

October 19, 2007

A Sharp Construction Sector Retrenchment Would Hit Ireland And Spain Hard

Primary Credit Analyst:

Trevor Cullinan, London (44) 20-7176-7110; trevor_cullinan@standardandpoors.com

Secondary Credit Analysts:

Frank Gill, London (44) 20-7176-7129; frank_gill@standardandpoors.com

Moritz Kraemer, Frankfurt (49) 69-33-99-9249; moritz_kraemer@standardandpoors.com

Table Of Contents

Construction Sector

Forecasts

Public Finance Impact

Related Articles

Methodological Appendix

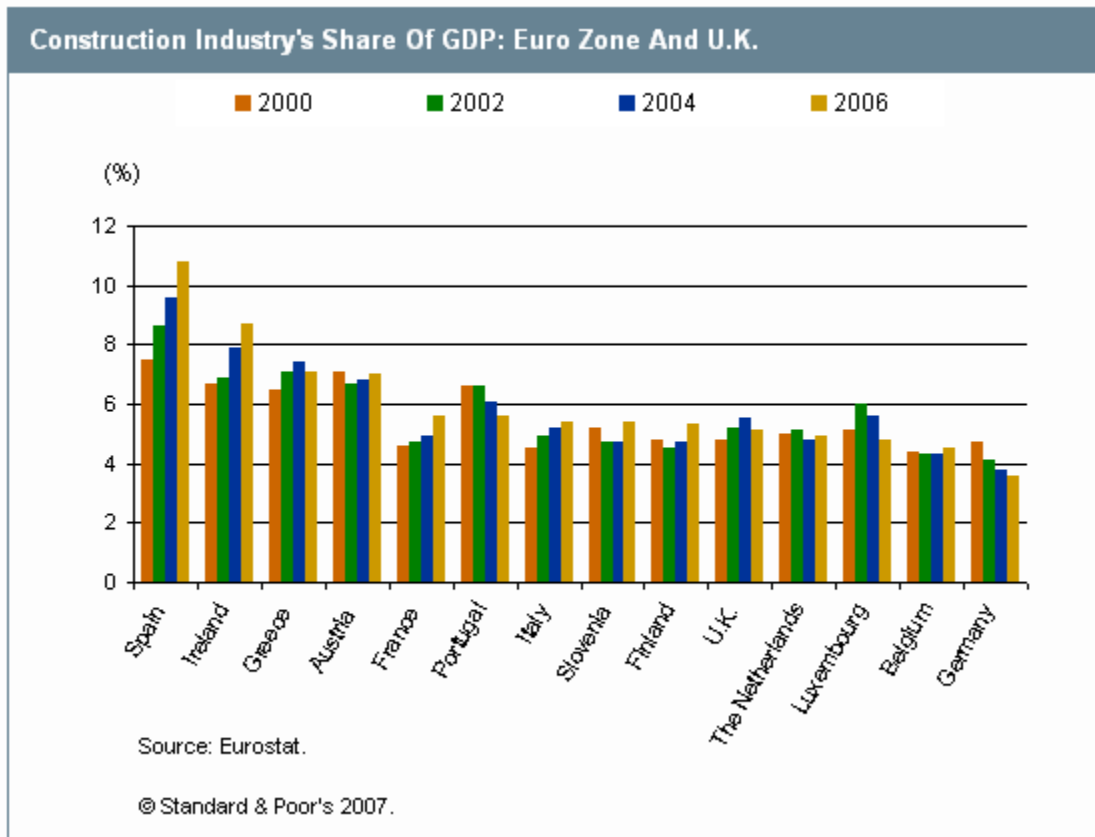
A Sharp Construction Sector Retrenchment Would Hit Ireland And Spain Hard

House prices in the Republic of Ireland (AAA/Stable/A-1+), the Kingdom of Spain (AAA/Stable/A-1+), and the United Kingdom (U.K.; AAA/Stable/A-1+) have risen among the fastest in Europe over the past decade and with their housing markets estimated as being at least 30% overvalued, and the downturn already in evidence, the correction could be protracted. The slowdown will hit economic growth in these three sovereigns to varying degrees. Standard & Poor's Ratings Services' scenarios focus on the impact of an expected slowdown in the construction sector. Our base case indicates that Ireland and Spain will likely take the most significant direct hit, while the U.K.'s more diversified economy, which is currently experiencing a less stark moderation in house price and construction sector growth, should weather the storm to a greater degree. Nevertheless, all three economies will experience a slowdown in growth and are open to the nefarious impact that falling consumer confidence could have on future economic output. Moreover, our stress scenario projections indicate that a sharper decline in the construction sector would result in a slower adjustment back to our base case scenario in Ireland and Spain, as compared with the U.K. Meanwhile, all three sovereigns will experience worsening fiscal positions, based on an assumption of unchanged spending plans, given--as we believe--that property-related revenues have passed their peak.

Construction Sector

The Spanish and Irish economies are heavily exposed to the direct effects of the housing market slowdown on the construction sector. This is due to the substantial and, until recently, increasing share of economic output and jobs directly related to the sector (see chart 1 and table 1). Given that the housing stock in Spain was already well above the EU-15 average earlier this decade and housing completions per 1,000 members of the population have continued to surge, further increasing the number of dwellings per capita (see charts 2 and 3), we expect to see some retrenchment over the coming years as illustrated by our base case scenario (see chart 4).

Chart 1



The boom in construction in Ireland, on the other hand, has been partly based on a period of catch up; Ireland's housing stock was significantly below the EU-15 average, suggesting that there could be further room for growth in the market over the coming years. We expect the U.K.'s housing stock to have moved closer to the EU-15 average. There is still likely to be some room for further investment, however, particularly in the south east of the country where lack of supply has been a key factor in the recent house price boom.

Chart 2

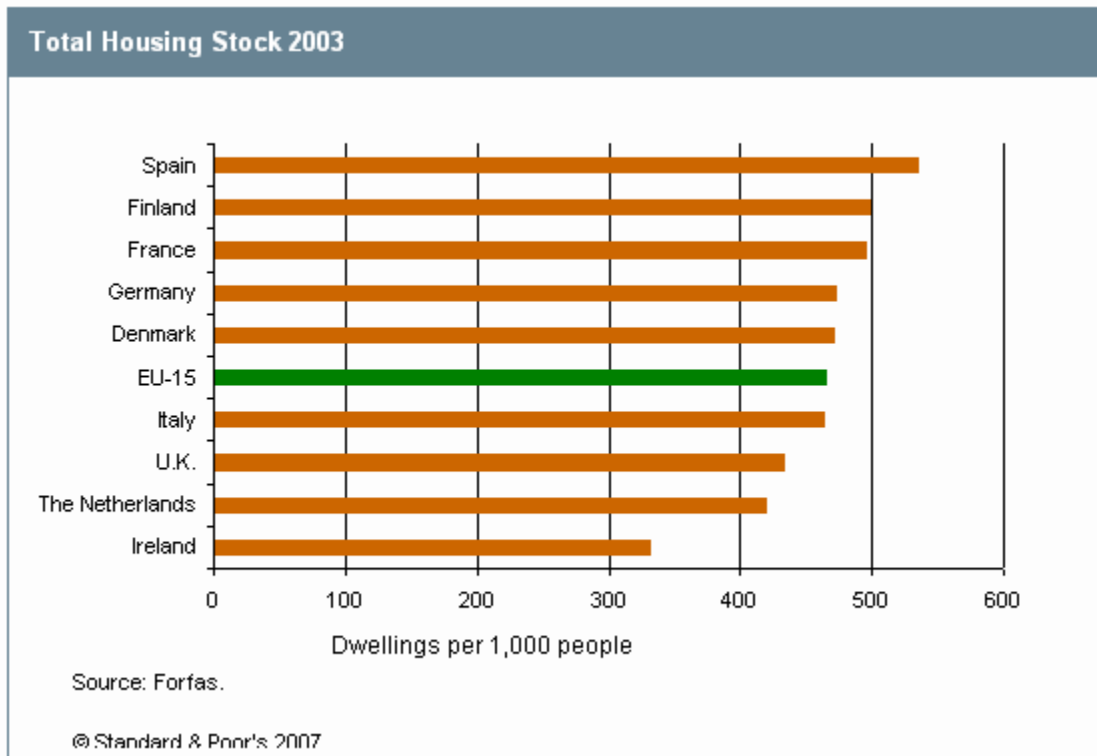
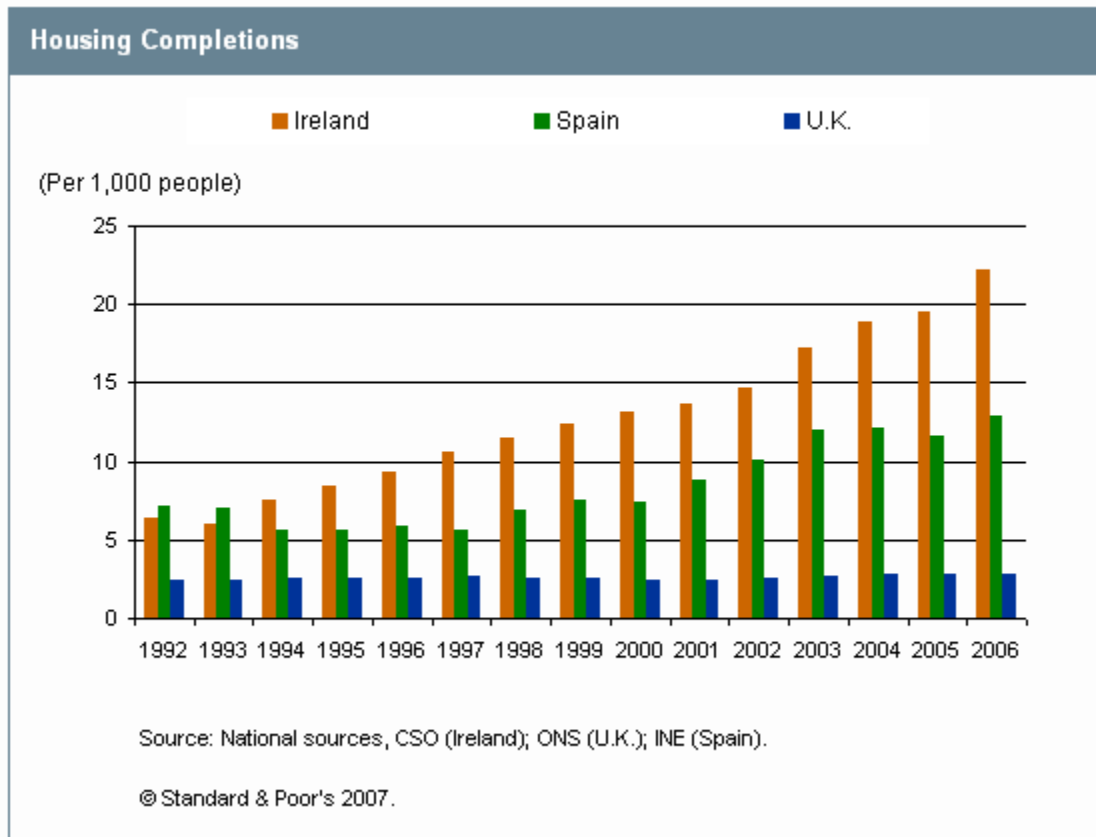


Chart 3



In all three countries large-scale immigration, coupled with increased household formation due, for example, to a growing number of single-person households as a result of divorce or people marrying at a later age, has played a part in fuelling demand. A consequence has been increases in house prices and building and, ultimately, economic growth. These factors will not change overnight. Meanwhile, public sector investment plans also remain substantial given the infrastructure needs in all three countries

Nevertheless, the number of houses approved for building in Spain fell sharply—by 8.7%—during the first seven months of 2007, having risen by 14% in the same period last year, although this increase was in part related to a change in the technical construction code ("codigo tecnico de la edificacion"), which meant that some construction projects were brought forward before the new regulation came into force. In Ireland, housing starts, based on housing registrations, are estimated to have dropped by 58% in August 2007. In the U.K., housing starts have also weakened, averaging an annual decline of 0.3% in 2005-2006, compared with average growth of 8.5% in 2003-2004. We expect a further acceleration in this trend in all three sovereigns: Falling share prices for property-related firms and exposed banks so far this year have further highlighted the difficulty of the current environment for the sector.

Despite the already evident slowdown—and in some cases sharp decline—in housing starts, the main effects will only be felt from 2008, as first-half 2007 economic growth was relatively robust in all three economies. Countries such as Ireland and Spain, where the construction sector accounts for a significant share of employment, will experience the sharpest impact as the sector slows (see table 1). In fact, construction sector jobs in Ireland fell by 0.1% in April

2007, compared with the same period last year, the first decline in over four years, while latest data show that the pace of decline accelerated to 2.4% in August. The U.K. is also vulnerable in this regard, as a large part of employment growth since 2000 has been generated by the construction sector. In absolute terms since 2000, construction sector jobs have increased by 768,000 in Spain; 352,000 in the U.K.; and 102,000 in Ireland.

Table 1

Total Employment And Construction Sector Components				
(%)	Average annual growth in total employment, 2000-2006	Construction, % of total employment, 2006	Average annual growth in construction employment, 2000-2006	Percentage of total employment growth attributable to construction, 2000-2006
Euro zone, 13 countries	1.5	8.2	1.6	6.5
Ireland	3.7	13.4	9.7	26.6
Spain	4.4	12.6	7.1	19.3
U.K.	0.8	8.1	3.0	30.9

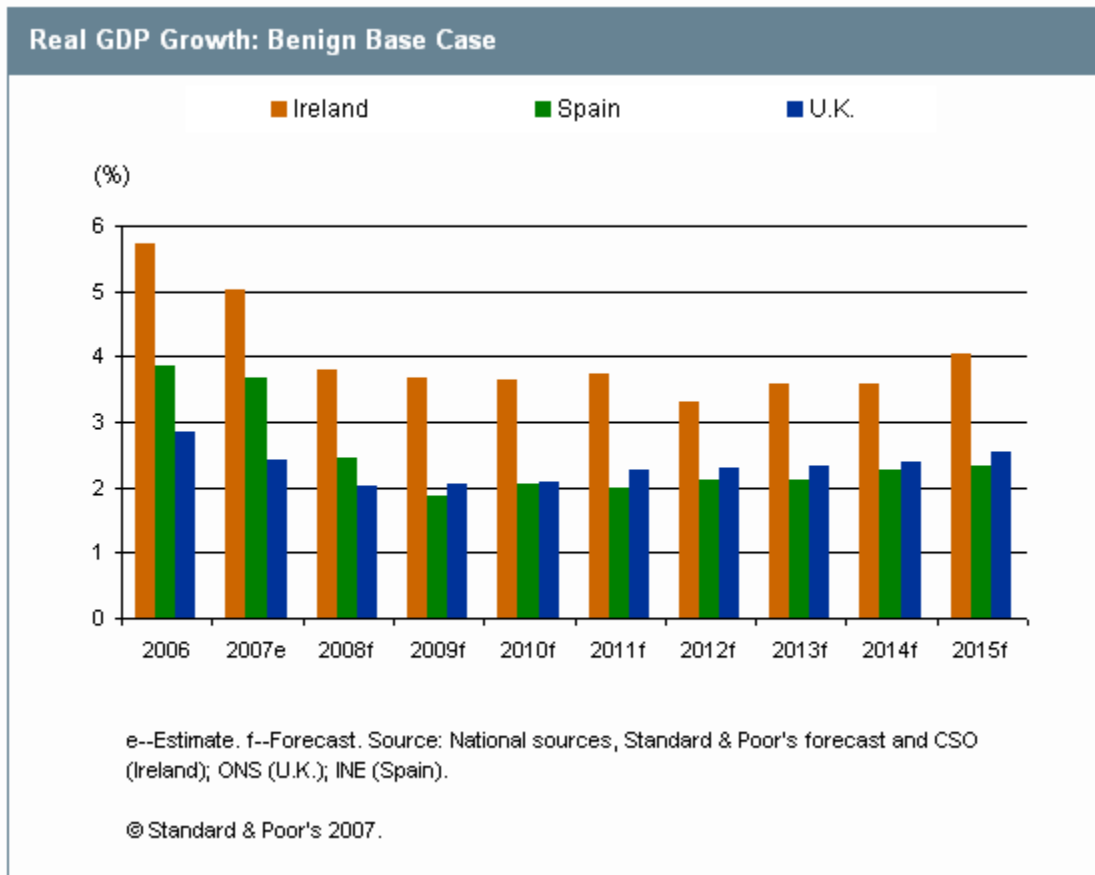
Source: Eurostat.

The proportion of workers on temporary contracts and the number of economic migrants employed in the sector will be important factors with regard to how quickly the three economies adjust to the slowdown. In Spain, 34% of those in employment were on temporary contracts in 2006, compared with the average of 17% for the 13 countries in the Eurozone, 6% in the U.K., and 3% in Ireland. A significant number of workers in the construction sector are likely to be on these temporary contracts. It would be a happy coincidence if these were also the more mobile workers, able to move on as jobs are cut, reducing the workforce and steadying unemployment figures, which could ease economic adjustment to the downturn. However, these are untested waters, and if many of these workers remain in situ without work, public finances could begin to show signs of strain (see the "Public Finance Impact" section for more details).

Forecasts

Under the benign assumption that the construction sector as a share of GDP will moderate gradually back toward its ten-year average, along with weaker service sector growth, both Ireland and Spain are to experience a significant slowdown in economic output, of about 1.2 percentage points, beginning in 2008. Economic growth in the U.K. will also weaken but to a lesser extent, given the smaller contribution to growth from construction in previous years (see chart 4).

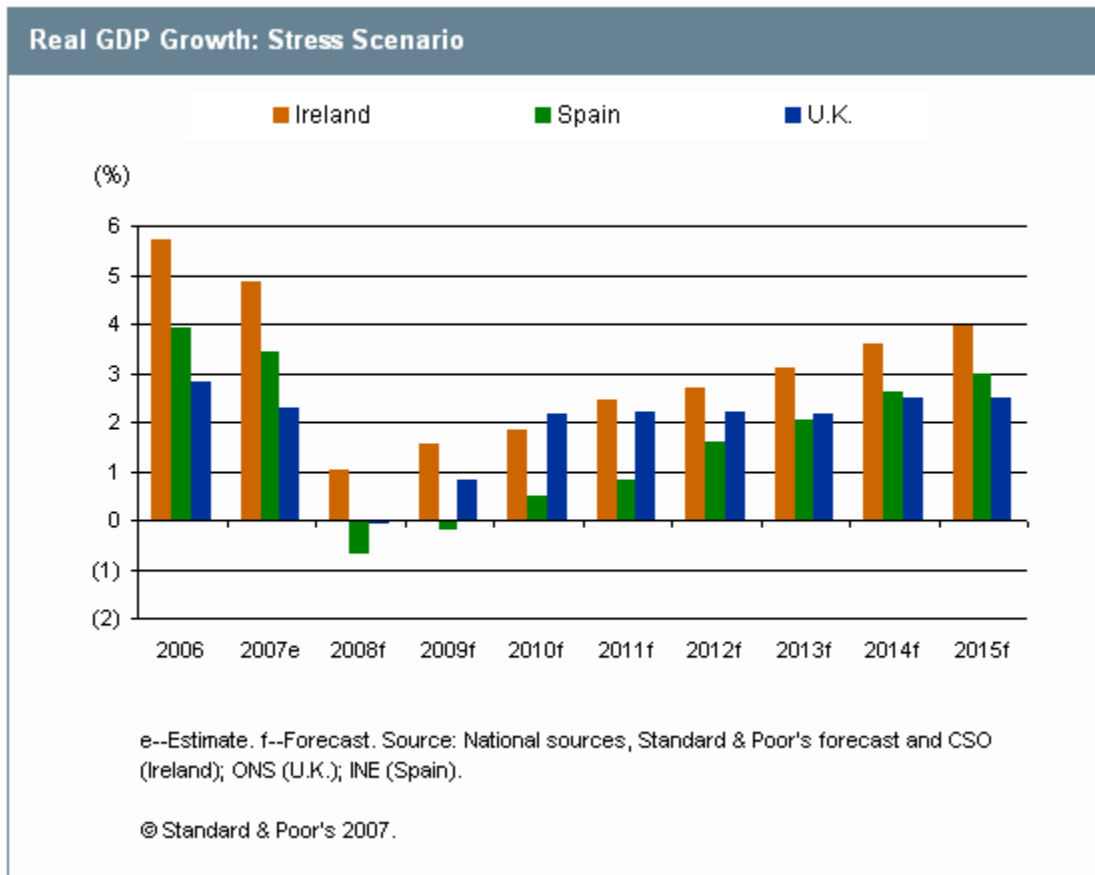
Chart 4



We have stress tested this base case with a sharper decline in construction sector output, estimated by applying the growth rates experienced by the construction sectors in the downturns in the early 1990s in the U.K. following a housing market boom, and in the mid-1990s in Germany following unification. We then took an average of the GDP growth rates resulting from the weaker contribution from construction, while also adjusting for weaker service sector growth.

The short-term impact of such a slowdown on economic growth would be significant compared with our base case scenario (see chart 5). Nevertheless, U.K. economic growth would likely rebound toward our base case GDP forecast for 2008 by the end of the decade, mainly because, according to our assumptions, the reduction in the service sector relative to the construction industry decline would be less pronounced than in the other two economies. In Ireland and Spain, though, economic growth would take until closer to 2015 to regain the growth rates expected in 2008 in our base case, due to the relative size of the construction sector in the overall economy. In all, then, a sharp downturn would have a much more debilitating affect for medium-term growth in Ireland and Spain.

Chart 5



The heavily indebted nature of the private sectors in Ireland (203% of GDP), the U.K. (189%), and Spain (170%) poses significant risks over and above that of a construction sector slowdown (for more information, please see "European Economic Forecast: Downside Risks Dampen The Outlook For Growth In Europe", published on Oct. 2, 2007, on RatingsDirect).

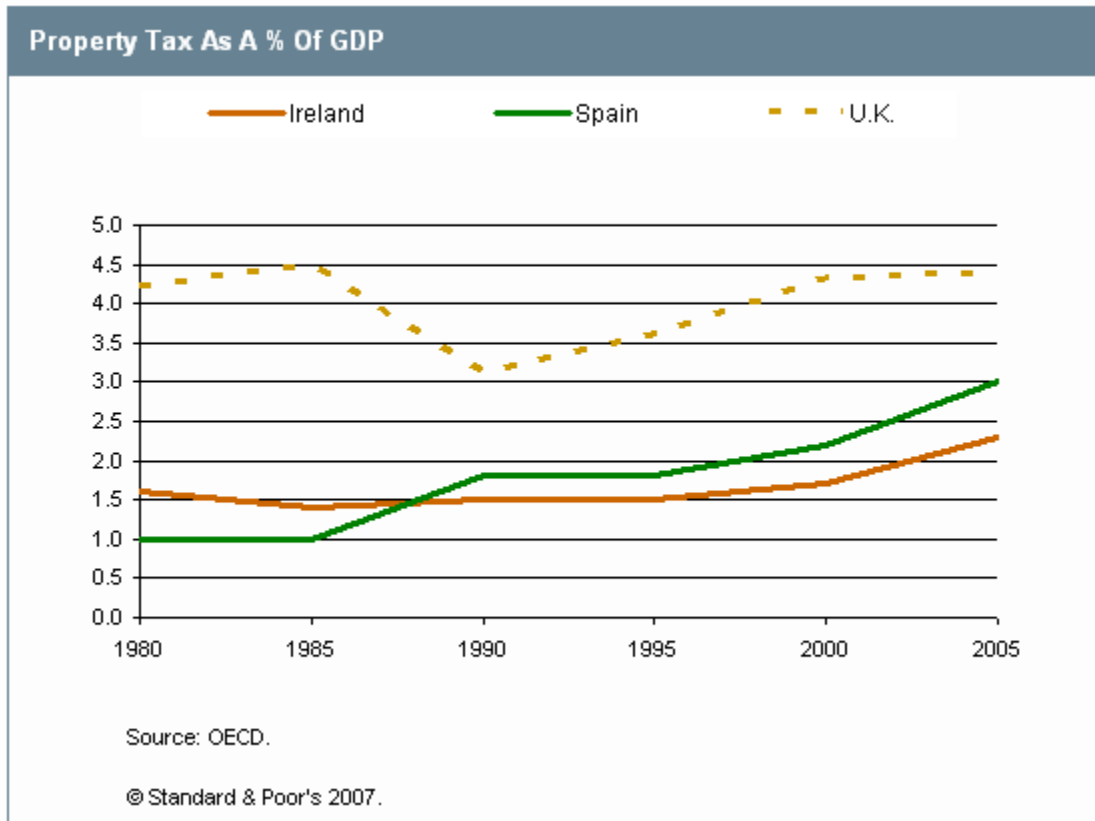
Public Finance Impact

Relatively low government debt burdens and high revenue-raising potential in the case of the U.K. and Ireland, plus general government surpluses in the case of Ireland and Spain, allow the three sovereigns some fiscal flexibility in order to assuage the effect on growth of the reduced contribution from the construction sector. Standard & Poor's fiscal flexibility index ("The 2007 Fiscal Flexibility Index: Continental Sovereigns Still Lagging Behind", published on May 31, 2007, on RatingsDirect) showed all three sovereigns to be well placed to adjust to adverse economic trends, with Ireland the best placed of them all.

Nevertheless, the U.K. treasury enjoys a large share of tax revenues directly related to the property market. The share of property-related tax revenues has also been picking up strongly in Ireland and Spain in the past decade. Between 1995 and 2005, taxes on property as a percentage of total taxation increased by 2.0% in Ireland, 1.9% in Spain, and 1.5% in the U.K. The current slowdown in these markets will remove this key plank of revenue growth,

collected both directly through stamp duty, VAT, and capital gains tax but also indirectly as increased housing wealth over recent years has encouraged household consumption, a slowdown in which will have a secondary impact on VAT revenues. The impact of the early 1990s housing market crash on this revenue source can be seen in chart 6.

Chart 6



In light of this, the Irish government is already attempting to manage down expectations ahead of the December 2008 budget, stating that the public can no longer expect double-digit spending growth, as the impact on tax revenues is already becoming apparent as the housing market slows. Meanwhile, in the run-up to next year's parliamentary elections the Spanish government has taken a different approach with the 2008 budget, promising a €2.3 billion increase in social handouts. As a result the government's forecast is for a reduction in the 2008 budget surplus to 1.2% of GDP in 2008, from an estimated 1.8% in 2007, which given the possible adjustment in the economy due to a sharp downturn in the housing market would seem less than prudent.

Spain's budget for 2008 also contains generous increases for regional aid, and it is in fact at the regional level that the housing market slowdown will be most keenly felt, as municipalities are significantly dependent on the property market for their revenues. Latest estimates show local government revenues from the property market at 2.8% of GDP in 2004 in Spain, compared with 1.7% in the U.K. and 0.6% in Ireland.

Standard & Poor's expects a slight worsening in general government balances over 2008 and 2009, according to our base case assumptions. However, given unchanged expenditure assumptions, if property-related revenues decline in line with a significant deterioration in the housing market, we estimate that public finances will deteriorate even

further (see table 2).

Table 2

General Government Balance (% of GDP)				
	Base line forecast		Stressed forecast*	
	2008	2009	2008	2009
Ireland	0.9	0.6	0.3	0.2
Spain	(0.1)	(0.5)	(0.6)	(0.5)
U.K.	(2.5)	(2.6)	(3.1)	(2.6)

*Property-related revenues to decline sharply in line with U.K. experience of the early 1990s. Source: Standard & Poor's forecast.

Related Articles

- Public Finance System Overview: Spanish Local And Regional Governments, Oct. 3, 2007
- Public Finance System Overview: U.K. Local And Regional Governments, Oct. 3, 2007
- European Economic Forecast: Downside Risks Dampen The Outlook For Growth In Europe, Oct. 2, 2007
- Economic Research: Europe's Housing Markets Fall In Line As Central Banks' Tightening Filters Through, Aug. 23, 2007
- The 2007 Fiscal Flexibility Index: Continental Sovereigns Still Lagging Behind, May 31, 2007
- Spain (Kingdom of) summary analysis, May 24, 2007
- Ireland (Republic of) summary analysis, May 24, 2007
- United Kingdom summary analysis, May 23, 2007
- United Kingdom full analysis, Jan. 25, 2007
- Ireland (Republic of) full analysis, Dec. 22, 2006
- Spain (Kingdom of) full analysis, Dec. 13, 2006
- European Economic Forecast: The Storm Clouds Gather Over European Housing Markets, Nov. 29, 2006
- Spain Country Report: Fiscal Coordination and Rating Implications, March 22, 2004

Methodological Appendix

Base case

- Construction sector share in GDP to gradually moderate from 2008, reverting back to 1995-2005 average.
- Related moderation in services sector growth as economies slow down, but where the service sector has been increasing its share in GDP, as in Ireland and the U.K., this trend will continue. In Spain, service sector contribution to GDP is assumed to be largely flat.
- Agriculture and energy sectors share of GDP largely flat. Industrial sector share of GDP expected to continue to decline, more quickly in Ireland and the U.K. than Spain, in line with trends since earlier this decade.

Stress test

The impact of the following two scenarios on the construction sectors of Ireland, Spain, and the U.K. is simulated and then an average taken of the resultant GDP growth rates to provide the stress scenario.

- U.K. construction sector historical growth rates beginning in 1991 applied to forecast data for the construction sectors of the respective countries from 2008.

- German construction sector growth from 1996 applied to forecast data for the construction sectors of the respective countries from 2008.

Service sector to decline in line with worsening construction sector. Given that the construction sectors in Ireland and Spain as a share of the service sector are double that of the U.K., the impact on the service sector in the U.K. is assumed to be less severe.

Other sectors of the three economies expected to grow at the same rates as in the base case.

Fiscal data.

The stress case applies a moving average of the fall in property-related revenues in the U.K. to Standard & Poor's base case forecast of general government balance in the respective countries.

Data sources are as indicated in the relevant charts.

Additional Contact:

Sovereign Ratings; SovereignLondon@standardandpoors.com

Copyright © 2007, Standard & Poors, a division of The McGraw-Hill Companies, Inc. (S&P). S&P and/or its third party licensors have exclusive proprietary rights in the data or information provided herein. This data/information may only be used internally for business purposes and shall not be used for any unlawful or unauthorized purposes. Dissemination, distribution or reproduction of this data/information in any form is strictly prohibited except with the prior written permission of S&P. Because of the possibility of human or mechanical error by S&P, its affiliates or its third party licensors, S&P, its affiliates and its third party licensors do not guarantee the accuracy, adequacy, completeness or availability of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. S&P GIVES NO EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE. In no event shall S&P, its affiliates and its third party licensors be liable for any direct, indirect, special or consequential damages in connection with subscribers or others use of the data/information contained herein. Access to the data or information contained herein is subject to termination in the event any agreement with a third-party of information or software is terminated.

Analytic services provided by Standard & Poor's Ratings Services (Ratings Services) are the result of separate activities designed to preserve the independence and objectivity of ratings opinions. The credit ratings and observations contained herein are solely statements of opinion and not statements of fact or recommendations to purchase, hold, or sell any securities or make any other investment decisions. Accordingly, any user of the information contained herein should not rely on any credit rating or other opinion contained herein in making any investment decision. Ratings are based on information received by Ratings Services. Other divisions of Standard & Poor's may have information that is not available to Ratings Services. Standard & Poor's has established policies and procedures to maintain the confidentiality of non-public information received during the ratings process.

Ratings Services receives compensation for its ratings. Such compensation is normally paid either by the issuers of such securities or third parties participating in marketing the securities. While Standard & Poor's reserves the right to disseminate the rating, it receives no payment for doing so, except for subscriptions to its publications. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

Any Passwords/user IDs issued by S&P to users are single user-dedicated and may ONLY be used by the individual to whom they have been assigned. No sharing of passwords/user IDs and no simultaneous access via the same password/user ID is permitted. To reprint, translate, or use the data or information other than as provided herein, contact Client Services, 55 Water Street, New York, NY 10041; (1)212.438.9823 or by e-mail to: research_request@standardandpoors.com.