>
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</table>

€133 billion to €194 billion (Figure 25). In the region of €78 billion of this investment was committed to the commercial property market in the UK.

Trends within the unlisted property funds sector, in particular the dramatic growth in value added and opportunistic investment funds\textsuperscript{14} emphasises the changing dynamic of the commercial property investment market in the UK during the growth cycle, notably the shift from income driven investment to one

\textsuperscript{14} Property fund investment styles comprise core, value added and opportunistic. The INREV classification is based on a number of parameters including the target IRR and the gearing ratio.
Figure 23  All Property Income Return and Capital Growth (Q2, 2004 – Q4, 2006)

Source: Investment Property Databank

Focused on capital growth. This shift reflected a wider manifestation of the generalised ‘search for yield’ within investment markets more generally arising from low interest rates and wider macroeconomic and monetary stability.

Between 2001 and 2003 the Bank of England base rate fell from 6% to 4%, while the five year swap rate, the conventional measure for commercial property lending fell from 6% to 5%. Even when allowing for a 1.5% to 2% lending margin over base, given that property yields stood at between 7% and 8% at this point (Figure 26) debt-backed property investment was self-financing.

Figure 24  Net Investment by type of foreign buyer £m per quarter (Q1 2004 – Q2 2007)

Source: Capital Economics (2007)
Investors were able to exploit the prevalence of the significant positive yield gap between both short term and long term interest rates and real estate caps rates. The margin between property returns over the cost of debt enabled investors to service the debt through income returns and contributed to the wide spread increase in the use of gearing to enhance investment performance. The low cost of debt meant that gearing played an important role in enhancing the performance of UK commercial property during the boom cycle. Indeed, the interaction between the low cost of debt and the level of gearing during the growth cycle made a significant contribution to overall performance and explains why highly geared investors were able to outperform during the growth cycle. Performance enhancement is greatest when the cost of debt is lowest and the loan to value ration of such debt is highest (Table 4).

Whilst gearing has the potential to enhance investor returns it also exposes the investor to greater levels of risk. Rising interest rates, or in the case of the current market correction, falling returns do not merely erode the effect of gearing, they potentially expose the investor to negative returns. In general, whilst stress levels in the commercial sector are not of the same magnitude as those in the residential sector, the greatest levels of distress are amongst highly geared investors.

**Figure 25**  Number and Value of European Non-listed Real Estate Funds

![Number and Value of European Non-listed Real Estate Funds](image-url)

*Source: INREV (2005)*

The widespread availability and use of debt during the growth cycle meant that lending to the commercial property sector increased dramatically. Research undertaken by De Montfort University shows that loans amounting to £66.1 billion were approved for commercial property in 2005, while in 2006 the value of loans approved stood at £81.1bn. The aggregated value of outstanding debt secured on commercial property at year end 2006 amounted to £172.1 billion with a further
£18.2 billion of debt securitised into the CMBS market (De Montford University, 2006).

The growth in lending meant that banks and other key lending institutions exposure to the property sector increased dramatically between 2001 and 2006 (Figure 27). Commercial property lending at the end of 2006 accounted for over a third of lending to private non-financial companies and 10.9% of all outstanding debt in the UK (Capital Economics, 2007).

In addition to widening their exposure to the commercial property sector during the growth cycle, banks and other key lending institutions became increasingly willing to absorb greater levels of risk in order to realise higher rates of return. This shift in risk tolerance is best illustrated by the dramatic increase in lending for speculative development between 2000 and 2006 (Figure 28). In 2000 development lending was largely confined to fully pre-let developments with no borrowing allocated to speculative development projects, but in 2005 and 2006, lending to speculative development projects accounted for approximately 41% of all commercial development funding (De Montford University, 2006).

The availability of credit has been a key driver of commercial property growth in the UK over the last decade. Without it property markets would have seized up. Bank debt outstanding to the commercial property sector at the end of June 2008 amounted to £232.1 billion, while deposits held at banks amounted to just £33.8 billion. The Bank of England Credit Condition Survey for the first three quarters of 2008 confirms that credit availability to the commercial real estate sector was reduced with loan approval rates down significantly over the first and second quarters of 2008 compared to figures for the same period in 2007. Compounding the problem from the commercial property sector perspective, a number of institutions have withdrawn from the market, so lending opportunities are limited.

The lack of credit has certainly compounded the downturn in the commercial property market but clear signs had started to emerge that the market was overheating and a correction had been anticipated by many analysts, even though many investors were unwilling to accept such forecasts. IPF forecasts in the period 2004-2006 had shown expectations at the start of each year of modest returns based on valuations, whereas the outcomes were
exceptionally high. The underlying market fundamentals could not justify the eventual strength of the up-phase much of which was the result of financial engineering (Peterson, 2007).

Conclusive evidence in the third quarter of 2007 suggested that the much anticipated correction in the UK commercial property market had started. The IPD Quarterly property Index posted negative returns for the first time since its inception in 2000 (Figure 29). At the end of September 2007, all property total return was calculated at -1%, marking the beginning of five consecutive quarters of negative growth. The most dramatic downturns were experienced in the fourth quarter of 2007, as the fallout from the sub-prime crisis began to transpire, and the fourth quarter of 2008 as the implications of the Lehman Brothers collapse began to manifest itself on the wider investment markets.

All property income returns have continued to grow throughout the downturn in the cycle due to lease structures, but overall total return has been down due to the dramatic

### Table 4 Effect of Gearing on Return on Equity

<table>
<thead>
<tr>
<th>Cost of Debt</th>
<th>Gearing</th>
<th>Unlevered IRR</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>6%</td>
<td>8%</td>
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<tr>
<td>4.25%</td>
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<td>8%</td>
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<tr>
<td></td>
<td>60%</td>
<td>9%</td>
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<td></td>
<td>70%</td>
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<td></td>
<td>80%</td>
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<td></td>
<td>90%</td>
<td>8%</td>
</tr>
</tbody>
</table>

Source: RREEF Research (2007)
write-downs on the value of commercial property. As a result capital growth has fallen markedly. Since the third quarter of 2007 to the end of the fourth quarter of 2008 the aggregate capital return as measured by the IPD Quarterly Index was -40.1%. The steepest decline over a single quarter was in the fourth quarter of 2008 when capital returns were measured at -14.4% (Figure 30).

The dramatic drop off in property values has caused yields to soften across all property types (Figure 31). Initial yields have moved out from 4.6% in the third quarter of 2007 to 5.9% in the third quarter of 2008, a year on year change of 1.3%. Over the same time frame equivalent yields have moved out from 5.5% in the third quarter of 2007 to 7.1% in the third quarter of 2008.

Figure 27  Bank lending to commercial property (Q4 1987 - Q1 2007)

![Graph of Bank lending to commercial property](image)

Source: Capital Economics (2007)

Figure 28  Allocation of Property Development Lending (2000 - 2006)

![Graph of Allocation of Property Development Lending](image)

Source: De Montford University (2006)
At a sector level, retail properties have undergone the most marked correction (Figure 32). All property total return for the retail sector was -1.8% and -8.1% in the third and fourth quarters of 2007. Total return for the retail sector was negative in all four quarters of 2008. Aggregated total return for the retail sector over the year was -16.9%. Total return for the office properties in 2008 stood at -24.1%, while in the industrial sector total return for 2008 stood at -22.3%

The negative total return is attributable to the fall in capital values as income returns across all three sectors of the property market have remained positive through the down cycle to the end of 2008 (Figure 33). Over the course of the downturn rental growth has been weakest within the office sector. The office sector which is predominantly based in London has a high dependence on the banking and related financial services sectors. Given the ongoing turmoil within the financial sector vacancy rates are expected to rise and there is also likely to be a marked increase in sub-lets. On the positive side there is not the level of over development that characterised the previous downturns so when the economy does pick up the office sector should come back quite quickly.

Rental growth in the retail sector is also expected to be “lacklustre” for the foreseeable future, with some negative rental growth forecast for 2009 and muted growth until 2011. At this time in the property cycle investors are reminded that occupiers are the real drivers of growth. Retailers’ profits margins are being squeezed and they will look for ways of easing that pressure. Increasing void rates are inevitable over the course of 2009 and into 2010 given the dramatic increase in business failures. It is anticipated that retailers will become much more selective in choosing their locations, as a consequence, existing prime schemes dominant in their market will outperform.

The uncertainty in the retail market could not have come at a more unfortunate time with an unprecedented wave of recent shopping centre openings taking place over the last two years and a number of others in the development pipeline (Blackman, 2008). The supply of shopping centres is at its highest level for twenty years with the lag between
the development cycle and market demand likely to contribute to an overhang in supply in the short term. When the current schemes are completed there will be nothing in the development pipeline until at least 2011 and no actual delivery of development on any scale until 2013.

Given the favourable exchange rate it was anticipated that large volumes of foreign capital would flow into the UK commercial property market, particularly from Germany and from Sovereign Wealth Funds. There was an increased level of interest particularly among the Sovereign Wealth Funds but this has not been translated into investment, again because there is a feeling that the market is not at its bottom, but also because of the fact that the Sovereign Wealth Funds were heavily invested in Wall Street and have had to absorb

Source: Investment Property Databank (IPD)
huge losses. The Sovereign Wealth Funds also tend to target the trophy investment and in that respect the types of stock they are looking for may not yet have entered the market. The level of German interest has receded in the wake of the economic contraction in the German economy.

The commercial sector has not endured the same levels of distress as the residential sector and, in the main, income levels have been in a position to service loans. This position could change as void rates are expected to rise dramatically if the recession is elongated. That is a concern but perhaps of greater significance is the fact that due to the dramatic fall in property values many investors are in danger of breeching what two years ago were considered conservative loan-to-value covenants with their banks. This could possibly spark a fire sale of assets and a number of infrequently traded properties could even enter the market.

Figure 32  Total Return by Sector (Q3 2007 - Q4 2008)

Source: Investment Property Databank (IPD)

Figure 33  Income Return by Sector (Q3 2007 - Q4 2008)

Source: Investment Property Databank (IPD)
An innovative alternative to the bank selling the asset is the growth in equity funds that are willing to buy the debt from banks were there has been breech of covenant where the bank has lost faith in the borrower. There is an estimated £76 billion of commercial property loans which need to be refinanced before 2010 so banks and investors need to explore innovative re-financing solutions if the pending crisis is to be averted.
Historic reviews of financial crisis can provide invaluable lessons as to how the current economic crisis might be resolved. Ultimately a financial crisis of this nature could be remedied by injecting large volumes of public sector money into the banking system. This, along with early and decisive government action on the recapitalisation of banks and the acquisition of troubled debts, could minimise the cost to the tax payer and the damage to the economy over the longer term.

This is best illustrated by the response of the Swedish and Japanese governments following the collapse of their respective banking systems in the early 1990s. Sweden acted swiftly, nationalising banks on the verge of collapse following the property market crash, allowing its economy to recover fairly swiftly. Japan, by contrast, took over a decade to recover from a financial bust that ultimately cost its tax payers a sum equivalent to 24% of GDP (The Economist, 2008c).

In the opinion of Zanny Minton Beddoes the global economy is in its worst state since the Great Depression of the 1930s. Following the stock market crash of October 1929 it took the US government three years to launch a series of measures aimed at restoring confidence. In the interim, America endured the worst economic collapse in its history. Thousands of banks failed, the economy shrank by a third and unemployment rose to 25%. The Great Depression, like the credit crunch of 2007-2008 was an economic crisis built out of a global financial crisis. The Wall Street collapse, much like the sub-prime mortgage debacle acted as a trigger, but it was the demise of the banking system that destabilised the international monetary system.

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Zanny Minton Beddoes is Chief Economist at The Economist.
The collapse of Credit-Anstalt, Austria’s biggest bank in 1931 produced something akin to the current scramble for banks to hoard cash. The Austrian Government blocked all but essential foreign exchange transactions, locking £300 million of foreign deposits inside its borders. All over Europe banks rushed to safeguard their assets. Just as had previously happened in the US, Europe was starting to store capital – the liquidity crisis was spreading. Every country looked after itself – Britain led the exodus from the Gold Standard – precipitating the collapse of the International Monetary Framework that had held the global economy together (Duncan-Ross, 2008). For many the legacy of the Great Depression lingered until the 1950s. Old certainties were gone and the international monetary system had been torn up and would have to be re-created – could the current crisis have similar consequences?

There are obvious parallels. Then as now, the epicentre of the financial crisis has been in the US and as with the Great Depression, governments around the world have intervened to try and restore market confidence and protect national economies. However, unlike the 1930s, the impact on international economic conditions has been much more profound. There are two principal reasons for this – the globalisation of financial markets and the fact that, unlike the 1930s modern economies are driven by credit – when the credit supply is cut off, economic growth stagnates. The developments in securitisation over the last two decades were supposed to avert such a liquidity crisis by ensuring that risk was diversified across international borders – but while the risk was dispersed, it was not reduced. Instead a new kind of risk was created – uncertainty about the location of risky assets. These assets have subsequently emerged to damage the economies of the world’s richest nations.

Unlike the position in the 1930s more decisive action has been taken in this instance to avert such widespread collapse within the global banking system. National governments in conjunction with central banks have understood the potential gravity of the situation and have acted swiftly, injecting capital into the banking system and protecting national interests. In America, the Federal Reserve and Treasury between them nationalised mortgage giants Fannie Mae and Freddie Mac, took over AIG the world’s largest insurance company, extended government deposit insurance to $3.4 trillion in money market funds, temporarily banned short selling and has pledged to take $700 billion of toxic mortgage-related assets onto its books.

In Europe, action has been equally monumental. The UK government nationalised Northern Rock and in October of 2008 injected more than £37 billion into the British banking system as part of a package designed to restore stability and safeguard distressed financial institutions including HBOS and the Royal Bank of Scotland and Lloyds TSB. On top of that banks could generate an additional £25 billion in capital in exchange for preference shares. Some £100 billion was made available in short terms loans from the Bank of England on top of an existing loan facility worth £100 billion, with up to £250 billion in loan guarantees available at commercial rates to encourage banks to lend to each other.

While the first phase of the UK’s support plan was designed to restore stability to the banking system, the second phase, announced in January 2009, has been designed to stimulate lending. The second phase consists of three components. An insurance element which guarantees bank loans for corporate and consumer debt, a mandate issued to state owned Northern Rock to increase lending, and new power for the Bank of England, allowing the institution to buy up to £50 billion in bank assets. The second phase of the bank bail out plan was necessary because the initial injection in October was used by the banks to cover bad debt provisions and shore up capital reserves.
The three core elements of the UK’s support plan - liquidity support, inter-bank lending guarantees and recapitalisation of distressed banks - have become, with national variations to take account of differing systems, the European standard. A Pan-European response to the financial crisis was agreed by the fifteen Eurozone economies in Paris in October 2008. Under a 13-point draft action plan, the European Central Bank will intervene in the financial turmoil to boost liquidity with Eurozone governments underwriting bank debt until the end of next year. Unlike the US model, the European package will ensure that systemically important financial institutions will not be allowed to collapse. Despite these extraordinary government interventions market and liquidity risks have risen. Funding and liquidity strains remain high as reflected in persistently wide interbank spreads and liquidity premiums (IMF, 2008b). The solutions developed thus far have not been the instant remedy that many analysts had expected.

In analysing the current financial crisis and contrasting it with previous incidents of financial stress to help identify key characteristics of any rescue package, two things become immediately apparent. The financial crisis is a global phenomenon, and it is reasonable to assume that the only way of addressing it is to develop global solutions. Global financial markets would benefit from a co-ordinated international response from those countries affected by the liquidity crisis. This would be the most effective as it would ensure consistency and cohesion of a response on a much grander scale than previously witnessed whilst also protecting the interests of national economies.

In the immediate aftermath of the sub-prime crisis in the US, government leaders around the world appeared to be in denial about the potential implications for their respective economies. As the fallout from the crisis broadened and intensified, the global nature of the crisis became more apparent. Mounting losses, falling asset prices and the global economic downturn had cast serious doubts over the viability of many high profile financial institutions, prompting governments to intervene to protect national interests. Whilst these interventions may have had the desired effect, in that they help safeguard many systemically important national intuitions they have largely failed to restore market confidence.

The IMF World Economic Outlook (2008) suggests that the reason why interventions by national governments have failed to restore confidence in the markets is because they have not addressed the widespread nature of the underlying problem. Indeed there are examples were actions taken to protect self interest by national governments has been to the detriment of neighbouring economies. In what is a global financial crisis government leaders must recognise that their decisions will have international consequences. The world’s largest economies have all been affected by the financial crisis and therefore it is feasible that a generic solution can be found. This should also be easier to implement and manage than implementing large numbers of individual national responses. International collaboration will be essential if a full blown and protracted global recession is to be avoided.

National leaders have now recognised that while the crisis may have originated in the US, an economic crisis does not respect national borders and that the best way to resolve the ongoing crisis is through international collaboration. Interest rates have been reduced in the UK, US, the Eurozone, Canada, Switzerland, China, Japan and South Korea representing a collaborated effort to tackle the slowdowns in the “real” global economy. It is

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16 German Finance Minister Peer Steinbruck declared in September 2008 that America was the source and focus of the crisis - before heralding the end of its role as the financial superpower.
important to remember that the credit crunch is principally a financial phenomenon and it follows that until confidence and liquidity are restored to the global money markets attempts to revive flagging economies will at best likely be palliative measures. This explains why the most dramatic round of interest rate cuts in history have had such a relatively limited impact in reviving economic conditions.

The second lesson that can be taken from evaluating previous incidents of financial stress is the need for swift and decisive intervention in order to prevent a deeper and more protracted downturn in global economic conditions. Delayed decision making heightens uncertainty – uncertainty fuels panic which in turn manifests itself in the volatility which has characterised financial and stock markets around the world over the course of 2008. The longer policy makers take in addressing the crisis the more damage will be done, and as a consequence solutions will have to be even more radical.

Policy makers around the world have absorbed the lessons of previous banking crisis in Japan and Scandinavia and have responded – albeit belatedly in order to attempt to avert a complete meltdown of the global banking system. Unprecedented intervention by governments and central banks have helped stabilise bank balance sheets and prevent further high profile casualties. Yet further interventions will be required if confidence and liquidity are to be restored to the financial markets.
Key Point Summary

- Resolving the greatest financial crisis since the great depression of the 1930s will require collaboration amongst international leaders. Fundamental decisions will have to be taken in terms of designing and implementing industry rescue packages and corporate bailout plans. The volume of capital required to restore stability and get the global financial markets functioning again will likely be of a magnitude not previously experienced.

- Historical reviews of financial crisis can provide insights and can serve contemporary policy development. It is important, however, to acknowledge that the scale of the current financial crisis is unprecedented. The implications have been much more profound than any previously witnessed and are being felt all around the world – a consequence of the increasingly open global financial markets.

- The extraordinary events of the last eighteen months call for exceptional courses of action. Resolutions will have to be efficiently appropriate and radical, effectively communicated and introduced in a co-ordinated manner. This will maximise their impact and help restore stability to global financial markets. But perhaps most importantly actions need to be decisive. In an environment overwhelmed by uncertainty, indecision manifests itself in fear.

- In the absence of a decisive and co-ordinated global response, global unemployment has rocketed and there has been a dramatic increase in the numbers of business liquidations, including a number of prominent long established brand names. This trend is set to continue throughout the worlds developed economies over the course of 2009 unless decisive action is taken by world leaders on a rescue package that will enable the international money markets to start functioning again – time is something many businesses do not have.
Analysing the global financial crisis in terms of the impact on the residential and commercial property markets in the UK and Ireland has required understanding of the synergies and connectivity that exist between real estate and financial institutions and between the financial markets and the economy. In undertaking that analysis it has become clear that an adverse feedback loop has developed between the financial markets and the real economy and that the ongoing uncertainty has spread to affect the wider investment markets, including real estate. It is important, therefore, to understand that the current downturn in the property market is not simply a cyclical correction of the asset class – that had commenced prior to the financial crisis. Instead what requires resolve is the complete dysfunction of the global financial system that has consequently spread to the real economy, and which in turn has exacerbated the downturn in property markets globally.

The collapse of the sub-prime mortgage market in the US triggered the crisis of confidence in the global financial system by exposing a widespread mis-pricing of risk within capital markets. As a result financial markets abruptly lost two ingredients central to their vibrancy; confidence and trust. Until confidence is restored to the banking system financial markets will not start functioning again. Government interventions in the banking system were necessary to stabilise the system and preserve the interests of systemically important financial institutions. The initial series of interventions by governments and central banks were vindicated in that they recapitalised the banks and prevented complete melt down of the global financial system. However, subsequent interventions intended to stimulate lending are destined to fail for two principal reasons.

Firstly, concerns continue to persist about the...
financial stability of many banks and other key financial institutions within the global money markets. Those concerns stem from the level of institutional exposure to so-called toxic assets. In January 2009, the IMF estimated banking losses from toxic assets globally to be in the region of US$2.2 trillion, a figure that had been revised upwards from US$1.4 trillion in October 2008. Globally, banks have already written down around half of those losses. The IMF highlights that UK and European banks have 75% as much exposure to US toxic debt as American Banks themselves. The US banks have thus far absorbed write downs of $738bn, the response of European banks has been much slower and thus far write downs have totalled just $294 billion. On top of this European banks have $1,600 billion exposure to Eastern Europe, increasingly viewed as Europe’s sub-prime debacle (Evans-Pritchard and Wethersfield, 2009).

There is agreement among the banks that the financial crisis is likely to persist until all losses have been crystallised. At the current rate of de-leverage this could take several years. Throughout the course of this investigation participants from the banking sector were unanimous in their view that confidence will only return to financial markets once toxic assets have been stripped from the system. The most effective management of toxic assets remains a source of debate but what is clear is that radical action is required at the global level if the financial markets are to start functioning again.

There are fundamentally four options available to governments in terms of how they resolve the problem of toxic assets. The first is for government to purchase toxic assets from the banks and set up a so-called “bad banks” into which all toxic assets would be deposited. This would enable banks to remove toxic assets from their balance sheets and reduce their need to hoard capital in anticipation of further write downs. The bad bank model was successfully introduced in Sweden during the Scandinavian financial crisis in the early 1990s and is the preferred option of the German government in terms of how the banking system should be cleansed to resolve the current impasse in the financial markets. The complexity in implementing the bad bank model lies in the valuation of toxic assets and in the development of an agreed international protocol for valuations to prevent protectionism at national level.

The second option would be for governments to offer a guarantee – after a first loss by the banks of the toxic assets. This is the model proposed by the UK government in their Asset Protection Scheme. A further option, as proposed by the US Treasury would be for private purchase of the assets with a government guarantee. This would involve the removal of the toxic assets from the balance sheet of banks, while providing government guarantees on their future value. The final option would be to nationalise the banks with the view to returning them to private ownership once they have been cleaned up.

In Europe, the European Commission are deliberating the best approach to take, but it is likely that a suite of options will be available, with countries given the option of adopting the model that best meets their specific need. The insurance backed schemes as proposed in the UK and the US on initial inspection seem overly complex and lack transparency, indeed when the US scheme was announced the financial markets plummeted. In an industry that is rife with uncertainty and indecision there is a need for clarity and simplicity if confidence is to be restored. The bad bank model, whilst not ideal – there are no ideal options to resolving the current crisis – would help restore confidence in the system. It would provide the reassurances that toxic debt had been removed from bank balance sheets as it did in the Scandinavian banking crisis, although that process was simplified.
by the fact their banks were nationalised. The insurance backed schemes being proposed by the US and the UK run the danger of creating Japanese style zombie banks - never properly restructured and perpetuating a credit freeze (Roubini, 2009).

The second major issue constraining lending is the contraction in the global economy. Economic recessions are not conducive to enhanced lending as the risks of default are dramatically enhanced. As a result the appetite for lending, even among banks that are in a position to lend has been greatly reduced. Governments do not have the power to force banks to lend but they have an onus of responsibility to create economic conditions that are conducive to lending. Within the global context that responsibility will fall to the economic ‘superpowers’ and in particular the G8 group of countries.

For all the criticism that the US has received throughout the current financial crisis, it remains the nation to which the world has looked for solutions. Reviving the US economy is of course fundamental within the global context and in this respect the newly elected Obama administration have been proactive, advocating a Keynesian styled intervention to fund infrastructure provision. The $787 billion stimulus package which was passed by US Congress in February of 2009 includes a wide array of fiscal measures, as well as a $39 billion allocation to roads and transit, $32 billion for energy, $9 billion for clean water and $20 billion for public schools. The Obama administration is keen to ensure that the measures proposed are implanted swiftly, however, it will take some time before the affects of the stimulus package impact on the real economy. Fellow members of the G8 group have announced similarly styled interventions, aimed at reviving their economic prospects. The UK has introduced a serious of fiscal measures designed to stimulate economic activity as well as enhanced public sector spending on infrastructure provision to include roads, schools and social housing.

The European Commission has also published an economic recovery plan designed to promote a Pan-European response to the contraction in the global economy. The first pillar of the plan includes proposals for a €200 billion budgetary injection (1.5% of GDP) to enhance purchasing power, boost demand and stimulate confidence (European Commission, 2008). The second pillar of the recovery framework emphasises the need for direct short-term action to reinforce Europe’s competitiveness in the long term and sets out a comprehensive programme to direct action to “smart” investment thereby ensuring that Europe has the necessary skill sets to compete within the global market place following the economic recovery.

The Irish Government has developed a recovery plan in line with that of the European Commission which will promote innovation as well as the development of renewable energy sources. The Irish economy may not be of sufficient magnitude to influence global conditions, but there is an onus on the Irish government to position the country so that it is well placed to benefit from the global economic uplift when it arrives. Central to the Irish Government’s recovery proposal is the need to enhance the competitive position of Ireland. This will be achieved through a competitive devaluation of wages.

Ireland is a classic example of an export economy and does not have the levels of internal demand to sustain economic growth. However, during the economic boom the Irish economy had become increasingly dependent on the construction and service sectors. This meant that the economy became increasingly indigenous. The traditional wealth of Ireland has been built on its export market and many leading economists feel that Ireland must look to enhance its export position to facilitate an economic recovery. Enhancing the overall
competitiveness of the Irish economy to ensure it is in a position to contend in the global market place will be essential to its long term economic prosperity.

Northern Ireland’s short term economic position is not as precarious as that of the Republic of Ireland. Personal consumption in Northern Ireland during the boom cycle compares favourably to that of the Republic of Ireland while the high volume of public sector and public sector related employment provides a natural buffer in the current economic climate. This is complemented by the favourable exchange rate and reduced VAT levy which has fuelled a dramatic increase in cross border trade. However, Northern Ireland is not immune to the consequences of the global financial crisis. Unemployment levels have risen dramatically, particularly within the construction and manufacturing sectors leading to increased calls for the Northern Ireland Executive to take decisive action to revive economic prosperity.

The Northern Ireland Executive’s ability to influence the economic position of the region is constrained by a lack of fiscal and monetary powers. However, there is an onus of responsibility on the NI Executive to develop an economic recovery plan to ensure that Northern Ireland is well positioned to benefit from the uplift in the global economy when it arrives. The European Commission’s economic recovery plan highlights the need for smart investment in energy efficiency and energy conservation and in the development of clean technologies to boost sectors like the automobile and construction industry. The NI Executive needs to ensure that Northern Ireland has the necessary skill sets to compete effectively in these global growth sectors.

In this respect the contraction within the construction sector in Northern Ireland should be taken as an opportunity for up-skilling within the industry and to enhance awareness of the concepts of sustainable development. All too often short term objectives have prevailed over long term strategic development within the construction industry. The long term direction of the construction industry at a global level will see greater emphasis placed on the development of greener, energy efficient buildings, and in the application of sustainable methods of construction – the construction sector in Northern Ireland needs to be in a position to respond to that challenge.

In terms of the wider economic response, the NI Executive needs to enhance its understanding and promote wealth creation within the local economy. The dependency on the public sector, whilst acting as a buffer through the current downturn, needs to be addressed over the long term. The Northern Ireland economy continues to be overly dependent on handouts from the UK treasury, but that resource base is depleting and Northern Ireland needs greater resolve to become financially independent. This message has been reiterated since the instatement of the NI Executive but more decisive action is required to make this vision a reality.

In the immediate term the downturn in the property market presents an opportunity for the NI Executive to bring forward infrastructure projects and to enhance the delivery of social housing provision as this will help relieve some of the stress currently being endured within the construction industry. All too often proposals have taken too long to implement, delaying their impact on the real economy, while the lack of clear and decisive direction from the Executive has compounded the uncertainty and fuelled the downbeat sentiment. The UK Government is expected to exert pressure on nationalised or part nationalised banks to start lending to the construction industry in a bid to help kick start the economy and a consensus exists among the wider property development industry that any lending that is likely to be forth coming will be made available for
regeneration or social housing provision.

Restoring confidence to the financial markets and stimulating economic activity will be central to the property market recovery. In terms of the residential markets there is a growing problem surrounding negative sentiment and the widely held belief that house prices are likely to continue to fall. The lack of confidence in the market is compounded by the rising levels of unemployment and the fact the repossessions have increased. In the midst of a deepening recession, concerns over job security are uppermost in the minds of potential buyers and for that reason they are reluctant to commit to the market – even when taking into account the fact that developers have offered substantive discounts on new build property.

In the commercial markets, the retail sector has borne the brunt of the downturn but this was to be expected as the retail sector is the most directly affected by the recession and the contraction in consumer spending. The office and industrial sectors are expected to endure similar levels of distress. The office sector is likely to see a significant rise in vacancy rates due to the contraction in the banking sector but to nowhere near the levels of the last downturn in the early 1990s.

In truth, the downturn in the UK commercial property market has created significant investment opportunities, in the fourth quarter of 2008 equivalent yields for all property had moved out to 8.2%. In tandem with the historically low interest rates the market could be reasonably expected to attract substantive levels of investment. This hasn’t yet materialised for a number of reasons. Firstly there is a consensus that the market has further to fall. Property derivative markets point to a peak to trough of some 55-60%, so if this is taken as a proxy then the commercial market has yet to reach the floor.

Secondly, there is a lack of lending opportunities. Currently only six UK based banks, two of which are German, are in a position to lend on big ticket transactions. Those banks have dramatically increased their lending margins. Therefore, whilst the LIBOR rate and five year swap rates might have fallen lenders are looking between 300 and 400 basis points over base and in that respect borrowing money is not as cheap as it may seem.

However, investors who have the capital resources to invest are positioning themselves to re-enter the market. This includes a number of institutional investment property funds who had withdrawn from the market pre-2005 when they identified that the market has overheated as well as investors who had been priced out of the market during the boom by highly geared investors. British Land and Land Securities have also enhanced their liquidity positions through asset disposals. Land Securities raised £755.7 million through rights issues in the equity markets, putting them in a strong position to purchase distressed stock if it fits into their overall strategic objective. Investment activity should pick up over the third and fourth quarters of 2009 – for many the figures are already starting to stack up, but a market recovery is unlikely until 2012-2013.
9.0 References


Oswald, A. (2009) We’re going back to work - but will we be sitting comfortably? The Times (January 2009).


