POLICY PAPER

Exploring the Steady-State Relationship Between Credit and GDP for a Small Open Economy – The Case of Ireland*

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Abstract: The rapid increase in credit in an economy is now commonly perceived to be one of the leading indicators of financial instability. This view has been reinforced by the aftermath of the international financial crisis, which commenced in mid-2007. A key policy response has been to focus on the ratio of private sector credit to GDP for an economy, observing, in particular, significant deviations between the actual and long-run trends of the ratio. This paper examines the issue of the steady-state relationship between private sector credit and GDP in the case of Ireland, a country which, even by international standards, experienced a sizeable expansion in credit over the past 10 years.

I INTRODUCTION

As a result of the established link between credit booms and financial crises, excessive credit growth is now generally considered a reliable “early warning indicator”. Traditionally, for most western countries, the amount of credit provision in an economy was directly related to the level of deposits within the financial system. However, over the past 10 to 15 years,

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financial innovation saw the link between credit and deposits broken with the consequent result of a general increase in credit provision. This sizeable build-up of credit has been identified by many as being one of the main contributing factors to the financial crisis, which began in mid-2007. As a result, greater attention is now focusing on determining what the “steady-state” level of credit should be for an economy and benchmarking this against the actual levels which pertain at a point in time.

From a macro-prudential perspective, the ratio of private sector credit (PSC) to GDP has become an increasingly popular benchmark of the sustainable levels of credit. Most recently, the Basel Committee on Banking Supervision (2010) has issued a proposal to incorporate this approach into the regulatory system, by using the deviation from long-run trend of the PSC/GDP ratio (the “credit gap”) to calibrate a countercyclical capital buffer. In the first instance, this method uses the ratio of credit to GDP, thus allowing credit to grow naturally in line with overall economic activity. Trending techniques are then employed to generate a long-run mean for the ratio and the actual position is then contrasted with this mean.

In this paper we examine, in a rigorous manner, the nature of the credit to GDP relationship in the Irish case. Ireland, in many regards, represents the classic example of a country where a rapid and sustained accumulation of private sector credit resulted in deep financial instability. Since the mid-1990s, the Irish economy experienced profound economic change, having, in the 1980s, witnessed negligible economic growth, an average unemployment rate of 15 per cent and high levels of personal taxation. The emergence of the so-called “Celtic Tiger” in the mid-1990s led to a sustained period of economic growth. Between 1995 and 2007, the size of the economy doubled with the total number of people employed in the country increasing by about 64 per cent. This sustained increase in income levels was coupled with a stable, low interest rate environment. At the same time, a considerable degree of financial liberalisation was taking place in the Irish credit market. Almost inevitably, a housing boom occurred, which, in terms of price increases and relative activity levels, was probably the largest across OECD countries for the period 1995 – 2008. The sharp contraction in the Irish property sector post 2008 has also been amongst the most significant in the western world with ensuing difficulties for the Irish financial sector.

In examining the ratio of Irish credit to GDP, we determine the presence of a number of different states in the relationship between these variables over the period 1982 – 2010. Based on this analysis, we determine the steady-state

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1 See also, Drehmann et al. (2010).
relationship between credit and GDP in the Irish economy and then perform scenario analysis to see what would have happened to Irish GDP between 1998 and 2010 if credit in the economy had grown more in line with deposit level growth over this period. Specific loan to deposit rates are used in this context as much of the sizeable increase in credit extended by the Irish financial system over the past 10 years was funded by access to wholesale money markets. When solvency issues concerning Irish institutions arose during the financial crisis, these markets were practically inaccessible for funding purposes.

In examining the Irish case, we think the results we obtain have a number of interesting policy implications. First, they call into question the use of simple private sector credit to GDP ratios for countries which have experienced significant credit increases over the past 10 years. As we will see, while the Irish case may be somewhat extreme in terms of the growth of credit, it was by no means the exception in Europe. Indeed, it would appear that there has been an emergence of two clubs across European countries in terms of the growth rate of the PSC to GDP ratio. In modelling a relationship between credit and GDP, our results also suggest that there may have been significant benefits to linking credit expansion with that of deposits. Our analysis suggests that had credit growth been set relative to deposits in the pre-crisis period, by late-2008/early-2009 the level of GDP would have been higher than the actual level. This result is of particular interest from a policy perspective, as the IMF/ECB/EU programme of support agreed in late 2010 specifically envisages a financial sector where credit expansion is more closely linked to deposit levels.

The rest of the paper is structured as follows; in the next section the relationship between credit and GDP is discussed from a broad policy perspective. The role of financial liberalisation in Ireland is then examined. In particular, we focus on the residential property market. An empirical section examines the issue of a structural break in the Irish ratio and a subsequent section presents a model of credit and GDP with a counterfactual simulation. A final section offers some concluding comments.

II CREDIT TO GDP AND THE POLICY ENVIRONMENT

2.1 The Role of Credit in Crises

The incidence of high credit growth in advance of financial crises has been recognised for some time. Numerous case studies have pointed to the incidence of high credit growth before crises (see, for example, Kaminsky’s (1999) discussion of the Asian and Latin American crises in the 1990s). In the
empirical literature, there is significant evidence of a link between rapid credit growth increasing defaults. For instance, Dell’Ariccia and Marques (2006) predict that episodes of future defaults are more likely in the aftermath of periods of strong credit expansion. Segoviano Basurto et al. (2006) show that credit to GDP is a good predictor of future defaults, while Clair (1992), Keeton (1999) and Salas and Saurina (2002) all link rapid credit growth with loan losses. Jimenez and Saurina (2006) find a direct, lagged relationship between credit cycles and credit risk.

Generally, this link between rapid credit growth and increasing defaults is linked to over-exuberant lending in the upswing of a cycle. During an upswing, the risk associated with loans may become underestimated. It has long been shown that there is an empirical link between GDP and credit growth. Additionally, there is evidence that banks’ lending mistakes are more prevalent in economic booms (when GDP is increasing) than in recessions. There are a number of channels through which this link between rapid credit growth and increasing defaults may operate.

Asset prices play a key role in this. From a demand perspective, on the upswing of a business cycle, increasing asset prices, increase the value of (property) collateral against which households and corporate can borrow. In addition, increases in other asset classes can increase the net worth of borrowers. From the supply-side point of view, taking a stylised balance sheet in which assets equal liabilities and equity, an increase in asset prices will push up the value of equity enabling a bank to expand the asset side of its balance sheet by increasing lending (see, for instance, Adrian and Shin, 2008). The role of securitisation is also important in this process. For instance, the ability to move assets off balance sheet in such a situation allows banks to continue to expand the asset side of their balance sheet without a concurrent increase in liabilities.

A number of potential channels through which lending standards may decline in an upswing have also been put forward. For instance, the traditional principal-agent problem may apply to the relationship between bank managers and shareholders. As shareholders have imperfect information, once the bank manager attains a rate of return which satisfies the shareholders, he may pursue objectives (for instance a growth objective) other than those which maximise the firm’s value. Herd mentality (Rajan, 1994) relates to the requirement for managers to compete with others in the market. Credit mistakes are judged more leniently if they are common to the whole industry, while managers are likely to be punished by shareholders if

\footnote{For a more detailed discussion of the literature, see Jimenez and Saurina (2006).}
they continually lose market share. As such, if competitors are pursuing market share objectives, it is in the interests of the individual bank manager to follow suit. The institutional memory hypothesis (Berger and Udell, 2004) posits that over time banks weight less the experience of the last crisis. As crises generally happen irregularly, the longer the time period since the last crisis, the fewer staff there are who recall that experience. For staff who still remember the last crisis, there is the ‘this time it’s different’ problem. Finally, financial liberalisation, and the associated reduction in reserve requirements, and expansion of international flows of cheap money is another important means through which credit may expand.3

All the above factors may lead to a decline in the creditworthiness of borrowers which will increase the vulnerability of banks’ loan portfolios to a shock to asset quality. When such a shock occurs, depositors (traditionally retail, but more recently, wholesale depositors) must reassess the safety of their savings in the bank, leading to funding liquidity pressures, and ultimately, insolvency, for those banks that are affected.

2.2 Credit as an Early Warning Indicator

As a result of the established link between credit booms and financial crisis, excessive credit growth is now generally considered a reliable “early warning indicator”. The issue in calibrating an early warning indicator is identifying credit growth that is justifiable based on economic fundamentals, and credit growth that may be deemed “excessive”.

A number of different approaches have been taken to estimate this in the literature. Perhaps the most predominant method, in many respects, is the signalling approach, which is used in Kaminsky (1999); Borio and Lowe (2002); Hilbers et al. (2005); Borio and Drehman (2009) and Alessi and Detken (2009). Most recently, the Basel Committee on Banking Supervision (2010)4 has issued a proposal to hard wire this approach into the regulatory system, by using the deviation from the long-run trend of the PSC/GDP ratio (the “credit gap”) to calibrate a countercyclical capital buffer. In the first instance, this method uses the ratio of credit to GDP, thus allowing credit to grow naturally in line with overall economic activity. The series is then de-trended using a Hodrick-Prescott (HP) filter, and a threshold level is then set, which weights in some way the relevant importance of type I (failing to give a signal

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3 Pill and Pradhan (1995) find that the ratio of private-sector credit to GDP best captures financial liberalisation, while Demirguc-Kunt and Detragiache (1998) find limited evidence of the predictive power of this ratio of financial crises, when used as a proxy for financial liberalisation.

4 See also, Drehmann et al. (2010).
when a crisis occurs) and type II errors (giving a positive signal when no crisis happens).\footnote{Probably the most popular method is to minimise the noise-to-signal ratio; however, other methods can be used: Borio and Drehman (2009) examine two alternative approaches: minimise the weighted sum of type I and type II errors given weights of alpha and one minus alpha for type I and type II errors, respectively; and minimise the noise-to-signal ratio subject to predicting some minimum percentage of crises, X.}

There are a number of drawbacks associated with the Hodrick-Prescott approach. First, the HP filter fits a trend through all the observations of real GDP, regardless of any structural breaks that may have occurred. Such structural breaks could easily occur in long-run data. For instance, Rajan and Zingales (1998) among others, show that credit growth is stronger in developed economies than in less-developed economies. As such, many emerging economies can have rapid increases in credit related to a “catch-up” process as the economy becomes more financially sophisticated. Such increases could be a perfectly appropriate and indeed necessary for the development of an economy, but could trigger a signal using the HP filter.

HP filters are also sensitive to end-point bias, as the trend line is fitted symmetrically through the data. If the beginning and the end of the data set do not reflect similar points in the cycle, then the trend will be biased upwards or downwards depending on the actual path of the series for the earliest and latest observations (Giorno et al., 1995). This issue may be reduced using ARIMA forecasts. In addition, HP filters are also sensitive to a time length selection; results from rolling HP filters may differ significantly from ex-post trend estimation (see Gourichas et al., 2001). Further, in the specific case of the PSC/GDP ratio, if GDP declines, but credit remains constant, a boom can be detected.

Finally, the outcome from a HP filter is sensitive to the smoothing parameter used. For instance, Borio and Lowe (2002) and Borio and Drehmann (2009) use a lambda of 1,600, the typical smoothing parameter for a business cycle. The Basel Committee on Banking Supervision use a smoothing parameter of 400,000, thus assuming that the credit cycle is 3-4 times the length of the business cycle. Figure 1 documents the gap between realised and trend for the Irish PSC/GDP ratio, with the trend estimated from a HP filter across a selection of lambda values. It is clearly evident that this change in smoothing parameters has a significant impact on the volatility of the de-trended series. Drehmann et al. (2010) show these findings are repeated at the international level.

Other methods have also been used to estimate the steady-state level of credit. While a number of models have examined the determinants of credit demand or credit supply separately, modelling and estimation techniques in
this area are complicated by the difficulty of disentangling supply and demand side effects. Hofmann (2001) uses a cointegrating VAR model on an individual basis for 16 industrialised countries. The findings are interpreted as long-run extended credit demand relationships, although some credit supply effects may also be captured. An error correction model is used to analyse dynamic interactions by computing orthogonal impulse responses. Eller et al. (2010) estimate the long-run (demand-side) and short-run (supply side) determinants of private sector credit developments, first identifying structural breaks in the data, then estimating a cointegrating VAR for a panel dataset, and then modelling short-run dynamics as a Markov-switching error correction model allowing coefficients to vary in different unobservable states. Egert et al. (2006) use an out-of-sample panel model to estimate the equilibrium level of credit in transition economies. Arguing that in-sample estimates are biased due to low initial levels of credit in what were once centralised economies, and
because coefficient estimates for these economies are unstable, the authors use small open developed economies to benchmark equilibrium credit in transition economies.

The growing literature on DSGE models also includes some estimation of equilibrium levels of credit. For instance, using Bayesian techniques, Gerali et al. (2010) estimate a model in which impatient businesses and households demand loans supplied by imperfectly competitive banks using both deposits and capital (which is accumulated from reinvested earnings). Margins charged on loans depend on elasticities of loan and deposit demand, interest rate stickiness and banks’ capital-to-assets ratio. Banks’ balance sheet constraints establish a link with the business cycle, which affects profits and capital, and therefore the supply of credit.

III PROPERTY PRICES AND FINANCIAL LIBERALISATION – THE CASE OF IRELAND

Since the early part of the last decade, the Irish economy and the property market, in particular, present as classic examples of excessive credit growth. Rapid expansion in private sector credit went hand-in-hand with a surge in both house prices and activity levels. In this section we briefly outline some of the changes in credit provision in the Irish banking sector and the impact this has had on the residential mortgage market.

The significant increase in the availability of mortgage credit in an Irish context can be observed in Table 1. The total value of mortgages issued increased threefold between 2000 and 2005. The total number of new mortgages went from just under 50,000 in 1995, to 80,000 in 2000 and to over 120,000 mortgages by 2005. The average size of a mortgage also increased considerably over the period. In 1995 the average mortgage extended by an Irish credit institution was €54,094; by 2005, this had climbed to €231,206. Inevitably, with such an expansion in credit, house prices increased substantially over the period. Between 2000 and 2007, prices rose by almost 65 per cent. The peak in house prices occurred in 2007:Q2 and since then the residential market has witnessed a substantial decline in activity as both residential construction and prices have fallen considerably.

This sharp increase in credit availability came after a period of considerable financial deregulation and liberalisation in the Irish market. The mid- to late-1980s and the 1990s saw the ending of the formal guidelines on bank lending to the private sector and the indicative guidelines on the sectoral allocation of credit by banks; the introduction of new interest-rate arrangements in 1985; a major relaxation of exchange controls in 1988 with a
Table 1: Summary Irish Residential Mortgage Market Statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Unit</th>
<th>1985</th>
<th>1995</th>
<th>2000</th>
<th>2005</th>
<th>2007</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding Level of Residential Lending (€m)</td>
<td></td>
<td>6,470</td>
<td>11,938</td>
<td>32,546</td>
<td>98,956</td>
<td>139,842</td>
<td>147,623</td>
</tr>
<tr>
<td>Total Value of Mortgages Issued (€m)</td>
<td></td>
<td>880</td>
<td>2,666</td>
<td>9,004</td>
<td>27,753</td>
<td>24,064</td>
<td>6,431</td>
</tr>
<tr>
<td>Average Mortgage Issued (€)</td>
<td></td>
<td>28,192</td>
<td>54,094</td>
<td>111,355</td>
<td>231,206</td>
<td>271,154</td>
<td>230,309</td>
</tr>
<tr>
<td>Total Number of Mortgages Issued</td>
<td></td>
<td>31,203</td>
<td>49,288</td>
<td>80,856</td>
<td>120,037</td>
<td>88,747</td>
<td>27,922</td>
</tr>
<tr>
<td>House Prices (€)</td>
<td></td>
<td>46,542</td>
<td>77,994</td>
<td>169,191</td>
<td>276,221</td>
<td>322,634</td>
<td>242,033</td>
</tr>
<tr>
<td>Housing Supply</td>
<td></td>
<td>23,948</td>
<td>30,575</td>
<td>49,812</td>
<td>80,957</td>
<td>78,027</td>
<td>27,142</td>
</tr>
</tbody>
</table>

Further relaxation in 1992. The primary liquidity ratio was also subject to liberalising measures as it was reduced four times from a level of 10 per cent in 1991 to 2 per cent in 1999, in conformity with the requirements of the new operational framework of the Eurosystem. The removal of credit and interest-rate controls would have given banks more freedom in determining the level and allocation of credit that they would like to supply. Furthermore, the removal of exchange-rate controls would have increased banks’ ability to attract deposits from non-residents.

Another seminal influence has been monetary union in Europe, which was quickly followed by the full integration of the Euro Area money market. A further feature of the liberalisation of the loan market was the cessation of Central Bank guidelines on the sectoral allocation of credit. This is highly relevant in the context of residential lending patterns as the Bank had consistently favoured the supply of credit to so-called productive enterprises and accordingly had discouraged its supply to the property market, which it had not perceived as being productive.

Traditionally, domestic deposit liabilities have been the main funding source for credit supply in the Irish market. However, an additional source of funding available over the past 10 years has been cross-border funding in the form of interbank borrowing and debt issuance. Such a source of funding was negligible before the mid-1990s but has grown exponentially since then. Both the timing of its emergence and its subsequent rate of growth would suggest that the funding rate has had a significant influence on domestic economic activity and particularly that in the mortgage and housing markets. This issue is commented on in more detail in Section IV below. An exact chronology of the control and subsequent liberalisation of the Irish credit market is discussed in
Although many of these liberalising measures took place a long time ago, up to 20 years ago in some cases, their full effects may have taken some time to fully materialise.

The relationship between house prices and greater availability of mortgage credit is examined in some detail in an Irish context by Fitzpatrick and McQuinn (2007). Using a variety of econometric techniques, they found a mutually reinforcing relationship between house prices and mortgage credit. In a related piece, Addison-Smyth, McQuinn and O’Reilly (2009) clearly demonstrate that the emergence and substantial increase in the ability of domestic banks to source funds from abroad had a significant impact on house prices post-2003.

IV EMPIRICAL EXAMINATION

Our primary focus is on the relationship between GDP and private sector credit (PSC) in the Irish economy over the period 1982-2010. In this analysis, private sector credit is defined as credit extended to private Irish residents by all resident credit institutions in Ireland. “Private Irish residents” refers to individuals living in the State for at least one year, private non-profit making bodies and enterprises, which operate within the State. A “resident credit institution” is one which is incorporated and located in the Republic of Ireland, including subsidiaries of parent companies located outside the Republic of Ireland; and branches of institutions that have their head office outside the Republic of Ireland.

In Table 2 a summary of the data for certain sub-periods is presented. In Figure 2 we plot the real annual growth rates of GDP and PSC over the period. What is evident is that for much of the sample, the growth rates would appear to be highly correlated suggesting the possibility of a long-run equilibrium relationship. However, for certain sub-periods it is apparent that any such relationship between the variables breaks down. From 1997 to 2001 and from 2003 to 2009 it is obvious that annual growth rates of PSC considerably exceeded that of GDP. This can be seen from Figure 3, which plots the ratio of PSC to GDP, i.e. financial deepening. While the ratio is relatively stable between 1982 and 1997, thereafter, the growth rate would appear to experience two sharp increases. Particularly, from 2003 onwards, this period

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6 See, in particular, Box 1 pages 96 and 97, which illustrates the building and dismantling of controls over the period 1973 to 1999.
7 1982 is the earliest date that data for PSC are available.
Table 2: Descriptive Statistics of Irish Macroeconomic Variables Per Cent

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>4.2</td>
<td>4.6</td>
<td>8.6</td>
<td>0.6</td>
<td>-4.7</td>
</tr>
<tr>
<td>Private Sector Credit (PSC)</td>
<td>9.5</td>
<td>6.1</td>
<td>16.1</td>
<td>11.7</td>
<td>5.6</td>
</tr>
<tr>
<td>Financial Deepening</td>
<td>98.2</td>
<td>61.4</td>
<td>97.0</td>
<td>171.4</td>
<td>219.2</td>
</tr>
<tr>
<td>Inflation</td>
<td>3.4</td>
<td>3.9</td>
<td>3.6</td>
<td>2.1</td>
<td>0.6</td>
</tr>
<tr>
<td>Funding Gap</td>
<td>28.6</td>
<td>11.6</td>
<td>29.1</td>
<td>61.6</td>
<td>77.1</td>
</tr>
</tbody>
</table>

Notes: The figures for GDP and PSC are real annualised growth rates, while the rest of the variables are actual rates. Private sector credit is defined as credit extended vis-à-vis private Irish residents by all resident credit institutions in Ireland. “Private Irish residents” refers to individuals living in the State for at least one year, private non-profit making bodies and enterprises, which operate within the State. A “resident credit institution” is one which is incorporated and located in the Republic of Ireland, including subsidiaries of parent companies located outside the Republic of Ireland; and branches of institutions that have their head office outside the Republic of Ireland.
of PSC growth was funded primarily through cross-border funding in the form of interbank borrowing and debt issuance. Traditionally, in the Irish economy, a relatively stable relationship existed between PSC and retail deposits. However, the extent to which this relationship broke down can be gleaned from Figure 4. This plots both the actual level of credit and deposits in the left panel and the percentage difference (or funding gap) on the right. The scale of this funding gap suggests that in the absence of a significant increase in future deposit levels, the Irish banking system is facing into a period of considerable deleveraging, which unless focused on non-core loans outside the Republic of Ireland, will have knock on implications for the domestic real economy.

While the build up of credit in Ireland has been somewhat extreme, the last 10 years has seen many European countries also experience significant increases. Figure 5 plots the degree of financial deepening for a sample of European countries from 1999 to the present. What is evident is the emergence of two clubs for this sample of countries. On the left hand side of the figure, the ratio is plotted for Ireland, the United Kingdom, Spain, Portugal and the Netherlands, while the remaining seven countries (Germany, France, Italy, Finland, Greece, Belgium and Austria) are plotted on the right.

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8 Deposits are defined as resident non-bank, non-Government deposits at resident credit institutions (formerly Table C9 in Central Bank Quarterly Bulletin).
Figure 4: Private Sector Credit and Deposit Levels in the Irish Banking System (1982-2010)

Figure 5: Select European Countries Levels of Financial Deepening
For the former set of countries, the ratio of private sector credit to GDP is around 200 per cent by 2010. This follows a period of sustained growth in the ratio, mainly from about 2003 onwards. While some countries in the latter category also experience growth, most of these countries have a ratio of approximately 100 per cent by 2010.

4.1 Structural Break Analysis

Earlier sections outline the shortcoming of basing new counter-cyclical capital requirements on HP filter techniques and argue targeting a steady state level would be more efficient. The problem is determining periods when the PSC/GDP ratio is at steady state level and periods of deviation. In a formal, statistical manner, the possibility of multiple states in a relationship can be explored using a Markov Switching framework.

A regime-switching model combines two or more sets of parameters into one system and also the likelihood of each regime at a given time. We define a two state Markov-switching model which allows for different means in the growth rate of PSC/GDP, taking the form,

\[
\begin{align*}
\frac{PSC}{GDP}_t &= \begin{cases} 
\alpha_1 & s(t) = 1 \\
\alpha_2 & s(t) = 2
\end{cases}
\end{align*}
\]

where \(s(t)\) denotes the state the economy is in at time \(t\).\(^9\) \(s(t)\) is determined by a Markov chain which itself depends on a transition matrix. The transition matrix gathers the probabilities that one particular state is followed by another particular state. These transition probabilities are assumed to be time stationary.

Table 3 shows the growth rate of the PSC/GDP ratio moves discretely between two regimes; one characterised by a stable ratio oscillating around zero growth (State 1) and another defined as highly positive and more volatile (State 2). In fact, estimates show annualised quarterly growth of more than 12 per cent for State 2. This results in a credit boom any time the economy is in State 2. The model is well defined as the transition probabilities show the level of persistence in each regime is quite high indicating that when the economy is in a particular regime in one period, it is highly likely to remain in the next time period.

Figure 6 presents the time series dimension, showing a high and consistent probability of being in State 1 for the period 1982-1997. The model then estimates a switch, with PSC outpacing GDP until 2001 when a US recession stifled the Irish credit boom. In 2003, another switch occurs with

\(^9\) The regime classification measure (RCM) of Ang and Bekaert (2002) indicates that both regimes are clearly defined.
Table 3: Estimates from Markov Switching Model

<table>
<thead>
<tr>
<th>Variable</th>
<th>State</th>
<th>Estimate</th>
<th>P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>σ</td>
<td>Non-Switching</td>
<td>5.875</td>
<td>(0.000)</td>
</tr>
<tr>
<td>α₁</td>
<td>1</td>
<td>0.3244</td>
<td>(0.22)</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>3.335</td>
<td>(0.000)</td>
</tr>
</tbody>
</table>

Expected Duration (time periods)

<table>
<thead>
<tr>
<th>State</th>
<th>Duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>29.38</td>
</tr>
<tr>
<td>2</td>
<td>13.66</td>
</tr>
</tbody>
</table>

Note: P-values are in parenthesis.

The Transition Matrix is given by:

\[
\begin{pmatrix}
0.97 & 0.03 \\
0.07 & 0.93
\end{pmatrix}
\]

Figure 6: State Probabilities for the Change in Mean of the Ratio PSC/GDP in Ireland 1982-2010

4.2 Empirical Model

The results from the Markov switching regime approach are used to motivate the econometric analysis. In particular, these results suggest the presence of a clear structural break in the PSC to GDP relationship around 1998. In Table 4 we present the results of Granger causality tests for the period 1982 to 1997. Standard F-Tests would suggest that, in the long-run, credit appears to be a determinant of both itself and GDP, while GDP would only appear to be a determinant of itself. This is not an altogether surprising result given the manner in which credit was regulated in the Irish economy.

Based on this, we run a series of long-run regressions with GDP as the dependent variable and PSC as the regressor. Given the results from the structural break analysis, we conduct the estimation over the entire (1982-2010) period and over the sub-period 1982-1997. The results are summarised in Table 5.

Table 4: Granger Causality Tests in Levels: 1982:1-1997:4

<table>
<thead>
<tr>
<th>Variable</th>
<th>F-Stat</th>
<th>P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>PSC</td>
<td>5.80</td>
<td>0.00</td>
</tr>
<tr>
<td>GDP</td>
<td>4.76</td>
<td>0.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Dependent Variable: GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>PSC</td>
</tr>
<tr>
<td>GDP</td>
</tr>
</tbody>
</table>

In the interests of robustness, we use two long-run estimators. Along with OLS estimates, we also use the dynamic ordinary least squares (DOLS) methodology of Stock and Watson (1993). The DOLS estimator falls under the single-equation Engle-Granger (Engle and Granger, 1987) approach to cointegration while allowing for endogeneity within the specified long-run relationships. Single equation approaches have been used in other models of the housing market, such as Muellbauer and Murphy (1997); Fitzpatrick and McQuinn (2007); McQuinn and O'Reilly (2007); and McQuinn and O'Reilly (2008).
The Stock and Watson (1993) DOLS approach explicitly allows for potential correlation between explanatory variables and the error process. It involves adding both leads and lags of the differenced regressors to the hypothesised long-run specification to correct for correlation between the error processes.\footnote{The error term is liable to be serially correlated so the covariance matrix of the estimated coefficients must be adjusted accordingly. This involves modifying the covariance matrix of the original regressors by specifying and estimating an AR(p) model for the error term. See Fitzpatrick and McQuinn (2007) for more on this.} In our application, the error term is assumed to follow an AR(2) process, while the number of leads and lags is set equal to 2.\footnote{We experimented with alternative values of k and length of the AR() process, however, our results were not significantly changed. Parameter estimates for the leads and lags in the DOLS estimation are available, upon request, from the authors.}

The results clearly demonstrate a significant relationship between the variables. With both OLS and DOLS, the private sector credit variable is highly significant. Clearly, over the period 1982 – 1997, the coefficient on the PSC variable is somewhat greater than what it is when estimated over the entire period. As GDP does not grow at the same rate as PSC after 1998, the size of the coefficient on the PSC variable is, consequently, smaller for this period. Figure 7 plots the OLS residuals from the regression over the two sample periods. In comparison with the residuals estimated over the entire sample period, those estimated over the period 1982 – 1997 appear to be well-behaved and stationary.

\begin{table}
\centering
\caption{Long-Run Estimates of Irish GDP}
\begin{tabular}{lcc}
\hline
 & OLS & DOLS \\
\hline
1982:4-2010:1 & & \\
psc & 0.506 & 0.489 \\
& (0.011) & (0.064) \\
1982:41997:4 & & \\
psc & 0.758 & 0.774 \\
& (0.014) & (0.038) \\
Cointegration test & & \\
& 6.3 & \\
Structural break test & & \\
Test & & \\
Bai-Perron & 1997:03 & 2006:01 \\
\hline
\end{tabular}
\end{table}

\textit{Note:} Standard errors are in parentheses. The cointegration test refers to the Engle-Granger (1987) test and the statistic is the t-stat on the lagged residual term from the long-run regression run over the 1982:4-1997:4 time period.
4.3 Counterfactual Scenario

Based on the long-run model estimated for GDP over the period 1982-1997, we also estimate the equivalent short-run model for both GDP and private sector credit. For the error-correction term, we use the residuals from the OLS regression of GDP on PSC. The results are summarised in Table 6 and it is evident, in the case of GDP, that the error correction term is negative and significant. Both short-term models have relatively high $R^2$.

Table 6: Short-Run Estimates of GDP and PSC 1982:1–1997:4

<table>
<thead>
<tr>
<th>Dependent Variable</th>
<th>$GDP_t$</th>
<th>$PSC_t$</th>
</tr>
</thead>
<tbody>
<tr>
<td>ECT$_{t\frac{1}{2}}$</td>
<td>$-0.27$</td>
<td>$0.49$</td>
</tr>
<tr>
<td></td>
<td>($-2.37$)</td>
<td>($3.75$)</td>
</tr>
<tr>
<td>GDP$_t$</td>
<td>$0.58$</td>
<td></td>
</tr>
<tr>
<td></td>
<td>($5.40$)</td>
<td></td>
</tr>
<tr>
<td>GDP$_{t\frac{1}{4}}$</td>
<td>$-0.35$</td>
<td></td>
</tr>
<tr>
<td></td>
<td>($-5.96$)</td>
<td></td>
</tr>
<tr>
<td>PSC$_t$</td>
<td>$0.48$</td>
<td></td>
</tr>
<tr>
<td></td>
<td>($5.25$)</td>
<td></td>
</tr>
<tr>
<td>PSC$_{t\frac{3}{4}}$</td>
<td>$0.26$</td>
<td>$0.38$</td>
</tr>
<tr>
<td></td>
<td>($2.78$)</td>
<td>($3.40$)</td>
</tr>
<tr>
<td>$R^2$</td>
<td>$0.91$</td>
<td>$0.82$</td>
</tr>
</tbody>
</table>

Note: ECT = error correction term, t-statistics are in parenthesis.
We then use the short-run model for GDP to perform a counterfactual simulation. The question asked is what would have happened to Irish GDP, post 1997, if credit in the economy had grown more in line with deposit level growth over this period. Two scenario levels of credit are accordingly used: (i) where PSC grew on a one-to-one basis with deposits (Scenario 1), and (ii) where credit grew by 1.2 times deposit levels (Scenario 2).

Specific loan to deposit (LTD) rates are used in this context as much of the sizeable increase in credit extended by the Irish financial system over the past 10 years was funded by access to wholesale money markets. When solvency issues concerning Irish institutions arose during the financial crisis, these markets were practically inaccessible for funding purposes. In the case of this first scenario, the explicit assumption is that lending in the domestic Irish banking system would have been funded entirely through domestic deposit levels and that institutions did not have recourse to wholesale funding over the period.

The recent IMF/ECB/EU programme of support sets out specific LTD targets for Irish financial institutions over the next three years.

The three different series for PSC are plotted in Figure 8. It is evident that under each scenario, the level of credit growth post 1998 is going to be

**Figure 8: Actual and Counterfactual Credit Levels**
substantially less than what actually occurred. In conducting the simulation, the results for the error correction model are used. Thus, given the moderate rate of credit growth assumed under the simulation, the assumption is that the economy responds in a steady-state like manner to this growth. In Figure 9 we then plot the actual level of GDP and the two simulated levels from the short-run model, as well as the percentage difference between the actual and scenario.

Under both scenarios, between 1998 and 2007, actual GDP levels were significantly higher than under the alternative credit level paths – for some years the difference is over 30 per cent. For the more conservative assumption on credit growth (the 1:1 relationship with deposits), it is evident that by 2010, actual GDP and the scenario level are pretty much the same. However, where credit grows relative to deposits, it can be observed that by late-2008/early-2009, the scenario level of GDP is greater than the actual level.

Figure 9: Scenario Results for Counterfactual Private Sector Credit
V CONCLUSIONS

A wealth of literature now links rapid credit growth with financial crises. Empirically, this has prompted a number of attempts to exploit data on credit growth to build early warning indicators of financial crises. From a policy perspective, the most recent example of this has been the countercyclical capital buffer proposed by the Basel Committee on Banking Supervision. The design of this buffer based on the deviation from trend (as calculated using a HP filter) of the PSC/GDP ratio.

We examine the use of such an approach in an Irish context. Even by international standards, post 2003, the accumulation of credit in the Irish economy has been considerable. The most obvious manifestation of this credit boom was through the residential housing market, where increases in Irish house prices were the largest over the last 10 years across OECD countries.

In examining the Basel proposal, the paper makes two contributions. First, it provides an alternative to the HP filter trending techniques by using a Markov switching framework. This determines periods of stability in the PSC to GDP ratio, thus allowing one to estimate the steady state relationship. A capital buffer to prevent excess credit can be based on deviations from this estimate. This would seem to be particularly warranted where a country experienced a rapid build-up of credit. While Irish credit growth increased markedly over the past 10 years, it is worth noting that other European countries also experienced significant increases. Indeed the paper notes the emergence of a “twin club” development across Europe in that regard. Thus, we feel the notion of alternative states in the GDP to PSC ratio needs to be allowed for in applying the Basel proposal across countries.

Additionally, the paper examines a counterfactual scenario in which the expansion in credit is linked to that of deposits. The analysis suggests that there may have been significant benefits associated with such a link. Specifically, in such a scenario our results suggest that GDP would have been higher than the actual level from 2008/early-2009.

REFERENCES


