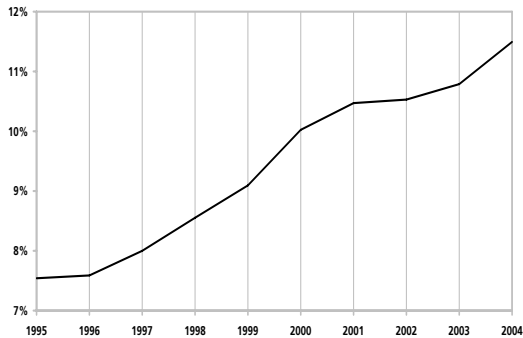


## Construction as a share of total employment, 1995–2004 (%)



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# Irish economy

## Construction risk manageable

- Construction's share of employment in the Irish economy has soared over the last decade. Building now accounts for 12% of employment in the economy.
- Housebuilding is now more important to the Irish economy than other building (e.g. office blocks, industrial estates, roads, schools and hospitals).
- Building accounts for a greater share of employment and expenditure in Ireland than in other developed economies.
- Over 40% of houses built in the past two years are lying vacant as second homes, holiday homes or unlet investment properties.
- Housebuilding must drop to a more sustainable level, where the marginal vacancy rate is closer to 10% than 50%.
- Overall construction employment will fall when the volume of housebuilding contracts. In the worst-case scenario, this will cause employment growth in the economy to drop to 0.3% for one year.
- More likely, overall employment growth will fall to 1.5%+ during the housebuilding adjustment.
- A peak in housebuilding is difficult to predict. But a further drop in rents or even falling prices may be the signal.
- The Irish economy seems well placed to absorb a downturn in housebuilding. We estimate that one percentage point will be lost from GNP growth in 2006 and 2007 but half of that is due to a methodological change in the National Accounts.
- GNP growth will still reach almost 4% per annum, more than twice the euro area average.

## Disclosures

**Davy is part of Bank of Ireland Group**  
**Please see full disclosures page 16**

## 1. Introduction

Construction has become increasingly important to the Irish economy over the last decade. That is not surprising for an economy that has doubled in size since 1997. The purpose of this piece is to explore what might happen when construction's influence begins to wane, as it inevitably will.

In this study, we attempt to quantify the "construction risk" in the Irish economy. By "construction risk", we mean quantifying the potential hit to employment and output in the Irish economy if housebuilding activity declines sharply.

Construction has been the fastest-growing area of the Irish economy over the last decade. Building now amounts to 22% of GNP and 12% of employment in the economy. Construction activity has reached such high levels in both a historic and international context that a reversal in the sector looks to be the greatest threat to growth in the Irish economy over the next few years.

The problem area is housebuilding, which has broken records continuously but is now nearing a peak. The salient variable is employment, because everything else follows from there. Employment in construction accounted for 12% of the total in 2004, of which the majority was in housebuilding.

Although non-residential building is recovering, it will not be enough to compensate fully for the inevitable drop in employment in construction when the volume of housebuilding shrinks. Nevertheless, we believe the Irish economy is capable of absorbing the adjustment in housing. We estimate that in the worst-case scenario—a sharp one-year downturn—employment growth will fall to just 0.3% that year. In the other scenarios, where the volume adjustment will be more gradual, the cumulative impact on employment growth will be similar but the damage will be spread over a longer timeframe.

The impact on GNP growth is extrapolated from our latest forecasts for the Irish economy out to 2007. Based on these forecasts, about one percentage point will be lost from growth in both 2006 and 2007, compared with the situation where housebuilding volumes remain at the projected 2005 level for two more years. But we still forecast GNP growth of close to 4% in 2006 and 2007.

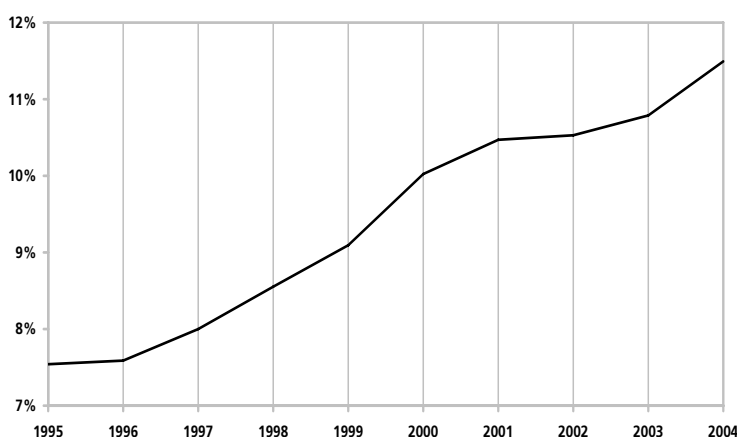
## 2. Construction's growing influence in the last decade

Construction has been a big driver of employment growth in recent years. It has accounted for a quarter of the 400,000 increase in employment since early 1998. Last year, its percentage contribution was even higher. Fully 41% of total annual employment growth in the economy in the year to Q4 came from construction, as employment in that sector jumped 13%. As a result, employment in construction soared to 12% of the economy-wide total, up from 8% seven years ago.

Expenditure on construction has grown steadily over the last decade. Spending on housebuilding increased 150% in 1995–2004. In 1995, 30,500 houses were built; by 2004, the number of completions had reached 77,000, equating to 19 houses for every 1,000 in the population compared with 8.5 houses per 1,000 nine years previously. The value of Irish residential spending amounted to 13.7% of nominal GNP last year.

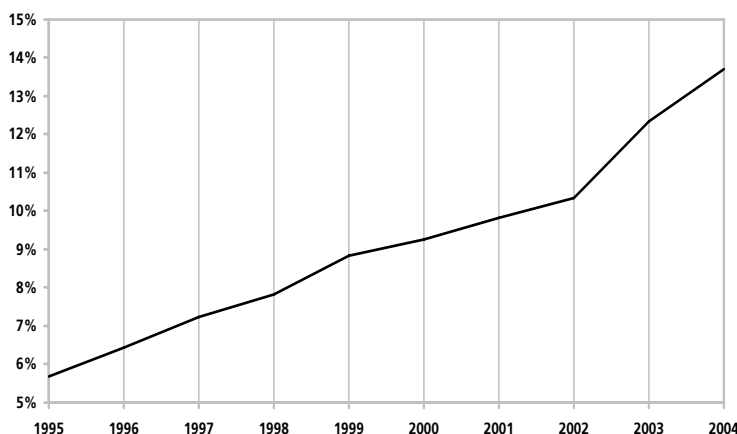
Boom time was not confined to housebuilding. Other (non-residential) building also more than doubled in 1995–2004. The combination of this building boom and heavy spending on machinery and equipment in the late 1990s resulted in overall investment in the economy rising sharply in that period. In money terms, investment quadrupled from €9bn in 1995 to €37bn last year. As a percentage of GNP, investment's share soared to 30% from 20% in nine years.

**Figure 1: Construction as a share of total employment, 1995–2004 (%)**



Source: CSO

**Figure 2: Residential construction as a percentage of GNP, 1995–2004**



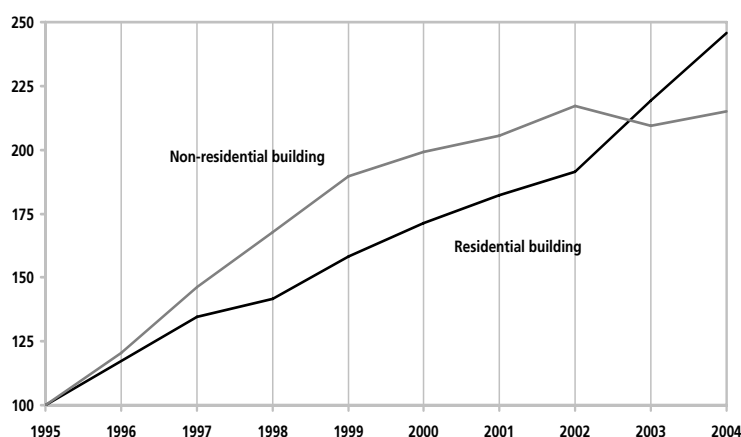
Source: CSO

### 3. Progression of residential versus non-residential building

The expansion of non-residential construction has not quite matched residential construction. But the growth gap since 1995 is relatively small. Other building apart from houses—including commercial (e.g. office blocks, industrial estates) and public spending (e.g. roads, hospitals and schools)—rose by 115% in volume in 1995–2004.

Compared with housebuilding, the upward curve for other building was not smooth. It can be broken down into three phases: 1995–2001, 2001–2003 and 2003 on. In the first phase, expenditure on structures apart from houses rose 106% in total. In the second, there was stagnation as spending inched up 2%. Last year spending recovered, growing by 3% over 2003. We expect quicker growth in non-residential building in the next two years of 6% or more each year.

**Figure 3: Expenditure on residential and non-residential building, 1995–2004 (volume 1995=100)**



Source: CSO

#### Housebuilding's majority employment share

Unfortunately, the Central Statistics Office does not split construction employment into those employed in housebuilding and the rest. We guess that the residential/non-residential split was about 55%/45% in favour of the residential sector. Therefore 100,000 people were employed in housebuilding in 2001 and 82,000 in other building. We base this calculation on historical output trends in the building sector and on the fact that housebuilding is more labour intensive than other building.

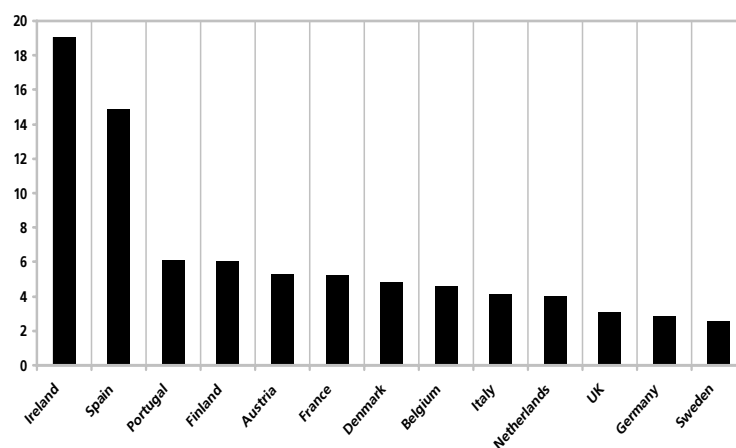
Non-residential building increased 5% in volume in 2001–2004. Assuming that average annual productivity growth in that sector was not dissimilar from the rest of the economy, then employment in non-residential building has at best attained its 2001 level again. Therefore, the net gain of 31,700 persons (or 17%) in construction employment since 2001 is entirely due to the housebuilding boom. That implies employment of about 132,000 people in housebuilding, making up about 62% of total construction employment and 7% of total employment in the Irish economy.

## 4. Irish construction ratios out of line with peers

### House completions

We are building a vast number of houses compared with our peers. House completions in 2004 totalled 19 per 1,000 of the population. In Germany, the equivalent ratio is less than three; it is five in France; six in the US; and only three in the UK. The closest country to Ireland is Spain, where 15 houses are built per 1,000. In fact, Spain is the only country that comes close to Ireland on any of the housing metrics.

**Figure 4: House completions per 1,000 of the population, 2004**



Source: Euroconstruct; CSO; Datastream; Department of the Environment, Heritage and Local Government

### Employment

Construction's share of employment in Ireland has risen from 8% to 12% in six years. That put Ireland on a par with Spain, where building activity accounts for exactly the same share of total employment. But Spain is not the norm: it builds a couple of hundred thousand holiday homes each year. No other developed economy comes close in the standings.

Next on the list is the US, followed closely by Japan. In those countries, construction's share of employment is around 9%. In France, 5.2% of workers make their living from building. To put the gap between Ireland and the rest (bar Spain) into context, total construction sector employment—residential and non-residential—averages 7% of economy-wide employment in other developed economies: in Ireland residential building employment alone accounts for 7% of total employment in the economy.

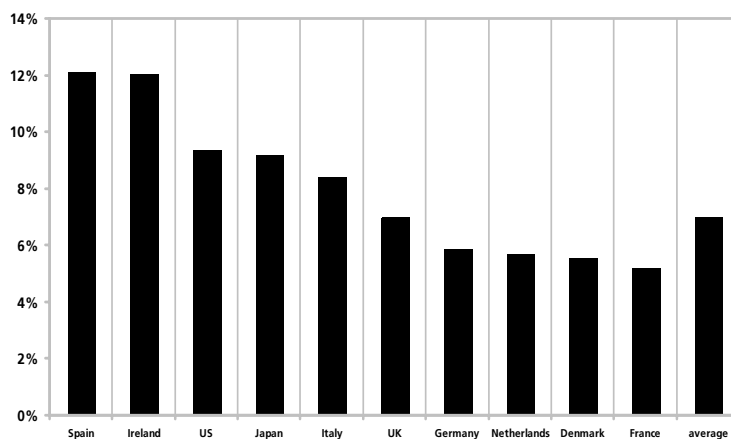
### Spending on overall building

Contrast investment in the Irish economy with other developed countries: the influence of housebuilding stands out. Data on residential investment show that Ireland is an outlier. According to Euroconstruct, Ireland's total residential construction (new dwellings plus improvements/renovations) amounted to 13.1% of the value of GNP in 2003 (10.9% of GDP). Once again, Spain was the closest to Ireland: 8% of the value of its GDP was spent on housebuilding. However, the ratio for big three economies in the euro area—Germany, France and Italy—was 5.5%, 4.6% and 5% respectively. In the UK, housing investment made up 3.2% of GDP; in the US, the ratio was 6%.<sup>1</sup>

In Table 1 we have replaced residential investment with total fixed investment, which includes non-residential construction and investment on machinery and equipment. This is a useful comparison because Ireland's building boom has boosted the overall investment ratio. The divergence in the ratios over the last decade is marked. Ireland's investment expenditure as a percentage of GNP was exactly in line with the eurozone average in 1995. By 2004, it was about 50% higher than the average.

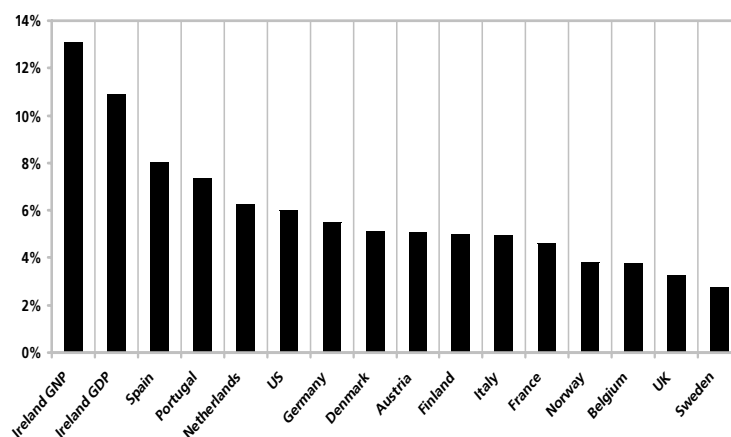
1. GNP approximately equals GDP in all other developed countries. Ireland is an exception due to the transfer-pricing practices of the foreign-owned multinational sector.

**Figure 5: Construction employment as share of total, 2004 (%)**



Source: CSO; Datastream

**Figure 6: Residential investment as a percentage of GDP, 2003**



Source: Euroconstruct; CSO; Datastream

**Table 1: Investment (GFCF) as percentage of nominal GDP, 1995–2004**

	US	UK	Euro area	Ireland – GNP	Ireland – GDP
1995	15.0%	17.0%	20.6%	19.6%	17.4%
2004	16.1%	17.0%	20.0%	29.8%	25.0%

Source: CSO; Datastream

## 5. Breakdown of housing demand

The boom in housebuilding has been astonishing over the last decade. In 1994, only 26,863 houses were built. Last year, 76,954 were completed. Building accelerated markedly in 2001–2004. Almost 50% more houses were built last year than three years earlier. It looks as though last year's total will be at least matched again in 2005.

Where is the demand coming from? We think the logical way to quantify it is to split demand four ways: occupied permanent residences, new houses to replace obsolete stock, second/holiday homes, and unoccupied investment properties.

**Table 2: Demand for housing**

	2002	2003	2004	2005F
(A) Completions	57,695	68,819	76,954	77,000
(B) Household formation (QNHS)	38,318	36,955	27,765	35,000
(C) Obsolescence	8,830	9,122	9,515	10,000
(D) Vacant (A-B-C)	10,548	22,742	39,674	32,000
Marginal vacancy rate (D/A)	18.3%	33.0%	51.6%	41.6%

Source: CSO; Davy calculations

### Occupied permanent residences

In the period from April 1996 to April 2002, household formation—the demand for new permanent residences—was running at an annual average rate of 28,000, according to the last Census (April 2002). We do not have precise figures on household formation since, but the CSO estimates it as part of the Quarterly National Household Survey. Since the last Census, household formation has averaged almost 34,000 annualised. Remarkably, it decreased 9,000 last year compared with 2003, yet house completions jumped 9,000 year on year.

### Replacement of obsolete stock

For obsolescence, we rely on John Fitzgerald's recent estimate that about 0.6% of the housing stock needs to be replaced each year.<sup>2</sup> We use the CSO estimate of the housing stock in 2002 and project it forward, using house completions since, to calculate the absolute number of houses built to replace obsolete stock each year. Average replacement demand is more than 9,000 units in each of the last three years.

2. John Fitzgerald, *The Irish Housing Stock: Growth in Number of Vacant Dwellings*, Special Article, ESRI QEC, Q1 2005.

## Second/holiday homes and unoccupied investment properties

What is left over amounts to second homes and holiday homes (the distinction between these is debatable but not important, since both form part of the residual) and investment properties that remain unoccupied. We reckon that in the year to the first quarter of 2003, fewer than 6,000 or 10% of properties were built and lying vacant as part of this bracket. But in the first half of 2004, we estimate that six out of ten houses/apartments were built to satisfy demand for second/holiday homes or were built as investment properties for which no tenant was found.

We have no way of breaking the demand for non-permanent residences into second/holiday homes and unlet investment properties. Anecdotal evidence suggests that the bulk of the residual units are second/holiday homes, many of which have tax breaks attached. A regional breakdown shows that the majority of second/holiday homes are in the western part of the country. Some second/holiday homes were bought primarily as an investment for capital appreciation, not for rental yield. But it is difficult to quantify how many homes fall into that category.

There is now a surplus of investment properties in the rental sector, as rents have fallen steadily for three years. According to the CSO, private rents are 8% lower on average than in the summer of 2002. However, a recent report from accommodation website Daft.ie suggests that rents finally stabilised in Q1 2005. Still, the gross yield on many residential investment properties is no more than 3%.

That rents are falling is hardly surprising, considering that the national residential vacancy rate is now more than 14%. At the time of the last Census, the vacancy rate was 10%. By vacancy rate, we mean the number of houses unoccupied at a given point in time as a percentage of the total habitable stock of houses. The vacancy rate has jumped sharply because the marginal vacancy rate in 2003 and 2004 was so high, reaching at least 30%+ in each year (see Table 2).

## Estimating more sustainable demand

We think a more sustainable level of demand is about 55,000 units per annum. In percentage terms, in the region of 80%+ of these would be occupied. That 80%+ would be comprised of household formation of 35,000–40,000 (requiring some rise in headship rates) and obsolescence of about 9,000.<sup>3</sup> That leaves a residual demand of 6,000–11,000 or so for second/holiday homes and vacant investment properties each year. The bottom end of that range for the residual (i.e. 6,000) seems reasonable to us because the marginal vacancy rate would be 11%, much more in line with historical experience than with what has occurred in the last three years.

It is important to note that demand for permanent residences will decline steadily over the next decade. Numbers entering the 25-to-34 age cohort will actually peak this year. More than 74,000 Irish-born people will reach the age of 25 this year but by 2014 that number drops to less than 52,000. That, in turn, reflects the peak of 74,000 in the birth rate that occurred in 1980 and the subsequent decline to 52,000 by 1989.

3. The headship rate is the tendency for people to form independent households. This drives household formation and falling household size.

## 6. Economic effect of drop in housebuilding

Construction employment will fall significantly when the volume of housebuilding eventually contracts. But how much will it decline? We have modelled four potential outcomes: output drops from a 2005 level of 77,000 to 55,000 in each case, but it takes one, two, three or four years for it to happen (see Table 3 below).

We make assumptions about employment growth in the rest of the economy. Agricultural employment is forecast to decline by 1% each year out to 2009. Industrial employment is forecast to remain flat in 2005–2009. Public services employment is seen growing at 2.5% each year. Non-residential construction employment is expected to increase at 4% each year. Finally, private services employment is projected to rise by 4% this year and then by 3.5% in 2006 and in each year after.

If house completions are unchanged year on year in 2005, employment in the economy is forecast to grow by 2.4%. The first scenario is the most damaging to the economy. There is a sharp adjustment over one year. We think that such an adjustment is unlikely in 2006, but it may happen in 2007. Housebuilding would drop from 77,000 in 2006 to 55,000 in 2007. As a result, employment growth in the economy would plummet to 0.3% from 2.2%.

Our second scenario, encompassing 2005–2007, is the most extreme: house completions drop from 77,000 to 55,000 or by 15.5% in 2006 and 2007. The contraction in housing output subtracts at least a percentage point from employment growth in both years.

The third outcome sees housing output falling towards a more sustainable level in three years. About three-quarters of a percentage point is lost from employment growth on average in each year in 2006–2008.

Finally, we look at the situation where volumes correct smoothly over a number of years. In this case, employment is hit by a little more than half a percentage point on average in each year in 2006–2009.

We have not mentioned the potential for ancillary jobs to be lost due to a contraction in housebuilding. This possibility is implicitly factored into our assumptions for employment growth in other areas. Types of jobs potentially affected include mortgage-brokers, shop assistants, cement plant workers, hauliers and estate agents.

**Table 3: Sensitivity of employment growth to fall in house completions**

House completions fall to 55,000	2005	2006	2007	2008	2009
<b>Scenario 1: over 1 year</b>					
Employment growth (%)	2.4%	2.2%	0.3%		
Loss (pp)	-0.2	-0.2	-2.1		
<b>Scenario 2: over 2 years</b>					
Employment growth (%)	2.4%	1.2%	1.4%		
Loss (pp)	-0.2	-1.2	-1.0		
<b>Scenario 3: over 3 years</b>					
Employment growth (%)	2.4%	1.5%	1.7%	1.7%	
Loss (pp)	-0.2	-0.9	-0.8	-0.7	
<b>Scenario 4: over 4 years</b>					
Employment growth (%)	2.4%	1.7%	1.8%	1.9%	1.9%
Loss (pp)	-0.2	-0.7	-0.7	-0.6	-0.6

Source: Davy calculations

A drop in construction employment may have greater implications for consumer spending than a similar contraction elsewhere in the economy. That is because since 1998 wage growth in construction has far exceeded that of industry, private services and even public services. Construction earnings have grown at an average of 2% *per quarter* in the last seven years, compared with 1.5% in industry and in the public sector and 1.4% in private services. The difference on an annualised basis comes to more than 2%.

Surprisingly, wage inflation in construction slowed dramatically at the end of last year. It fell quarter on quarter seasonally adjusted in Q4 2004. On an annual basis, wage inflation in building slowed to less than 2%. Luckily, real wages are growing fast enough elsewhere in the economy to compensate, should this trend continue. But further out, when building volumes contract, employment growth in the economy may drop by as much as one percentage point (worst-case scenario), while wage growth is tailing off in housebuilding.

### **Higher imports may push GNP lower but productivity will rebound**

The impact on national income of a correction in housebuilding is less clear cut. Potential economic growth will be dampened by lower employment growth. But a rebound in productivity may compensate for part of the output lost through lower employment.

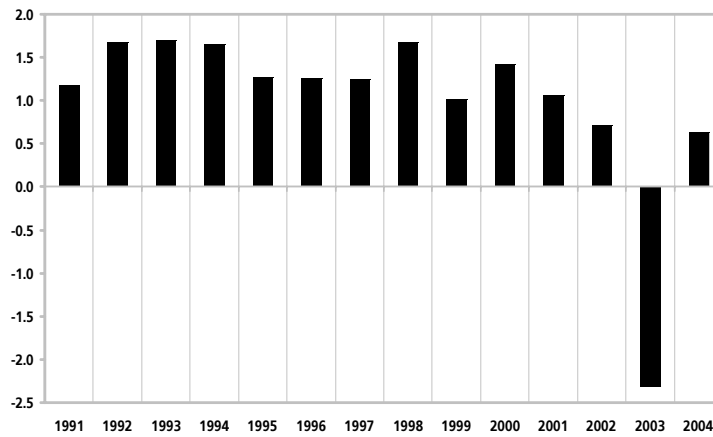
Productivity decreased sharply in construction in the last few years. In 1998–2004, output per construction worker dropped by 16%. Most of the damage was done from 1998 to 2001, as the housebuilding boom began in earnest. The obvious explanation for falling productivity in the sector is that housebuilding is more labour-intensive than other heavy construction. We expect that productivity will at least stabilise because of the gradual shift from residential back towards non-residential construction. Output per worker in construction may gravitate back towards the average rate of output per worker in the economy. Hence, the fall in overall output may not be quite as large as the overall fall in employment.

Arithmetically, GNP may be hit by higher imports in the years ahead. Imports seem to have been temporarily depressed by the housebuilding boom. Intuitively, the import content of housebuilding is lower than that of commercial/office building and that of large infrastructure projects. Steel, which is imported, is a more important material in non-residential construction than in housebuilding.

Maybe it is the lower import content of housebuilding that has led to the breakdown of the textbook relationship between imports and final demand. Imports in 2004 in value terms were 2% *below* their 2001 level and up less than 4% in volume. At a micro level, imports of materials—including steel—plunged a massive 22% in value in 2001–2003, the exact period when non-residential construction hardly grew at all. Caveats include the relative weakness of consumer demand growth (although it still averaged almost 3% per annum) and the impact of a VAT fraud, which reduced both imports and exports in 2003. But overall it seems that non-residential building is more import intensive than residential building, which may dampen GNP growth in the years ahead.

There are three main influences on national income from a housebuilding contraction. The hit to employment may at worst dampen potential growth by one percentage point. The other negative influence is the possibility of higher imports as the dynamic of the construction sector changes. On the credit side, a recovery in building productivity will compensate in part for lower employment.

**Figure 7: Ratio of import growth to final demand growth, 1991–2004**



Source: CSO

### **New methodology will exacerbate arithmetic effect of a downturn on GNP**

There is another negative influence but this is purely statistical and not related to the real economy. The CSO will move to a chain-linking system for the national accounts from the release of Q1 data on. This is the method used by the US and UK and has become compulsory for all eurozone economies.

In practice, this means the weighting of each sector will be updated each year. So the previous year's weighting in current prices will be the base for volume changes instead of a constant price base of 1995. Revised estimates will see a boost to growth mainly due to the low weighting of the residential construction back in 1995. That sector has grown its output by much more than the average in value terms over the last decade.

Importantly, because its gross-value-added weight is much higher now, the opposite will happen on the way back down. In other words, arithmetically GNP will drop by more in percentage point terms under the new system than under the old one when housebuilding volumes begin to decline on an annual basis. Our latest macro forecasts are based on the chain-linked new methodology.

We see housebuilding falling from 77,000 units in 2005 to 71,500 in 2006 and then further to 65,500 in 2007. That drop in housing activity will subtract one percentage point from GNP growth in 2006 and in 2007 compared with the situation where housing completions stay constant at 77,000. However, the real economic loss is only about 0.5 percentage points from GNP in each year. The statistical impact accounts for the rest.

## 7. How to predict turning point in housebuilding

We have found it difficult to predict an inflection point in the housebuilding sector in the past; but we still believe that a sustainable level of housebuilding is well below current levels. Fortunately, we find that when the volume of activity eventually contracts, the economy may not suffer too much damage. In the worst-case scenario, we reckon that one percentage point will be shaved off employment growth. Economic growth may not slow by as much as that due to improved productivity in construction.

What might signal or hasten an imminent downturn in housebuilding volumes? A further dip in rents and ultimately prices would be the obvious indicator that the market is excessively supplied. According to the CSO, private rents have decreased by 8% since the summer of 2002. A recent survey by the Dublin accommodation website Daft.ie suggests that rents stabilised early this year, having declined by 10% in 2002–2004. But over the last six months house price inflation has slowed to 3% on an annualised basis, a four-year low. House prices are unchanged outside Dublin since September.

Demand for new housing primarily comes from first-time buyers, inward migrants, investors and purchasers of second/holiday homes. Waning demand for housing from one or more of these groupings would lead to a reduction in housebuilding.

### First-time buyers

Interest rates, real income growth, and access to the mortgage market are the crucial variables for first-time buyers. Our best guess is that the European Central Bank will stay on hold throughout 2005. When rates eventually rise, they will probably not go too high too quickly. The futures market is pricing in a refi rate of 2.75% by end-2006 and 3.25% in three years' time, which translates to variable mortgage rates of between 4% and 4.5% compared with about 3% now. Such an increase seems small in percentage-point terms but the percentage increase in repayments is not inconsequential.

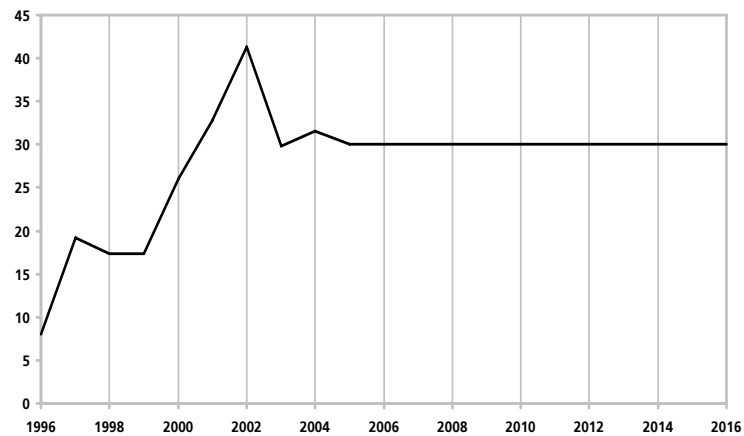
One threat to that benign outcome is a vigorous recovery in the eurozone, resulting in rapidly accelerating inflation and much higher interest rates. However, a slowdown in Irish real income growth is unlikely this year and next due to healthy employment growth outside construction, wage growth of at least 4%, and falling inflation. Another factor to quell demand would be impeded access to the mortgage market. This would also be linked to higher rates, as credit risks for banks would be heightened. Moreover, a simultaneous economic downturn would see credit controls tightened.

### Immigration

Net inward migration peaked at 41,000 people in 2002 and averaged 25,000 people between 1996 and 2004. In 2006–2016, the CSO baseline projection sees net inward migration of 30,000 each year. Yet net inward migration has accounted for a relatively small part of housing demand in recent years. Inward migrants have accounted for about a third of the 34,000 average annualised increase in net new households since Census 2002.

We assume that average household size for inward migrants is about three people per house (returning citizens may occupy at less than three per house but non-residents probably occupy at a higher rate than three). Therefore, 10,000 new houses will be needed for inward migrants each year until 2016, using the CSO's baseline forecast. Its forecasts have proved to be conservative in the past. Whether the CSO's latest one continues that trend depends on sustained strong growth in the Irish economy.

**Figure 8: Net inward migration, 1996–2016F**



Source: CSO

### **Investors**

Investor demand for housing has not waned despite the erosion of net yields, which are now barely above the rate of inflation. Expectations of capital appreciation have sustained investor appetite for property so even negative real yields may not be enough to quell interest. However, sentiment can change quickly without an observable catalyst: think back to 2000 and the bursting of the technology bubble.

### **Second/holiday homes**

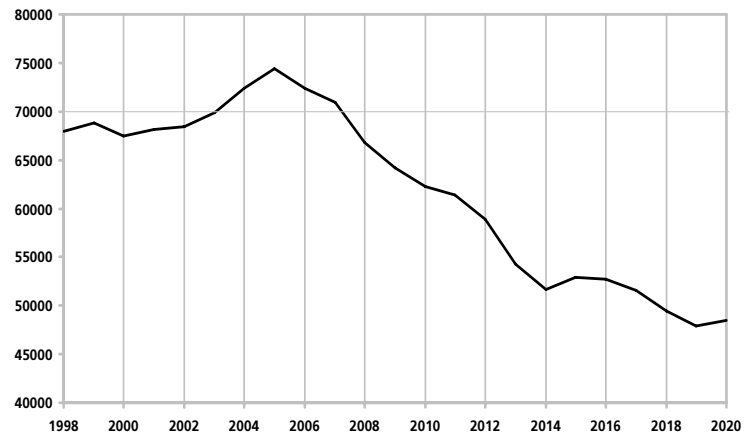
Strong real income growth is fuelling demand for second/holiday homes. (Demand for second/holiday homes may also have been boosted by the phasing-out of tax breaks on certain holiday cottages. The change, announced in Budget 2003, was to have been brought in by end-2004 but this was later extended to mid-2006.) Absent slower economic growth, it is difficult to say when demand for second/holiday properties will wane. Issues that could change the status quo include government micro-management in the shape of a tax on such homes; the phasing out of all tax breaks; planning bottlenecks; lower expectations of capital gains; or mounting public pressure against one-off housing in the countryside.

### **Demographic influences**

Beyond 2007, the number entering the critical 25-to-34 age cohort will tail off dramatically. In 2010, almost 10,000 or 12.5% fewer Irish-born persons will reach the age of 25 compared with three years earlier. By 2014, the number of persons reaching 25 will fall by a further 10,000; a near 30% drop in seven years.

A buoyant economy, zero real interest rates and continued flows of migrants may keep house completions near the 2004 level for another year or two. But the housebuilding peak is high and it might be better to begin the adjustment process sooner rather than later.

**Figure 9: Number of Irish-born persons reaching 25 years of age, 1998–2020F**



Source: CSO

## 8. Conclusion

Construction has been an integral part of Ireland's internal dynamic since the downturn of 2001/2002. Housebuilding continues to reach record levels. This has pushed construction employment to a level that is unsustainable as a percentage of total employment. Building's share of total expenditure is also above equilibrium. Not only are these ratios high in a historic Irish context but they are also out of line compared with other developed economies, with the possible exception of Spain. It seems, therefore, that over the next number of years housing output will fall significantly.

Employment in housebuilding will decline in line with volumes. How much that affects total employment growth in the economy will depend on two things: whether or not there will be demand for newly redundant workers elsewhere in construction; and whether or not the rest of the economy is growing at potential.

Our model makes assumptions about employment growth in the different areas of the economy. The model suggests that the economy may cope well with the inevitable reduction in housebuilding. To what extent employment growth is dampened depends on the severity of the downturn. We frame four scenarios, where housebuilding falls to a more sustainable level of 55,000 units in one, two, three or four years. In the worst-case scenario—an abrupt one-year downturn—employment growth will fall close to 0% in that year. In the other scenarios, employment growth will still be at least 1% and may reach nearly 2% during the housebuilding downturn.

If employment growth dropped by as much as a percentage point, then potential economic growth would be constrained. But there are other factors to take into account, including some compensation from stronger productivity growth in construction and the drag from higher imports.

We have recently pushed our Irish economy GNP forecasts out to 2007. We compare our forecast for GNP, where we have explicitly factored in a 7% contraction in residential construction in 2006 and another 8.5% reduction in 2007, with the situation in which housebuilding volume remains at the 2004 level for the next three years. We find that the downturn in the sector will knock one percentage point from GNP growth in each year. Half of this is the real economic growth loss; the other half is due to a methodological change in the National Accounts.

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Davy is part of Bank of Ireland Group.

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