IRELAND MARKET VIEW H2 2023

October 2023
Mace Consult

Foreword

While the current situation for the construction industry in Ireland is one where production has fallen recently, we are much more confident about how the sector will fare in the more medium-term. There is an incredibly large pipeline and, with the government enjoying a remarkable surplus, this is only likely to increase. However, for the moment, some of the fragility of the sector is due to inflation and a tight labour market, and if the government chooses to spend even greater sums, then this could trigger renewed inflationary problems. In particular, labour shortages will only become more pronounced. In Q2, the number of people working in construction hit its highest level since the global financial crisis, and this was against a backdrop of falling construction production. If the industry starts to expand as it might, finding all the necessary workers will become a significant impeding factor.

Much of the reason for optimism comes from the infrastructure industry. While the residential and non-residential sectors are seeing production fall, civil engineering has grown strongly over the first half of the year.

Recognising some of the challenges this presents, the government has put in place new rules for major projects. Greater scrutiny for such schemes, across the planning and business case process is set to create barriers and, in order to successfully deliver them, clients will need to work with experienced, trusted partners, capable of providing a full service offering.

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Overview of the economy

After falling into a technical recession in the first quarter of the year, GDP recovered in Q2. As usual, GDP does not provide a good reflection of the domestic economy, with the significant drop in Q1 coming about largely due to weaker investment in intangible assets. To avoid this well-known problem, the Central Statistics Office publishes alternative indicators to better show how the economy is faring. While Modified Domestic Demand (MDD), which excludes many of the distortions caused by a handful of large multinationals, has also reported several quarters of falling output, the drop-off is less severe than with GDP, and there was growth of 1% in Q2.

Within MDD, modified gross domestic fixed capital formation has declined in three of the past four quarters. This category, which includes building and construction, has shrunk 2.4% over the past year. Helping offset this, and limit the wider economic damage, is household consumption. Despite the challenges posed by high levels of inflation, it accounts for half of MDD and continues to grow.

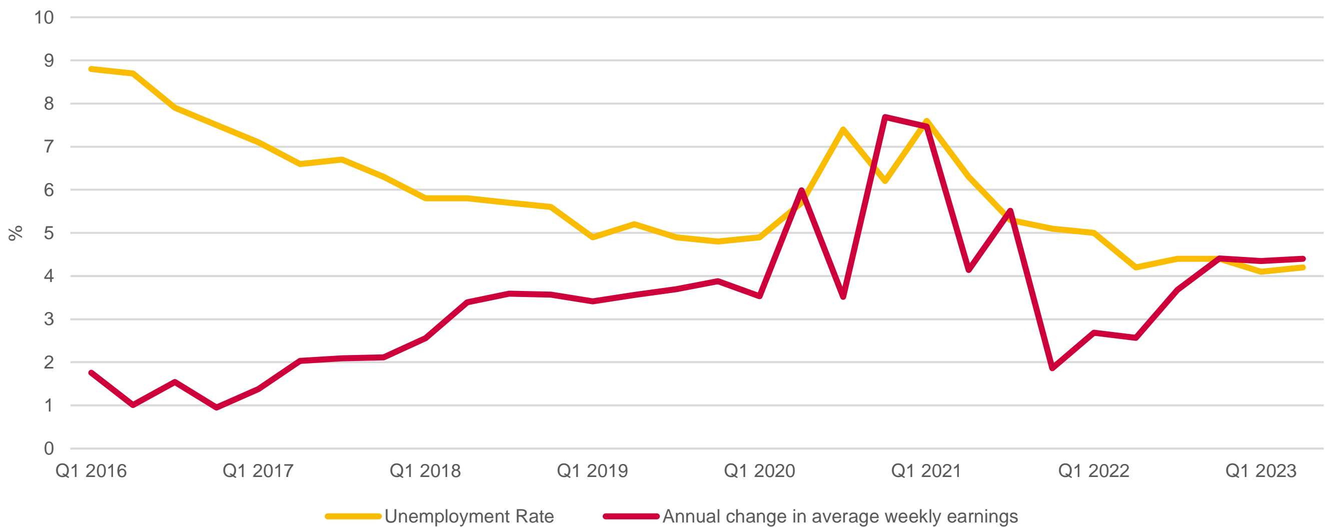
Labour market performing well

One reason for this is the strength of the labour market. The unemployment rate, which has been at 4.1% for most of the year, is at its lowest level ever. Employment is also growing steadily and the rise of 41,000 people in work in the second quarter was one of the best quarters on record. Similarly, vacancies, while a little down on last year's levels, remain close to these highs. Currently, these factors are contributing to reasonable wage growth, although with inflation outstripping pay, workers are becoming poorer in real terms. In Q2, average weekly earnings were 4.4% higher than a year earlier, despite signs that growth is slowing, with the quarterly figure the weakest in a year.

Figure 1: Domestic demand

Source: Central Statistics Office

Figure 2: Unemployment rate and weekly earnings



Source: Central Statistics Office

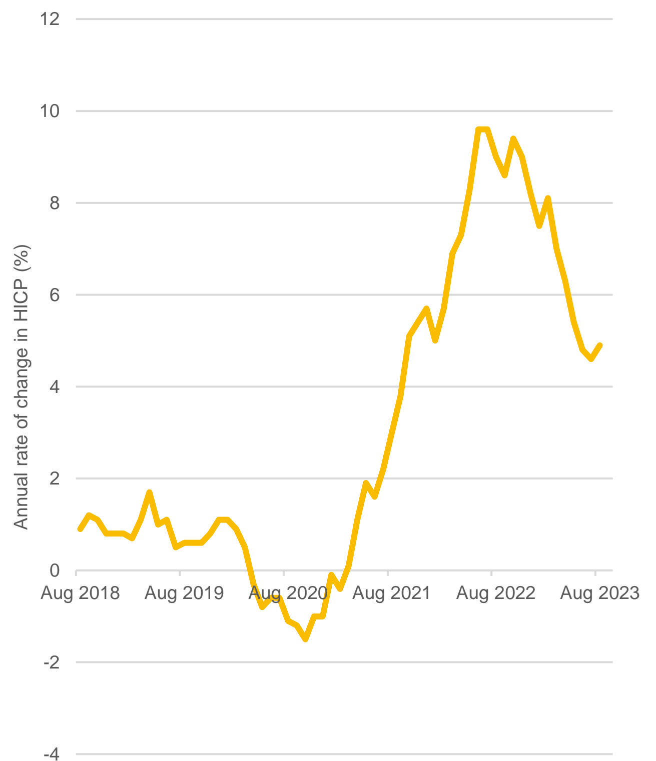
Inflation almost half last year's level

Having eased considerably from its peak last summer, there was a minor uptick in inflation in the latest release for August.

Nonetheless, the general trend is downwards, and despite the recent rise in the price of oil, the rate of inflation should slow further throughout the next 18 months. While inflation didn't quite reach the double-digit levels that occurred elsewhere in Europe, global supply chain problems and higher energy prices still had a significant effect. With many supply chain problems now resolved, inflation should continue to cool, although the pace at which it does so will depend on second-round effects. As wage pressures persist and firms try to maintain profit margins, there is a risk that inflation will become more entrenched and stay higher for longer.

In an attempt to bring inflation under control, the European Central Bank (ECB) has raised interest rates in ten successive meetings, taking the deposit rate to 4% and starting to slow growth. Yet, while the ECB has cut its GDP forecasts, that it has increased its inflation numbers shows the move is not having the desired effect. There is much talk about whether interest rates have peaked, but even if they have, it will be some time before they start to come down, which is likely to hurt parts of construction.

Figure 3: Inflation rate

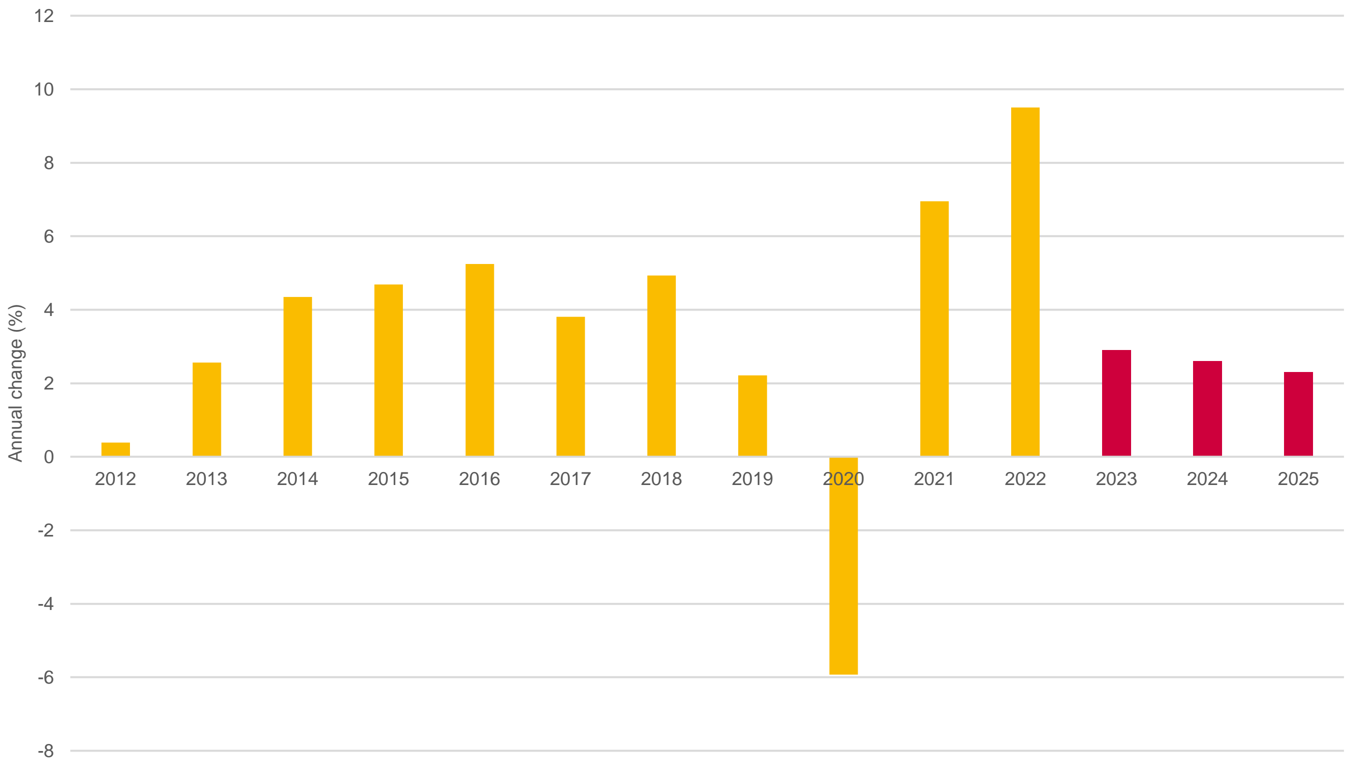


Source: Central Statistics Office

Economic outlook

Forecasts from the Central Bank of Ireland suggest growth will slow in 2024 and 2025. However, MDD should still increase by more than 2% in both years. This compares favourably with GDP forecasts from the ECB, which anticipates euro area growth will be 1% and 1.5% in the next two years. For the majority of Western European countries, growth forecasts are marginally worse, and the sluggishness of Ireland's neighbours is likely to hinder many exporting sectors. A tight labour market and continuing low unemployment rates will support household spending, which in turn will continue to support the economy. Added to this, strong tax receipts will allow for increases in government spending, while simultaneously leading to a fall in debt as a share of GDP. However, as we discuss later, as well as creating opportunities, such a healthy fiscal position also poses challenges.

Figure 4: Domestic demand forecast



Source: Central Statistics Office, Central Bank of Ireland

Construction sector

Construction production, which declined in every quarter last year, rebounded in Q1 2023, before falling again in the second quarter. Not only is production still almost 20% lower than it was pre-pandemic, but since the end of 2021 it has declined nearly 10%. As mentioned earlier, this weakness is having an impact on the wider Irish economy. Even so, it is not all bad news. Notably, civil engineering followed a jump of 6.9% in Q1 with a rise of 5.8% in Q2. This robustness is in contrast to recent survey results. However, even if there is a fall in production, a strong pipeline – especially linked to energy and transport – should help the sector as the decade progresses.

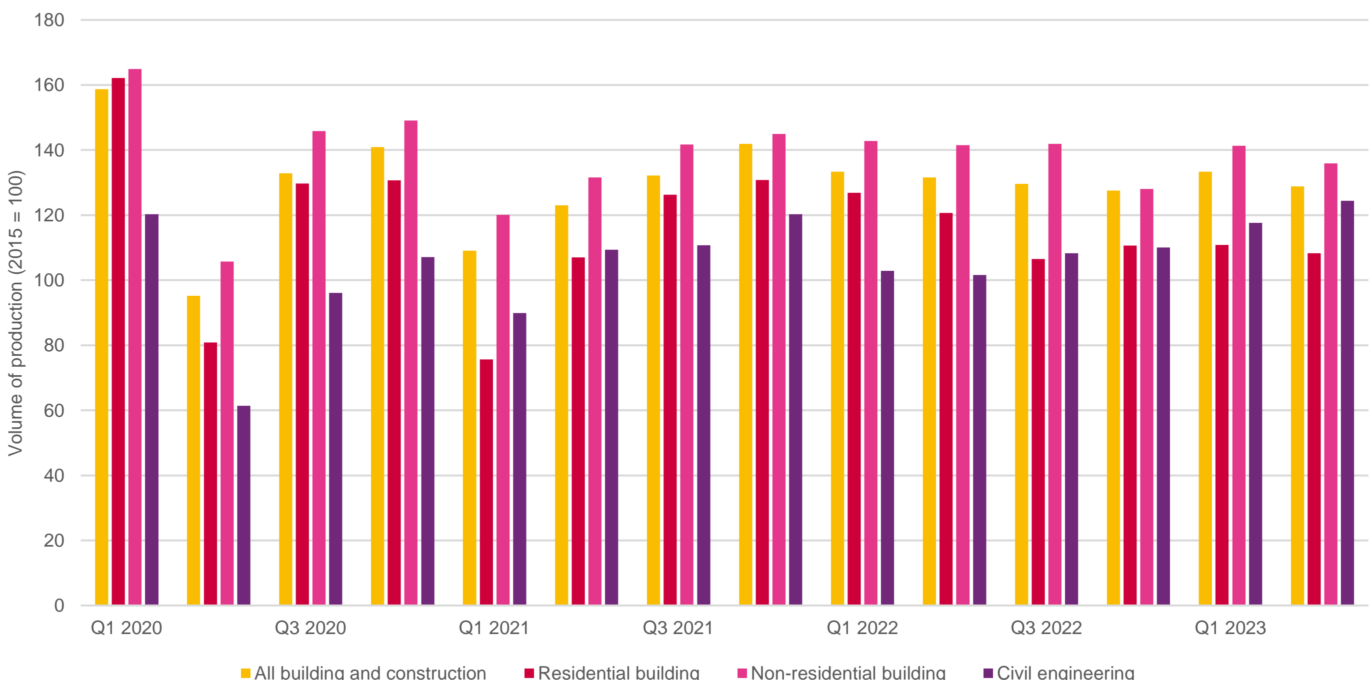
Since the end of 2021, production in the residential sector has fallen considerably as rising inflation and then interest rates have hurt household confidence. Similarly, there has been a large drop-off in planning permissions granted, and whereas the number of dwellings completed has been exceptional over the past two years, a lack of new projects is likely to lead to further falls in production.

The non-residential part of the industry has also declined noticeably recently, likely in part due to the challenges facing the technology sector and weaker demand for new offices. That said, this is a short-term trend, and the technology sector should recover strongly. Over €1 billion of spending going towards three new elective hospitals in Dublin, Cork and Galway will also support prospects in the coming years. The latter two are at a more advanced stage, and the hope is for main contractor procurement in second half of next year, likely boosting production from 2025.

Construction material prices still a problem

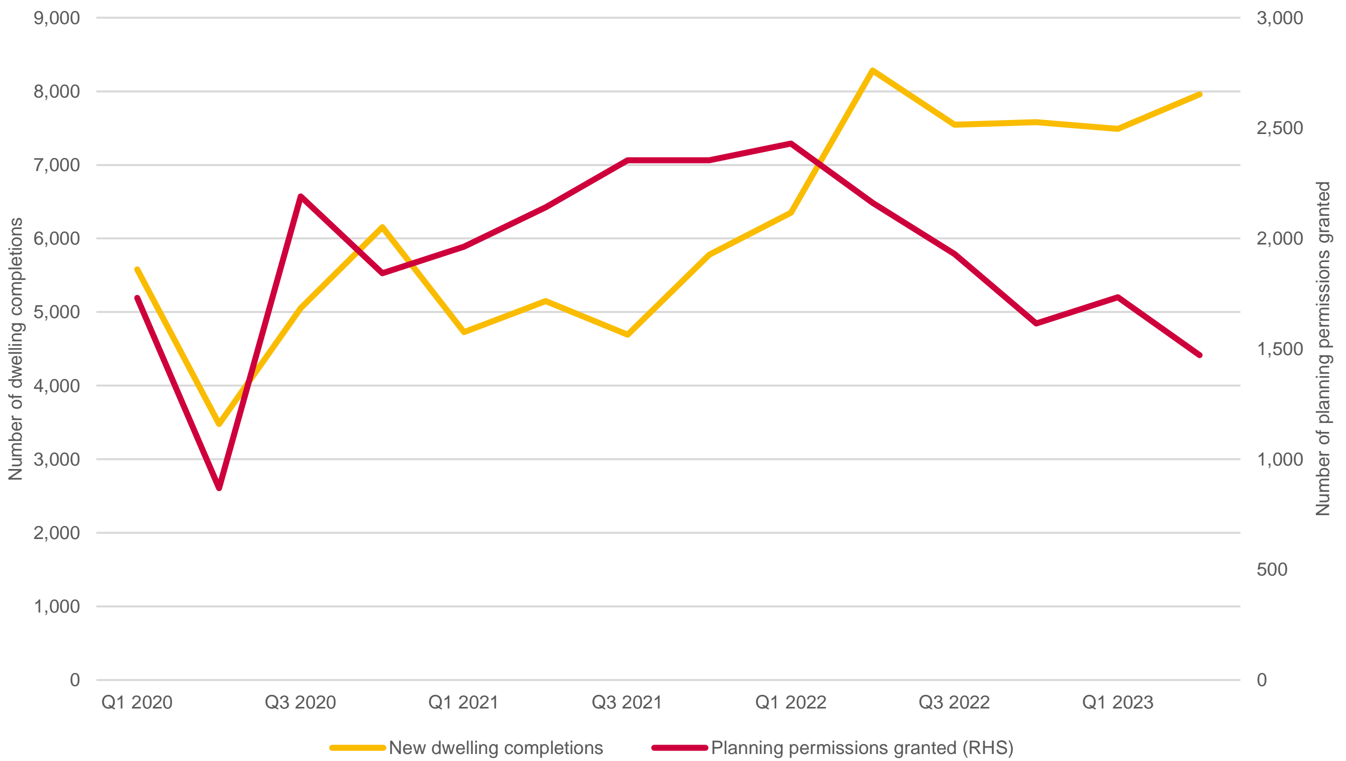
In July, the wholesale building and construction material price index was 1.2% lower than its April peak. While the annual rate of construction material price inflation is 2.2%, the recent drops do suggest pressures starting to ease, potentially giving some respite for contractors. However, this easing is minimal relative to the rises that have happened. Prices are still 36% greater than in December 2020 – noticeably more than the increase in consumer prices, which have risen around 20% over the same period.

Figure 5: Construction production



Source: Central Statistics Office

Figure 6: New dwelling completions and planning permissions granted



Source: Central Statistics Office

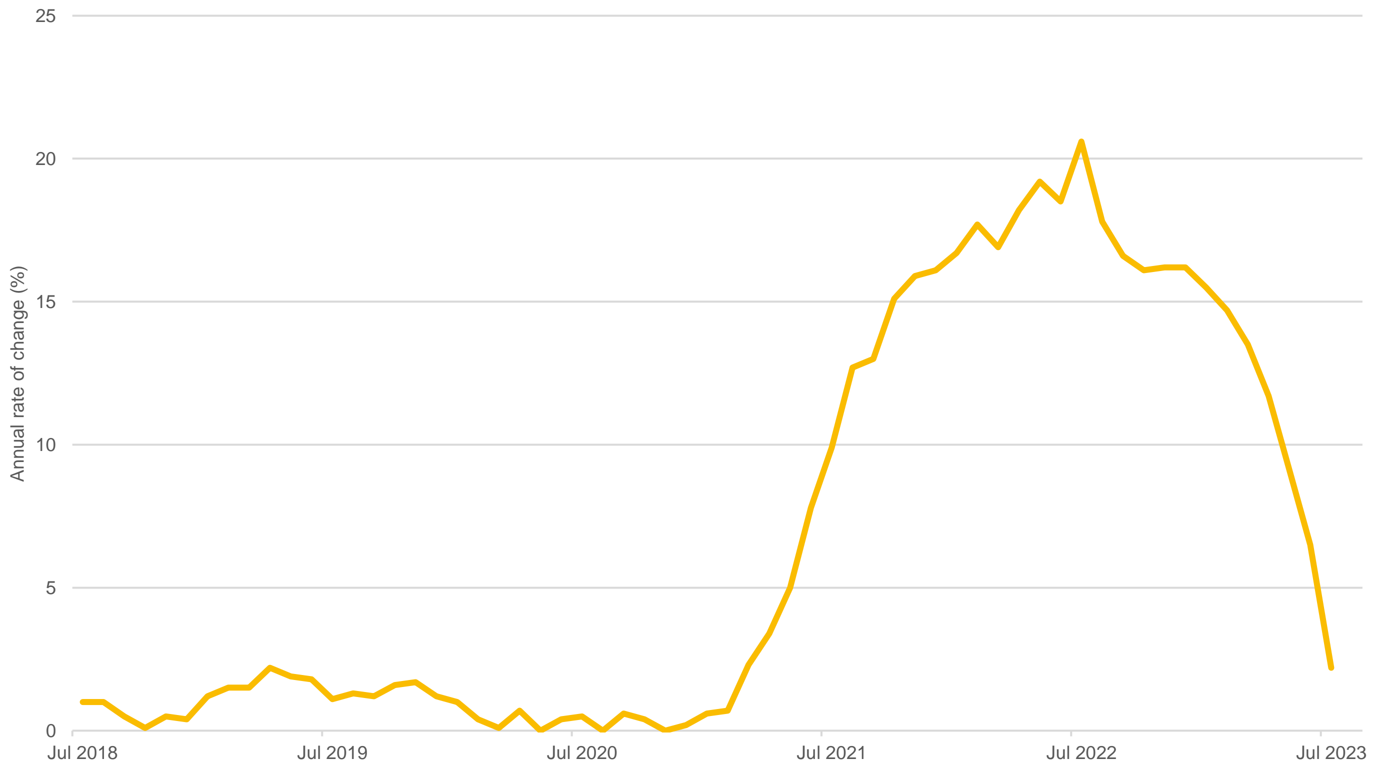
Of the specific materials that the Central Statistics Office covers, there are some which have seen significant declines recently. This is most evident with timber products, where prices are over 20% lower than their 2022 peaks. Still, as with the wider index, this is much larger than at the end of 2020. However, for many products, noticeably lower prices are not yet apparent. As an example, concrete and cement, having increased significantly in the latter part of 2022, have barely changed over the last few months. These highly energy intensive products will benefit from lower energy prices but, due to large manufacturers typically hedging their purchases, the feed through may take time.

While production declined in Q2, the number of people working in construction jumped to its highest level since 2008. This increase, which helped bring down the number of vacancies, is doubly surprising given weekly earnings were 1.2% lower than a year ago, albeit they had risen rapidly before that. Looking ahead, if production remains weak, pay is likely to as well and demand for workers may fall. Yet were production to pick-up, then pay would surely follow.

Construction outlook

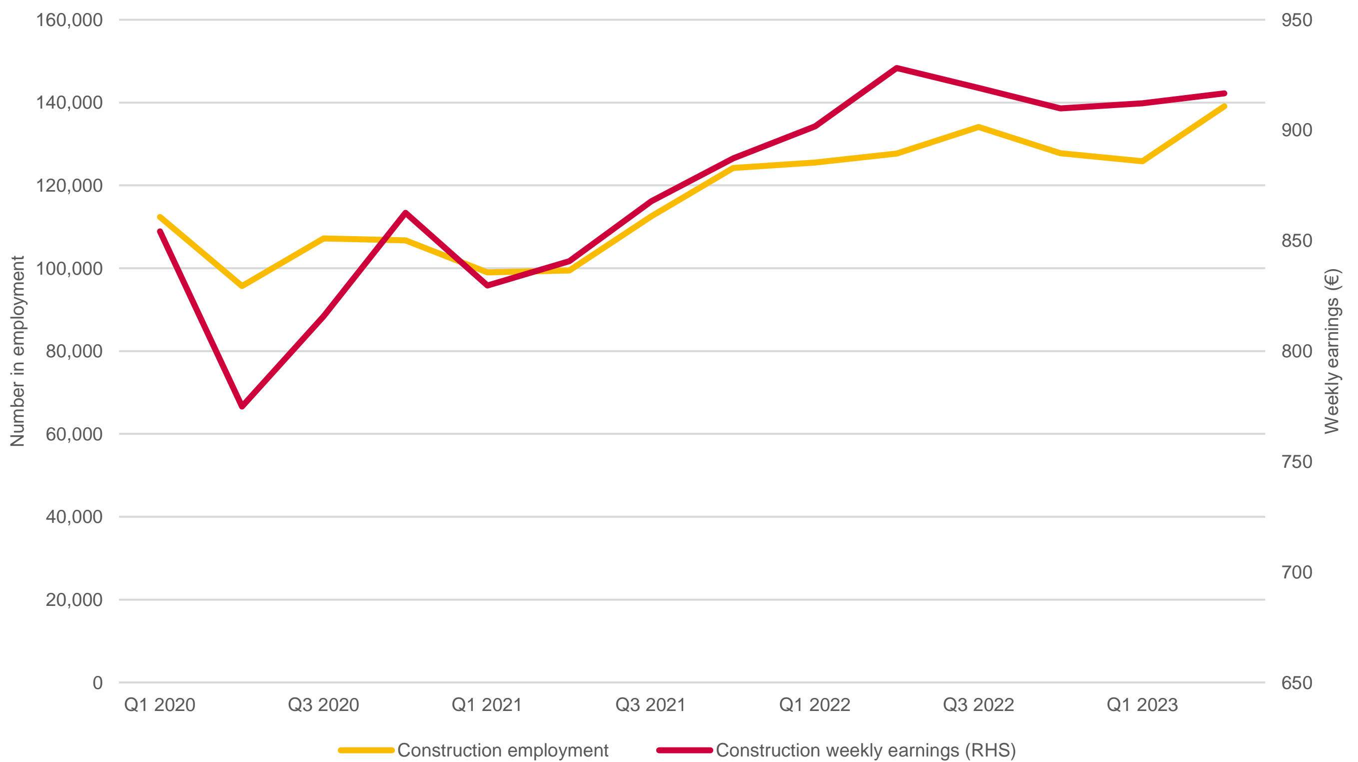
There are a number of headwinds currently facing the sector, particularly due to interest rates and inflation, and the BNP Paribas Real Estate Ireland Construction PMI reports that business optimism is lower than usual. However, looking slightly further ahead, there are several reasons to be positive. Both the ongoing housing shortage, along with the plans from government for significant investment, suggest the industry should strengthen. Assuming there are no more shocks to material prices, the biggest factor that will hold back growth is likely to come from labour shortages. Already a problem, how the industry copes with some of the larger proposed schemes will determine just how fast it can expand.

Figure 7: Wholesale price index for building and construction materials



Source: Central Statistics Office

Figure 8: Construction employment and earnings



Source: Central Statistics Office

Opportunities

There are a number of opportunities and considerations for clients in the near future. We summarise some of these and explain how Mace can help clients make the most of them.

Government spending

Recent years have seen the government surplus surge. Tax receipts are set to outweigh spending by €10bn this year, potentially rising to over €20bn by 2026. Multinationals have provided much of this newfound wealth, and what to do with has become one of the most pertinent political questions. Answers vary from cutting taxes to creating a sovereign wealth fund, as well as clamour for more spending on infrastructure and housing. Infrastructure was one of the opportunities we discussed in our H1 report and will almost certainly remain a rapidly growing sector throughout the 2020s.

With such growth, the government has made reforms to how it deals with large projects. Changes to the Public Spending Code, now mean that the threshold to be considered a major project has been raised from €100m to €200m. One aim of this is to get smaller projects progressing more quickly through the evaluation process. However, for larger projects, there is now a more rigorous assessment, with extra government oversight, and the need for additional consent in planning. The hope is that the new rules will result in more effective delivery of both smaller projects as well as major ones. For the latter, it means clients will need to work with trusted partners who have experience in delivering such large-scale projects. Without a strong project team, government consent becomes less likely, potentially leading to lengthy delays and much greater costs.

Data centres and the energy market

Linked to government spending plans is growth in the energy sector. Currently, electricity demand is outstripping supply, with a forecast from EirGrid published last year suggesting this is likely to worsen in the short-term. Data centres are one of the main reasons behind this shortfall. Using vast amounts of electricity, the sector is set to continue to grow over the next decade. Data from the CSO showed that, in 2021, electricity consumption from these hubs accounted for 14% of total consumption, up from 5% in 2015. With one estimate suggesting this could rise to 30% by 2030, it seems evident there will be many more data centres under construction, and there will be an associated need for new electricity generation.

One sector set to help cut these deficits, albeit not immediately, is offshore wind. In May, Ireland held its first offshore wind auction. Awarding contracts for four projects, this was an important move in Ireland's 2030 Climate Action Plan. Currently, there is only one offshore wind farm in Ireland and exploiting the sector's potential is a crucial part in meeting government targets. Plans show that, by 2030, there should be 7GW coming from offshore wind, expanding substantially by 2050 to 37GW. Such growth will involve investments in a wide-ranging supply chain, which the government will address next year as part of its National Industrial Strategy for Offshore Wind. These will include building factories for manufacturing turbines, developing ports in order to transport, operate and maintain the turbines, and working on the grid connections which allow the electricity generated at sea to connect to EirGrid. As a new industry in Ireland, taking experience from those who have worked in other countries with more developed sectors can help ensure successful delivery of such schemes. As always, managing projects to time and cost will be a priority.

Challenges

As well as opportunities, there are a number of challenges, and here we present a couple in more detail as well as looking at mitigations.

Government spending

It may seem counterintuitive, but government spending is also one of the biggest challenges, and there is concern that if it pushes too hard, the economy will overheat, driving inflation up. These doubts are best reflected by the Irish Fiscal Advisory Council, an independent statutory body whose mandate includes assessing the government's fiscal stance. In a pre-budget warning, it highlighted concerns that the government was set to breach the National Spending Rule in each year to 2026. In the council's view, such spending at a time when unemployment is low could lead to more persistent wage and price pressures. This could particularly hurt poorer households, as well as damage the government's credibility and also potentially be unsustainable if tax receipts from a few large companies dry-up.

The European Central Bank setting interest rates only amplifies the risk around higher inflation and, whereas countries with their own central bank could expect tightening monetary policy in such a scenario, there is no guarantee this is what the rest of the eurozone will require. With Germany's economy sluggish, and many other European countries facing weak growth as a result of high inflation, it is possible that the ECB will choose to cut rates at an inopportune moment for the Irish economy. The current expectation is that the ECB may start to cut rates in the second half of next year. Even if forecasts this far out come with significant health warnings, the risk is that lowering interest rates at a time when Irish government spending is jumping, could create considerable domestic inflationary pressures. Whether this risk comes to fruition or not, it is important be aware of. Given inflation is still hovering around 5%, it should come down. However, cost consultants and clients shouldn't get overly complacent about the speed at which it does.

Delivery problems

As already touched on, a second major challenge relates to the labour market and having enough skilled workers to deliver all of the construction work that could take place. Ireland's unemployment levels are already very low and the number of people in the construction industry has risen to its highest since before the global-financial-crisis-induced-downturn. Even with the industry performing worse than before the pandemic, this means there is unlikely to be much scope for easy expansion. The Construction Industry Federation Q2 Economic Outlook Survey reported 77% of firms were having problems finding skilled labour, making it the biggest challenge facing business. While the same organisation is pushing the government for greater investment in training, such supply-side initiatives take time to implement and bear fruit. The only other alternative is increased immigration. Yet, with immigration always a politically sensitive topic, and other European countries also needing construction workers for their decarbonisation plans, the influx of skilled labourers needed to deliver all of the sizeable infrastructure projects may not be forthcoming. As such, wage pressures, and rising costs are a major risk.

The labour force problem is also not solely around construction workers. There are confidence issues around the businesses who are delivering some of the projects, and whether they have the capability to do so. Recent controversy surrounding the National Children's Hospital, which is one of Ireland's largest ever healthcare projects, has seen budgets soar, considerable delays to the programme and suggestions of underperformance from the main contractor. Undoubtedly a complex project, news stories about costs increasing by more than €500m, which comes from government funds, paint a troubling picture given there are a number of similar sized projects in the pipeline. Managing costs on these schemes in a more prudent fashion will be a potentially defining challenge for the industry over the next decade.

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