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*Highlights in this issue:*

- **A buoyant housing construction sector has helped sustain the Irish economy's momentum**
- **A downward adjustment towards more sustainable levels in housing output is likely in the years ahead**
- **Risks related to the property market call for prudent policies**

# Ireland: no place like (my own) home?

*by Zdeněk Čech**

## *Summary*

*Ireland clearly stands out in international comparisons as a country with extraordinarily buoyant housing construction growth over the last decade. A swift supply-side response to increasing demand pressures for property increased residential building to record levels. However, it largely failed to stop the upward movement in property prices – which also partly reflects the limited supply of land zoned for development. Strong housing construction has nevertheless become a significant driver of Irish economic growth and in particular helped sustain growth in the aftermath of the global downturn in the early 2000s. In the years ahead, given a number of uncertainties (including inward migration), a gradual tapering-off in housing construction towards a more sustainable long-term path is likely. However, any external shock – such as a significant exchange rate appreciation – to Ireland's small, open, trade-dependent economy, added to recent competitiveness pressures, might lead to a sharp contraction in residential construction from its current very high levels. Furthermore, escalating property prices (together with infrastructural bottlenecks) have the potential to constrain growth over the medium term. Maintaining a prudent fiscal stance, without compromising social cohesion and the commitments addressing the infrastructural needs of the economy, is the key challenge Ireland faces in the field.*

## *The construction sector helps economy maintain momentum...*

*Economic activity has become increasingly driven by buoyant residential construction*

In the second half of the 1990s, the Irish economy grew at double-digit rates and was by a wide margin the fastest growing economy among the euro area countries. A wide array of both long- and short-term factors, including a favourable external environment and a sizeable pool of available labour, played a role in the economy's impressive convergence experience (Čech and MacDonald, 2004). The ability to exploit the opportunities offered by globalisation was also crucial and led to a significant FDI inflow, notably benefiting the manufacturing, while strong productivity growth (and shift of resources to traded goods) boosted Ireland's competitiveness. The run-up to EMU cemented the policies of opening the economy and facilitated the macro-stabilisation process and structural reforms. However, the extraordinary growth factors of the 1990s (the so-called "Celtic Tiger" period) were largely consolidated by the early 2000s. The economy decelerated but, nonetheless, GDP continued to expand at a healthy pace of around 5% p.a. In particular, economic momentum was increasingly helped by buoyant construction output, its residential component boosted by fast-rising property prices. The solid Irish housing market, as in other industrialised countries around the world (Borio and McGuire, 2004), helped to cushion the slowdown in global

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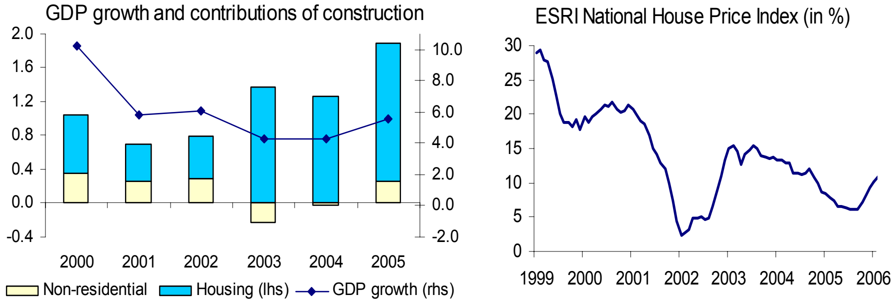
economic activity after the turn of the decade. However, the property sector in Ireland continued on a steep upward trajectory also in more recent years, with overall economic growth largely driven by an upsurge in residential construction activity (chart 1a). The fact that the impressive supply-side response has not put a brake on property prices, which have actually re-accelerated since mid-2005 (chart 1b), suggest that demand for housing remains extremely solid (see also box below).

**Chart 1: Buoyant Irish housing sector**



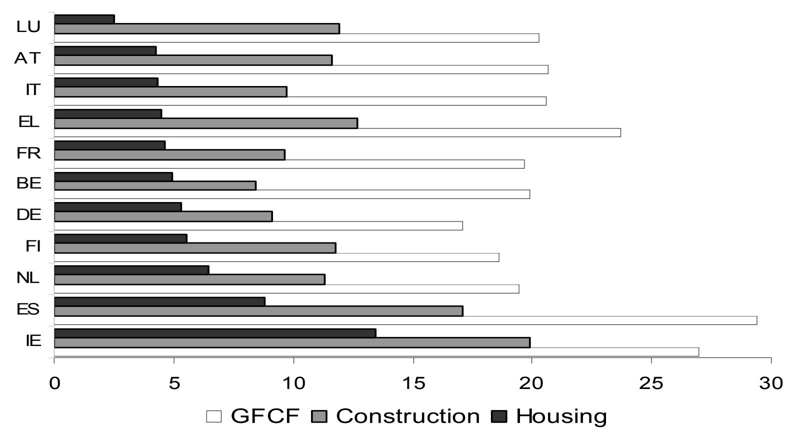

*Source: Commission services, ESRI Ireland*

## *Construction output overshooting equilibrium levels?*

*The housing construction sector in Ireland is large by any measure…*

The Irish construction sector and in particular its housing subcomponent have become extremely large by any measure over recent years. As a result, construction is an important part of the macroeconomic environment in terms of output, employment and investment. Recent strong overall employment gains, reaching around 4½% in 2005, have been largely driven by developments in the sector (see also European Commission, 2006). The construction-to-GDP ratio climbed to almost 20% of GDP in 2005, the highest in the euro area (relatively closely followed only by Spain), while the housing subcomponent accounted for around 13½% of GDP (chart 2).

**Chart 2: Components of gross fixed capital formation, euro area countries (2005, in % of GDP)**




*Source: Commission services*

*…and is possibly overshooting its equilibrium levels*

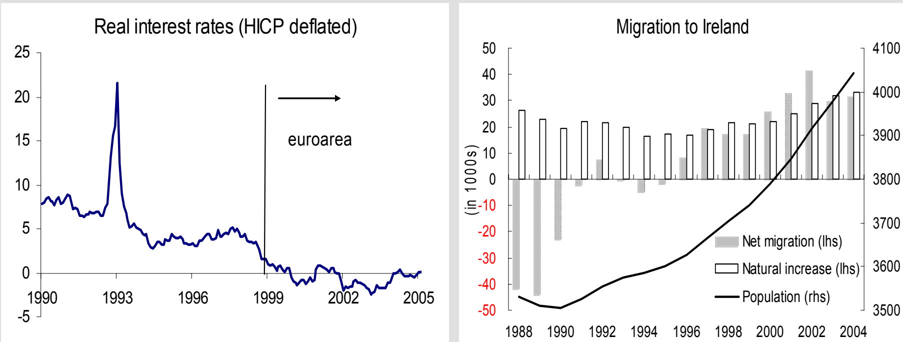
Figures for 2005 indicate that house completions increased by 5.2% on the year, reaching nearly 81,000 housing units. Available data and indicators for 2006 suggest that housing construction expenditure is likely to remain strong also in 2006, further exceeding the high levels of the previous year. The projections in the ESRI's Medium-Term Review (ESRI, 2005) suggest that a much lower rate of housing completions, of the order of 60,000 to 70,000 per annum, would represent a more sustainable long-term path. While a number of factors (such as immigration and growing female participation) have probably pushed estimates of sustainable housing output in Ireland upwards, it nevertheless appears that housing output might be currently overshooting equilibrium levels and some degree of downward adjustment is likely in the years ahead.

### *Box: Factors underlying the booming property market in Ireland*

Several factors help explain why property market developments have been more buoyant in Ireland than in most other industrialised countries. On the *demand side*, strong growth in real disposable income, demographic trends (including strong inward migration – chart 2b), lower real interest rates leading up to euro area entry and enhanced access to mortgage finance (the latter helped by financial innovation) have played a particularly crucial role. As regards government intervention in the property market, Rae and van den Noord (2004) argue that favourable tax treatment of housing (in particular in the form of property-based tax relief) has given people an additional incentive to invest in housing and that its positive tax treatment appears to reduce the sensitivity of demand to changes in property prices. In Ireland, these factors have probably added to price pressures and have been unsupportive to achieving housing market equilibrium.

On the *supply side*, the policy of the Irish government has focused on increasing availability, in particular through increasing residential densities, better infrastructural provision and enhanced planning. Tierney (2006) argues that this intervention, following the suggestions of the so-called Bacon report (2000), is positive. Barry (2006) takes a different view, seeing these reforms as "conservative in the extreme" in relation to the artificial scarcity of development-zoned land. In any event, the increase recorded in the supply of new houses has not cooled down property price pressures. House prices have surged, almost quadrupling over the last decade, and have continued to increase strongly and across all sectors also into 2006 (chart 1b).

**Demand factors affecting the housing market**




*Source: Commission services, CSO Ireland*

## *Macroeconomic impact of the construction boom*

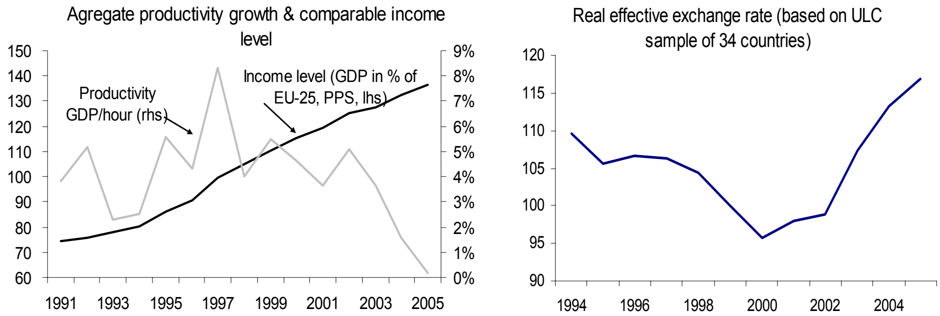
*The construction boom is benefiting from inward migration…*

The buoyancy of the Irish property sector in recent years has a number of macroeconomic implications. Following buoyant demand conditions and the favourable international environment towards the end of 1990s, wage rates rose very rapidly. On entering EMU, Ireland was thus expected to face the prospect of real exchange rate appreciation (chart 3b) through higher wage growth than in its trading partners (Bergin et al., 2004). However, the Irish experience suggests that the wage-driven adjustment process for competitiveness under EMU is weak. There was no apparent process of fostering lower relative wage growth at the aggregate level to forestall a loss of competitiveness and consequent costs in terms of lost output and increasing unemployment. Instead, the openness of the Irish labour market and strong inward migration flows (notably to the construction sector) seem to have represented the most significant adjustment mechanism (Honohan and Ledin, 2005).

*…but the labour market as a whole remains tight*

Despite the construction (and services) sectors having benefited in recent years from inward migration, notably from the recently-acceded EU Member States, the labour market has remained remarkably tight (with unemployment in 2005 at just above 4%) and a significant positive wage growth differential vis-à-vis other euro area countries has been maintained. As a result, competitiveness has deteriorated (see REER in Chart 3b) and export growth become somewhat muted (as compared to the recent past). Meanwhile, economic growth has become increasingly driven by domestic factors, including booming residential property construction, and boosted by expanding credit (notably in the form of mortgages). The shift of resources into house-building and services, traditionally labour-intensive and with limited scope for productivity improvements, has resulted in a decline of aggregate productivity growth (chart 3a).

**Chart 3: Selected macroeconomic indicators**




*Source: Commission services*

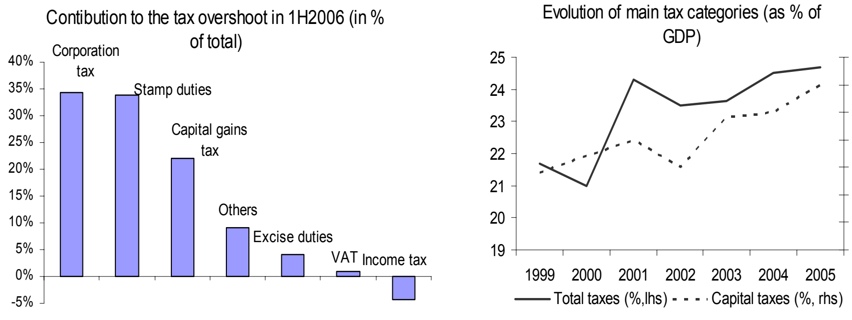
*The construction boom might also lead to a suboptimal allocation of resources…*

The construction boom has led to increasing concerns about the skewed nature of investment. The recent accumulation of assets does not always involve investment leading to higher future output (ESRI, 2006), which might imply potential knock-on effects on future competitiveness (Barry, 2006). As regards the macroeconomic outlook, the high share of construction in overall output and rising levels of indebtedness of households (European Commission, 2006) could put the economy in a vulnerable position if housing output were to adjust more rapidly to more sustainable levels. However, there seems no significant evidence in Ireland that housing equity withdrawal has stimulated domestic demand (Osborne, 2005); it may be that individuals might be cautious about borrowing against property wealth because of the psychological importance of home ownership (Hogan and O'Sullivan, 2003).

*…and to higher volatility in fiscal revenues*

The expansion of residential construction and fast-rising house prices have also had a profound impact on *fiscal aggregates*. Budgetary trends suggest that tax revenues have become more and more reliant on the property market (see Chart 4). These developments were notably apparent in the Exchequer cash data for the first half of 2006. The better-than-expected outturn in this period was helped by the buoyancy of property-market-related capital taxes (stamp duties and capital gains tax), which will likely increase the tax-to-GDP ratio and the tax elasticity relative to GDP (as compared to the average of recent years) for this tax category for the year as a whole. As a result, the Irish authorities in July 2006 re-estimated the general government balance expected in 2006 as a whole as a surplus of 0.7% of GDP, compared with the deficit of 0.6% of GDP forecast in the budget presented in December 2005. Should construction activity return swiftly to more sustainable levels, it would have a direct negative impact on the general government balance (via falls in VAT and capital tax revenues). In particular, given the features of the Irish tax code, tax revenues related to the property market (based on the volume of transactions) might be somewhat more volatile than in other countries applying a standard *ad valorem* property tax, because capital taxes strongly hinge upon developments in *both* housing output and property prices.

**Chart 4: Construction sector boom – impact on fiscal aggregates**



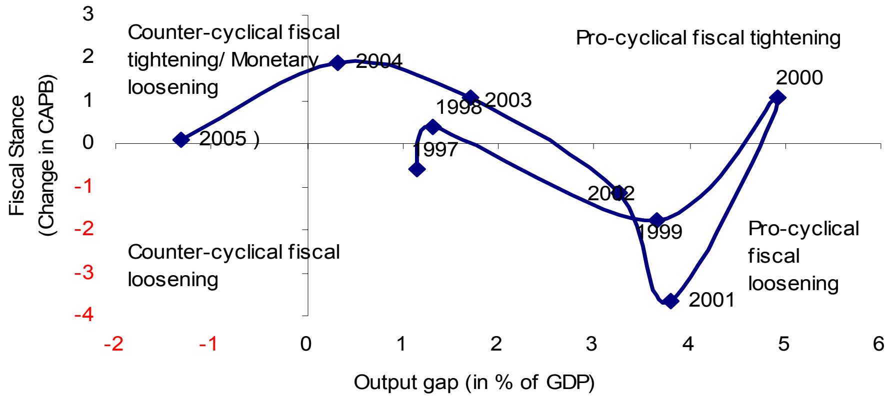

*Note: Tax overshoot defined as the sum of tax revenues in excess of the planned profiles published by Department of Finance of Ireland (January 2006).*
*Source: Commission services, Department of Finance Ireland*

## *Feeding an unbalanced policy mix*

*The fiscal stance may have contributed to the rise in property prices over the last decade…*

EMU membership has been a challenge for Ireland, notably owing to the consequent loss of monetary policy as an independent instrument of economy policy (Čech and MacDonald, 2004) and lower real interest rates leading up to euro area membership. Irish fiscal policy appears not to have fully prevented a pro-cyclical bias (as illustrated in chart 6 where the overall stance of fiscal policy is measured by the change in the cyclically-adjusted primary balance, CAPB) and may have somewhat contributed to overheating pressures in the property market. In recent years the stance of fiscal policy as conventionally measured has somewhat tightened. Nevertheless, this can be partly attributed to one-off factors (for instance related to special investigations of the Irish tax authorities) and to the increase of revenue from property market-related capital taxes.

**Chart 5: Ireland – the fiscal and monetary stance**




*Source: Commission services*

*…and the management of demand pressures is the main challenge over the medium term.*

Recent property tax buoyancy has allowed the Irish government to achieve a uniquely favourable fiscal position, opening the possibility of cutting taxes and increasing expenditure in the budget for 2007. In these circumstances maintaining a prudent fiscal stance could be challenging, including avoiding adding to domestic demand pressures that otherwise could contribute to driving the housing market further away from its equilibrium. In this context, a particular risk stems from the release of the bulk of SSIA funds in years 2006 to 2007 (a government-sponsored saving scheme amounting to an equivalent of around 8½% GDP) and uncertainties as to whether the bulk of these proceeds will be spent, adding to demand pressures, or reinvested in other savings instruments; the prospect is that at least part will be spent when the funds mature. Finally, given the features of the Irish tax system, a solid fiscal stance might help to cushion a possible downward adjustment of housing output towards more sustainable levels.

## *Looking ahead: risks are mounting*

Given the weight of the residential construction sector in the Irish economy, fuelled by rapidly rising levels of household indebtedness, it seems that the growth composition is becoming increasingly imbalanced. The short-term prospects for the Irish economy nevertheless remain buoyant, as domestic demand stimulated by maturing savings accounts and the demographic 'power-house' are likely to remain for some time the drivers of economic growth.

*Short-term prospects are buoyant…*

*…but high property prices and infrastructural bottlenecks might lower potential growth over the long run*

However, over the medium run, risks to the macroeconomic outlook appear to be mounting. In particular, a possible post-boom housing adjustment might be painful in an environment of rising interest rates. The main challenge of fiscal policy is therefore to avoid adding to domestic demand pressures, while not compromising social cohesion and commitments addressing the infrastructural needs of the economy; in this context possible changes to the tax code away from the relatively favourable tax treatment of housing could be explored. Action in this area would help reduce the risk that escalating property prices (alongside apparent infrastructural bottlenecks) might tend to reduce the supply of skilled labour from overseas and thus act as a brake on future potential growth.

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