

# **Strategic Business Comment – Issue 1**

## *“Ireland’s Mounting Debt Problem”*

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## Summary

- **Private Sector Credit has virtually doubled in the last three years and the rate of growth continues to accelerate. The indebtedness of the private sector is one of the most serious risks that the Irish economy faces going forward.**
- **Property related lending (construction, real estate activities and mortgages) has increased from 34.4% of total lending at end-March 2000 to 59.5% at end-March 2006.**
- **Lending to the personal sector for house mortgages and lending for construction and real estate activities accounted for 79% of the increase in total lending to households and non-financial corporations over this time period. Lending to both the personal sector and non-financial corporations has been property driven to an unprecedented extent. The economy is very susceptible to any downturn in the property market.**
- **At end 2005 Irish non-financial corporation's debt to GDP ratio was 56% greater than the Euro-area average and 41% greater in the case of households. The private sector's debt to GDP level is very high in a Euro-area context.**
- **The vast bulk of residential mortgages (84%) are on variable rates of interest. Only 1.6% of total mortgages are fixed for a period greater than five years. At the end of the day almost 96% of Irish residential mortgages are exposed to changes in short-term interest rates. This represents a significant risk to the personal sector.**
- **The exposure of non-financial corporations has received little attention in the media coverage of debt. It is not possible to ascertain the business sector's interest rate risk from official statistics. However, much of the debt is likely to be priced off Euribor. Taken in combination with the surge in property related lending the sector is exposed to both rising interest rates and any downturn in the property market.**
- **There is no sign of credit growth abating. If Private Sector Credit grows by 25% in 2006 and 20% in 2007, the ratio of Private Sector Credit to GDP will rise to 206% in 2007 from 161% in 2005. The ratio**

**of Private Sector Credit to GNP would increase from 190% to 243%. This rate of growth is unsustainable.**

- **The problem going forward is the prospect of further increases in interest rates. The magnitude of the increase in European interest rates will both surprise and hurt. The ECB will act forcefully to stem inflationary pressures and official rates may rise from their current level of 3% to over 4% in 2007.**
- **Should Private Sector Credit reach a figure that is more than double GDP and interest rates exceed 4%, debt service and repayment will be a significant burden for both the personal and business sectors. In these circumstances the lengthy process of redressing the problems on private sector balance sheets will begin.**
- **It is difficult to see how the escalation of private sector debt in recent years cannot at some stage lead to problems for the Irish economy. The issue is not if it will but rather when it will.**
- **The risks associated with the build up of debt are significant for the Irish economy as we move closer to 2008 and a period of adjustment is likely.**

## Introduction

Growth in Private Sector Credit (PSC) has surged over the last ten years. The absolute level of PSC increased virtually sevenfold from December 1995 to December 2005. Over the same time period nominal GDP has trebled. The ratio of PSC to nominal GDP stood at 70% in 1995 but by the end of 2005 it had risen to 161%. Over the same period, PSC as a percentage of GNP rose from 79% to 190%. Over the last three years, PSC has grown by over 95%. These statistics are of serious concern and clearly highlight that the indebtedness of the private sector is one of the most serious risks that the Irish economy faces going forward.

## Sectoral Distribution of Credit 2000 – 2006

In table 1, the sectoral distribution of credit at end March 2000 and 2006 is presented. The percentage of total lending accounted for by each sector of the economy is displayed for both these years. Over the six year period both agriculture and manufacturing industry have declined in terms of their proportion of the overall total and at the same time the importance of construction, real estate and the personal sectors in overall lending has increased dramatically.

**Table 1: Sectoral Distribution of Credit: End March 2000 – End March 2006**

	End-March 2000		End- March 2006	
	€bn	% of Total	€bn	% of Total
Agriculture	3.1	3.1	3.9	1.4
Manufacturing	4.7	4.7	5.8	2.1
Construction	2.8	2.8	16.6	6.1
Wholesale/retail	4.0	4.0	10.3	3.8
Hotels & restaurants	3.8	3.8	9.7	3.6
Financial intermediation	34.9	34.8	45.8	17.0
Real estate & business	8.4	8.4	49.8	18.4
Personal (households)	34.5	34.4	120.1	44.4
Other	4.0	4.0	8.6	3.2
<b>Total</b>	<b>100.2</b>	<b>100.0</b>	<b>270.7</b>	<b>100.0</b>

*Source: Central Bank & Financial Services Authority of Ireland, Quarterly Bulletins*

Specifically over the period:

- The agricultural sector's share of total lending has declined from 3.1% to 1.4%.
- Manufacturing industry's share fell from 4.7% of total lending to 2.1%.
- Financial intermediation dropped from 34.8% of the total to 17.0%.
- Real estate activities share of the total climbed from 8.4% to 18.4%.

- The construction sector share of total lending increased to 6.1% from 2.8%
- Lending to the personal sector rose from 34.4% of total lending to 44.4% and within these numbers mortgage lending has increased from 25.4% to 37% of total credit advanced.

These figures reflect a very fundamental shift in the Irish economic dynamic. Property related lending (construction, real estate activities and mortgages) has increased from 34.4% of total lending at end March 2000 to 59.5% at end March 2006 (the figure has been derived by excluding business activity figures from the total number for real estate and business activities in table 1).<sup>1</sup>

In table 2, the absolute growth rates for the various sectors over the period March 2000 to March 2006 are presented.

**Table 2: Change in Distribution of Credit: Personal & Non-Financial Corporate  
(End-March 2000 – End-March 2006)**

	Change (€bn)	% Change	% Share of Total Change
Agriculture	0.8	25.8	0.5
Manufacturing	1.1	23.4	0.7
Construction	13.8	492.9	8.6
Wholesale/retail trade	6.4	160.0	4.0
Hotels & restaurants	5.9	155.3	3.7
Real estate & business	41.4	492.9	25.9
Personal (households)	85.6	248.1	53.6
Other	4.6	155.0	2.9
Total	159.6	244.4	100.0

*Source: Central Bank & Financial Services Authority of Ireland, Quarterly Bulletins*

In this table, the total advances figure has been adjusted by stripping out advances to financial intermediaries. This is done to isolate lending to the personal and non-financial corporate sector and therefore reflects actual borrowing to fund activity in the real economy<sup>2</sup>.

Over the time period concerned, total borrowing by the personal sector and non-financial corporate sector has increased by approx 244%. This is an enormous rate of increase in borrowing over a six year time period. Nominal GDP grew by 77% over the six years to end 2005 and this puts the scale of the surge in borrowing into context. Within this total, lending to fund real estate and business activities and construction increased nearly sixfold.

<sup>1</sup> The Central Bank & Financial Services Authority of Ireland state that “The share of property-related lending in total PSC (adjusted for lending to non-bank IFSC companies) reached 65.8 per cent in the first quarter of 2006.” – (source: “Sectoral developments in Private sector Credit – March 2006”, [www.centralbank.ie](http://www.centralbank.ie), 29.5.2006).

<sup>2</sup> It is not possible to state from the numbers exactly where the lending to financial intermediaries goes exactly. Some of it would be lent on to others sectors e.g. financial leasing companies lend on as do credit unions but the ultimate destination of the funds is not clear from the data.

The level of personal lending more than trebled, and within this total, the level of mortgage lending virtually quadrupled. As can be seen from Table 2 construction, real estate and business activities and personal lending accounted for €140.8bn or 88% of the €159.6bn increase in lending over the period.

Property related lending includes house mortgage finance, lending to real estate activities and lending to the construction sector.<sup>3</sup> The growth in these lending figures over the period end March 2000 to end March 2006 are displayed in table 3.

**Table 3: Growth in Property Related Lending  
(End March 2000 – End March 2006)**

	Increase €bn	% share of change in total lending
Construction	13.8	8.6
Real estate activities	38.1	23.9
House mortgage finance	74.6	46.7
Total	126.5	79.3

*Source: Central Bank & Financial Services Authority of Ireland, Quarterly Bulletins*

The increase in house mortgage lending to the personal sector amounted to €74.6bn and when this figure is added to the construction and real estate numbers the total increase in property related lending amounts to €126.5bn or 79.3% of the total increase to households and non-financial corporations (€159.6bn). Lending to both the personal sector and non-financial corporate sector has been property driven to an unprecedented extent over this period.

<sup>3</sup> Central Bank & Financial Services Authority of Ireland, Quarterly Bulletin 3 2006, Page 30

## Sectoral Borrowing in a Euro-area Context

Lending statistics for the Euro-area are published monthly by the European Central Bank. Their numbers include cross border lending and there will therefore be some small discrepancy between their numbers and those of the Central Bank of Ireland. In table 4 figures for household debt and lending to non-financial corporations as a % of GDP at end 2005 are presented.

**Table 4: Lending to Households and Non-financial corporations  
2005 (% GDP)**

	Non-financial corporations	Households
Euro-area	42.7	52.5
Belgium	30.3	40.7
Germany	34.4	64.1
Greece	38.2	36.2
Spain	64.0	68.7
France	35.7	41.6
Ireland	66.4	74.1
Italy	45.7	27.7
Luxemburg	127.0	84.6
Netherlands	48.2	83.4
Austria	49.3	44.5
Portugal	59.8	68.1
Finland	26.5	44.4

Source: European Central Bank, Eurostat

Non-financial corporate debt in Ireland at 66.4% of GDP is the highest in the Euro-area excluding Luxemburg.<sup>4</sup> This is well in excess of the Euro-area average of 42.7% and only Spain exhibits a similar ratio to us (64%). Borrowing by Irish households at 74.1% of GDP is also well in excess of the Euro-area average of 52.5%. However, both Luxemburg and the Netherlands have higher household debt/GDP ratios than Ireland (84.6% and 83.4% respectively).

In table 5, Ireland's debt to GDP ratio relative to the Euro-area debt to GDP ratio for both non-financial corporates and households is presented for 2002 and 2005.

<sup>4</sup> Cross border lending will be significant in the case of Luxemburg given the country's relatively small size and the proximity of bordering countries.

**Table 5: Ratio of Irish to Euro-area debt/GDP levels (%).**

	2002	2005
Non-financial corporations	103	156
Households	100	141

Source: European Central Bank, Eurostat

The ratios in table 5 clearly show

- Ireland’s debt to GDP levels for both households and non-financial corporations are very high in a Euro-area context.
- At the end of last year Irish non-financial corporation’s debt to GDP ratio was 56% greater than the euro-area average and 41% greater in the case of households.
- At the end of 2002 the debt to GDP levels for both non-financial corporations and households were in line with Euro-area averages.
- This situation has altered fundamentally over the last three years as Irish private sector borrowing has surged.<sup>5</sup>

### Personal Debt (private households)

Personal debt represents over 44% of the total stock of PSC and house mortgage finance accounts for the vast bulk of personal debt (83%). Thus, the personal sector is borrowing primarily for property purchase. Outstanding debt on personal credit cards is running at just over €2bn or under 2% of total personal debt and is relatively small in overall context. However, it should not be forgotten that the interest rate charged on credit card debt is high in real terms and does pose a very heavy burden for borrowers in stress situations. At the end of March 2006, personal deposits with the credit institutions amounted to €65bn.<sup>6</sup> A crude estimate of the current value of residential property suggests that the figure could lie between €500bn to €600bn.<sup>7</sup> Total personal debt amounted to €120.1bn at the end of March 2006. Therefore, personal sector assets are a significant multiple of personal sector liabilities by this measure.<sup>8</sup> Thus, on the face of it the aggregate personal sector balance sheet looks very healthy. However it should be kept in mind that these are aggregate figures and therefore they do give any information on how personal assets are distributed amongst the population. Without doubt the distribution curve will be highly skewed. On top of this, in many cases property held will be the family home and is

<sup>5</sup>Spain has also exhibited a sharp deterioration in debt to GDP ratios relative to the euro-area over same time period (although not as severe as in the case of Ireland).

<sup>6</sup> Table C9, Central Bank & Financial Services Authority of Ireland, Quarterly Bulletin 3 2006.

<sup>7</sup> A total of 1.8 million private residences and communal establishments were identified by CSO enumerators during the course of the April 2006 census. Of these 1.5 million were expected to be occupied on the night. The CSO have the average price of both a second hand house and apartment at €330k in 2005 (Source: “Construction and Housing in Ireland”, CSO, July 2006). Both figures for private residences are multiplied by the average price to give the range of values.

<sup>8</sup> This measure only includes deposits with the credit institutions and does not include funds placed with the life companies and other investment institutions.

therefore not a liquefiable asset. In any downturn in the property market liquidity tends to dry up and therefore disposal of property to generate cash can be more difficult under these circumstances. One should not be lulled into a false sense of security by aggregate figures which show a strong personal sector balance sheet. There can be no doubt that there are segments of the personal sector at risk to a downturn in the economy and rising interest rates.

In table 6 figures are presented for residential mortgages which show the split between fixed and variable rate.

**Table 6: Variable and Fixed rate mortgages (% of total)**

	End- March 2001	End-March 2006
Variable Rate	69.0	84.0
Fixed Rate	31.0	16.0

*Source: Central Bank & Financial Services Authority of Ireland, Quarterly Bulletins*

The vast bulk of residential mortgages are currently at variable rates of interest and the proportion on variable rate has increased over the last five years.<sup>9</sup> Only 16% of residential mortgages are currently at fixed rates compared to 31% in 2001. This reflects the fact that we have witnessed historically low interest rates in recent years. In table 7 a breakdown of fixed rates mortgages in the years concerned is presented.

**Table 7: Fixed Rate Mortgages (% of total)**

	1-3 years	3-5 years	5 years +	Total
March 2001	14.6	11.5	4.9	31.0
March 2006	11.7	2.7	1.6	16.0

*Source: Central Bank & Financial Services Authority of Ireland, Quarterly Bulletins*

While the proportion of total mortgages on fixed rate has been declining it is also interesting to note that mortgages on a fixed rate for three years and over have declined from 16.4% of the total to a mere 4.3% at end March 2006. At the end of the day almost 96% of Irish residential mortgages are exposed to changes in short-term interest rates. This represents a significant risk to the personal sector.

<sup>9</sup> Variable rate includes fixed rate mortgages up to and including one year.

## **Non-financial corporations**

It is not possible to disaggregate the maturity structure of the debt profile of non-financial corporations from the data. However, the option of using off balance sheet instruments to hedge interest rate risk is available to the corporate market (e.g. swaps). The data for such instruments are in the aggregate and not broken down into maturity profile. At end March, a total of €133bn was outstanding in floating/fixed swaps (i.e. paying floating and receiving fixed).<sup>10</sup> These figures include transactions where the counterparty is a bank and it is not possible to extract the figures where the counterparty is a corporate. It is not unreasonable to assume that a significant proportion on non- financial corporate borrowing is priced off Euribor and therefore at risk to higher interest rates.

## **No sign of a slowdown in credit growth**

There is no sign of credit growth abating. In the twelve months to June, PSC grew by 30.3% and residential mortgage lending by 29.1%. The economy is forecast to grow by 5% in volume terms this year and 5.25% in 2007<sup>11</sup>. If we have PSC growth of 25% for 2006 and 20% in 2007, this would see the ratio of PSC to GDP rising to 206% by end 2007 from 161% in 2005. The ratio of PSC to GNP would rise to 243% from 190% over the same time period. This rate of growth is unsustainable.

## **Rising Interest Rates**

The problem going forward is the prospect of rising interest rates. The equity markets have been extremely volatile of late on the back of inflationary concerns (and geopolitical tensions) and the implications of rising inflationary expectations for both short term and long term interest rates. The balance of payments deficit in the United States is very much a concern for foreign exchange markets. There is now a view that U.S interest rates may have peaked but the jury is still out. Japanese interest rates are on the way up. UK interest rates are also expected to go higher. In the Euro area economic growth is picking up, inflation (2.4%) will remain above 2%, monetary and credit growth are accelerating (the annual rate of growth in the money supply is running at 8.5%) and therefore the ECB “will exercise strong vigilance so as to ensure that risks to price stability over the medium term do not materialise”<sup>12</sup>. This will result in higher interest rates. At present, real short-term interest rates in the Euro area are extremely low (0.6% with the Repo rate at 3%). With inflation expected to average 2.2% in 2007, real interest rates have further to increase.

<sup>10</sup> Table C12, Central Bank & Financial services Authority of Ireland, Quarterly Bulletin 3 2006

<sup>11</sup> Source: Central Bank & Financial Services Authority of Ireland, Quarterly Bulletin 3 2006, Page 7

<sup>12</sup> Press Statement, Jean-Claude Trichet, President of the ECB, 6.7.2006 (www.ecb.int)

Rising European interest rates have been well signalled and will not cause a surprise. However, the magnitude of the increase in interest rates will both surprise and hurt. The strong Euro will constrain the ECB somewhat but they will act forcefully and that we may see official rates increase to 3.5% by end 2006 and to over 4% in 2007 from their current level of 3%. Without question this will have an adverse impact on the Irish property market and economic activity. Should private sector credit reach a figure that is more than double GDP and interest rates exceed 4%, debt service and repayment will be a significant burden for both the personal and business sectors. In these circumstances the “feel good” factor stemming from rising house prices will have disappeared and the lengthy process of cleaning up private sector balance sheets will begin.

### **Conclusion**

It is difficult to see how the escalation of private sector debt in recent years cannot at some stage lead to problems for the Irish economy. The issue is not if it will but rather when it will. Lending has been primarily property related and therefore the economy is vulnerable to any significant set back in property prices. Of more immediate concern is the prospect of rising interest rates. We may see short-term European interest rates above 4% in 2007 and remain at these levels for some time. This would represent a virtual doubling of interest rates over a two year period. Both the personal and the corporate sector are exposed to movements in short-term interest rates given the preference for funding at variable rates as opposed to fixed rate funding. Historically low interest rates have fuelled the property boom. Property prices are not immune to rising interest rates. Forecasts for economic growth this year and next remain strong. However, the erosion of our competitive position means the economy is vulnerable to any external shock. The risks associated with the build up of debt are significant for the Irish economy as we move closer to 2008 and a period of adjustment is likely.