Box 4

Recent developments in euro area construction activity

This box reviews the factors behind the recent recovery in the construction sector and evaluates its strength in the light of short-term indicators and in the context of the broader macroeconomic outlook. Construction activity grew rapidly in the period preceding the financial and economic crisis that started in 2008. The subsequent recession was very pronounced in the sector: from peak to trough, both value added and employment declined by around 25%, with large differences across countries\(^1\). Although the economic recovery in the euro area started in 2013, construction activity does not seem to have bottomed out until 2015 and has only begun to show signs of recovery in recent quarters (see Chart A).

Among the largest euro area countries, Germany and the Netherlands have seen the most resilient construction activity in the period since 2004 (see Chart B). Before and after the crisis, construction activity in most of the largest euro area countries (with the exception of Germany) exhibited a significant cyclical pattern, driven by the boom and bust of the property market. Between 2004 and 2007 the largest positive contributions to euro area construction activity were made by France, Italy, the Netherlands and Spain, while construction in Germany was

\(^1\) In some Member States, the decline was as high as 75% (Greece and Cyprus), while in others it remained moderate (for example, 2.5% in Belgium and 7% in Germany).
much weaker. After 2008 construction activity fell in most of the largest economies, with the exception of Germany, where it remained relatively flat until 2010. Value added and production in the construction sector began to pick up in Germany after 2010, led by an increase in housing demand, while in Spain and the Netherlands the sector started to grow only in early 2014.

**The most recent recovery in construction activity has been broadly based across countries.** Construction production increased in the last quarter of 2015 and the first quarter of 2016 in Germany, Spain, the Netherlands and several smaller euro area countries, while in France and Italy it seems to be stabilising. Similarly, increases in value added were recorded in most euro area countries over the same two quarters.

The recovery in the housing market is linked primarily to higher demand, which is expected to remain strong. Several factors support demand for housing investment. First, real disposable income growth has started to accelerate as labour markets have improved, while households are more willing to invest when the probability of becoming unemployed is lower. Second, real mortgage lending rates have declined and credit conditions have been favourable, partly reflecting the recent monetary policy measures in the euro area. Third, recent fiscal measures, including tax incentives in several countries, support housing demand. Finally, returns on alternative forms of household investment are low, providing further incentives for residential investment. These factors are expected to continue supporting demand for housing and construction activity in the forthcoming quarters.

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3 Construction production and value added co-move closely, but they differ in several respects. See the box entitled “A closer look at differences between industrial gross value added and industrial production”, *Economic Bulletin*, Issue 1, ECB, 2016, which also applies to the construction sector.

4 According to the classification of types of construction, buildings include both residential and non-residential buildings. Developments in the production of buildings, however, correlate strongly with those in residential investment.

5 Fiscal incentives for housing investment have been introduced in Belgium, Germany, France, Italy, Malta, the Netherlands, Austria and Finland.
Short-term indicators give a somewhat mixed picture regarding the outlook for construction. On the one hand, the volume of building permits granted suggests an increase in the construction of buildings looking ahead (see Chart D), and the construction confidence indicator in the European Commission's business surveys is currently around its long-term average. On the other hand, the first quarter of the year might have been influenced by weather effects and thus some caution is warranted when considering the strength of the figures for the year as a whole. In the first quarter of 2016, Germany made the largest contribution to the increase in euro area construction value added. This strong increase in construction activity in Germany, however, may be related to the mild weather conditions. Indeed, in each of the past three years (including 2016), the first quarter has been the strongest (although in 2015 this was reflected in higher value added and investment, but not in higher production), but has been followed by a decline in the second quarter, pointing to weather effects over the winter periods. Furthermore, the Purchasing Managers' Index on euro area construction output, following strong increases at the start of the year, has declined significantly in recent months to a level indicating broadly flat construction activity, and the assessment of order books has followed a similar path. In addition, monthly construction production fell in April and May, signalling some risks to the strength of the recovery in the construction sector and residential investment in the second quarter of 2016. Taken together, these short-term indicators point to some correction in the strong growth of construction activity seen in the previous two quarters.

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6 See also Monthly Report, Deutsche Bundesbank, May 2016, p. 51.