

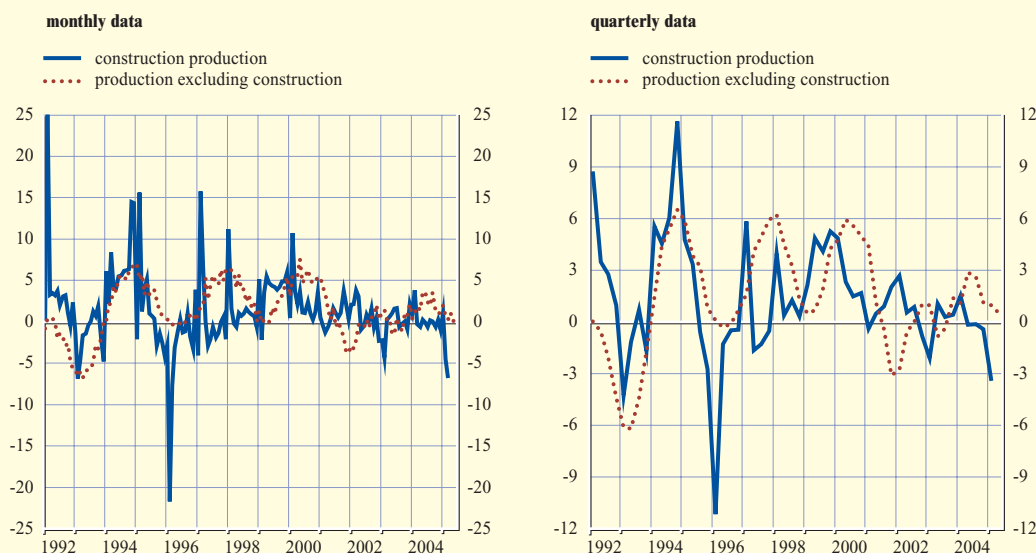
#### Box 6

##### **CONSTRUCTION DEVELOPMENTS IN THE EURO AREA**

Construction output constitutes around 17% of overall industrial production in the euro area. Moreover, this sector accounted for just over 28% of overall industrial employment and some 19% of industrial sector value added (in constant prices) in 2004. In the same year, construction investment accounted for nearly half of total investment in the euro area and, as a result, some 10% of real GDP. This clearly shows that construction is an important sector when assessing cyclical movements in the overall economy.

Chart A Industrial and construction production in the euro area

(annual percentage changes)



Source: Eurostat.

Nonetheless, there are a number of reasons why construction is normally excluded from industrial production and analysed separately. It exhibits a much larger degree of volatility, which complicates the assessment of short-term movements in activity. This is evident from the left-hand panel in Chart A, which displays the annual rate of change in construction production together with industrial production excluding construction calculated on the basis of monthly data. Moreover, euro area construction production data, although calculated on a monthly basis, are currently only released at a quarterly frequency. However, following the amended Council Regulation concerning short-term statistics, which entered into force in August 2005, Eurostat is likely to publish this series at a monthly frequency by 2006. Another advantage of looking at construction output separately is that short-term developments in the euro area data are often considerably affected by country-specific factors. In contrast to industrial production excluding construction, which exhibits a high degree of co-movement across euro area countries, construction output is characterised by substantial differences between countries.

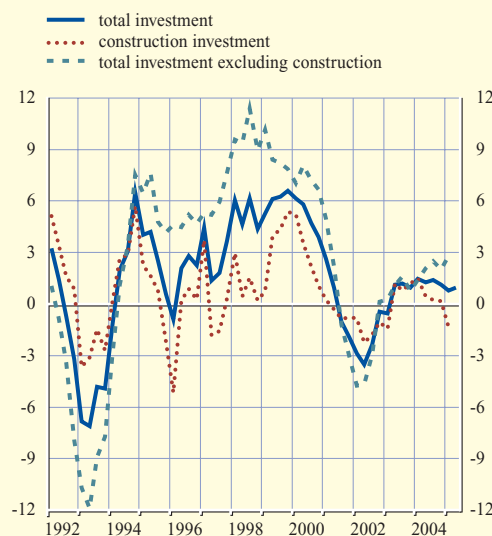
One possible way of eliminating some of the volatility of construction growth is to calculate the annual rate of change using quarterly data (see the right-hand panel of Chart A). Although there are some differences between growth in construction output and industrial production excluding construction, they show fairly similar cyclical movements at the euro area level, reaching peaks as well as troughs at roughly the same time. The average annual growth rate since the early 1990s has been around 1.5% for both construction and non-construction production. However, the correlation between the two series has declined over recent years and is currently around 0.4. Indeed, a notable difference can be observed over the last couple of years. While annual growth in industrial production excluding construction gradually picked up between 2001 and end-2004, construction output displayed a much weaker growth pattern.

Subdued developments in a number of countries explain part of this weakness. They also help to explain why construction investment did not strengthen and, hence, why euro area total investment growth has recently been weaker than would be expected given prevailing low financing conditions and relatively strong corporate earnings (see Chart B). While construction continued to expand strongly in Austria and Finland, its momentum declined somewhat in Spain and Italy. Moreover, construction output shrank substantially in Belgium, Germany and the Netherlands. In the case of Germany, both residential and business construction continued to suffer from significant excess supply, while public construction remained depressed. However, industrial output excluding construction gathered momentum in all countries except Italy as the production of export goods benefited from the favourable external environment.

Despite the relatively high degree of longer-term co-movement between construction and non-construction industrial production, there are a number of factors which are particularly important for the evolution of construction production. First, weather conditions play a crucial role as regards construction, with extreme or unfavourable weather delaying or even halting ongoing construction work. This is one reason for the volatile growth of construction production. Second, construction may be influenced by fiscal measures. For example, in the late 1980s and early 1990s, euro area construction production expanded to a large extent on account of German construction, which was in turn heavily influenced by government incentives that were introduced following German reunification. Third, financial market developments are also important determinants of construction output. For instance, movements in interest rates affect housing demand and, thus, construction investment, owing to changes in financing costs. Finally, demographic changes may also have an impact on the

**Chart B Investment in the euro area**

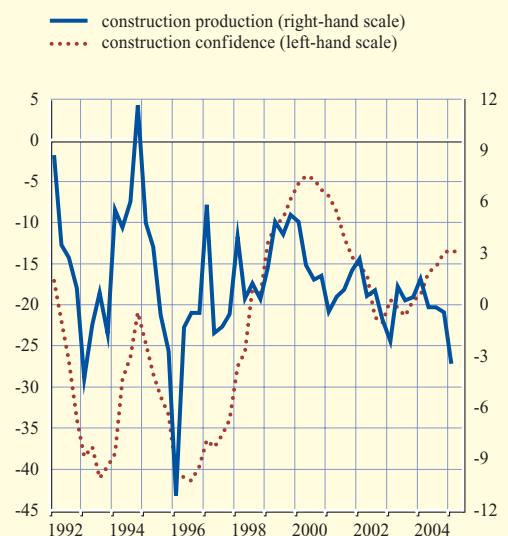
(annual percentage changes; quarterly data)



Source: Eurostat.

**Chart C Construction production and confidence in the euro area**

(annual percentage changes, percentage balances; quarterly data)



Sources: Eurostat and European Commission Business and Consumer Surveys.

demand for housing over the long term and consequently on construction production. The above factors may help to explain the relatively large differences in construction developments across euro area countries.

Some evidence of short-term developments in the construction sector may be derived from the monthly business opinion surveys made available by the European Commission. The construction confidence indicator, which is based on questions relating to an assessment of order books and employment expectations in the construction industry for three months ahead, has been broadly consistent with construction activity developments since the early 1990s (see Chart C). However, the confidence indicator does not capture the higher frequency shorter-term fluctuations in actual construction output and does not appear to contain much leading information. More recently, the confidence indicator continues to signal an improvement in activity in the construction sector, although this is somewhat at odds with the latest developments in actual construction output. Construction confidence improved recently in all euro area countries except Italy and Greece. In the latter case, the worsening in construction confidence since end-2003 seems to reflect the unwinding of the stimulus to construction in the run-up to the Olympic Games.

To sum up, in the construction sector there are relatively large differences across countries in terms of supply and demand conditions. This has contributed to heterogeneous growth developments within the euro area in recent years. While some countries have experienced positive growth rates for construction production and investment, others have experienced a contraction, which has blurred the assessment of the underlying trends in overall industrial production and investment. Notwithstanding such country differences, the construction sector forms a significant part of the total euro area economy and thereby plays an important role in the assessment of overall developments in activity.