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Germany 2007: Undiminished high construction production and increased construction prices

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After the high growth of 2006, the first quarter of 2007 also shows undiminished high **construction production**. Evidence of this is provided by the number of hours worked, which see growth rates in double figures in all fields of civil and structural engineering; yet it is surprising that growth in industrial construction lagged somewhat.[1] It remains to be seen to what extent the extremely strong increase in the performance of the construction industry reflects demand or simply consistently favourable weather conditions, for there was actually no real winter in the two quarters preceding and following the new year. Data on the finishing industry in the first quarter indicates a lower dynamics – the number of hours worked increased by almost 8%, compared with 24% in the construction industry. This means that the demand for construction work and services related to existing buildings, particularly in housing construction, is not continuing at the high level last achieved.[2]

Construction prices increased rapidly at the beginning of the year, by 7.7% on average for all types of building as compared to the same month of the previous year (February 2006) and by 4.4% as compared to November of the previous year.[3] Without the effect of the higher VAT rate, the price increase amounts to around 5% as compared to the previous year: the increase is partly due to increases in costs – statisticians cite examples of material and energy prices. Problems with delivery of a number of primary products such as construction machinery were also reported. There is also the question of the distribution of profit margins: the price increase for work performed by subcontractors is particularly crucial for the construction industry: the fact that cheap labour is no longer readily available plays a role here. Construction workers from neighbouring countries in the east are less and less dependent on the German market, since wages are more attractive in other EU countries and, even in their home countries, potential earnings are now not much lower than the minimum wages paid in accordance with the law on payment of foreign workers seconded to German construction sites. Large companies are faced with the problem that they frequently have more long-term contracts with subcontractors, who then, for their part, pass on increased costs.

1 This is presumably because in the previous year – with unfavourable weather conditions – more work was carried out in this segment than in the other segments where there was no demand pressure.

2 In the previous year, finishing services had expanded extremely dramatically, particularly at the end of the year.

3 Cf. Federal Statistical Office, subject-matter series 17, series 4, Preisindizes für die Bauwirtschaft, February 2007.

JEL Classification:
L74, O11

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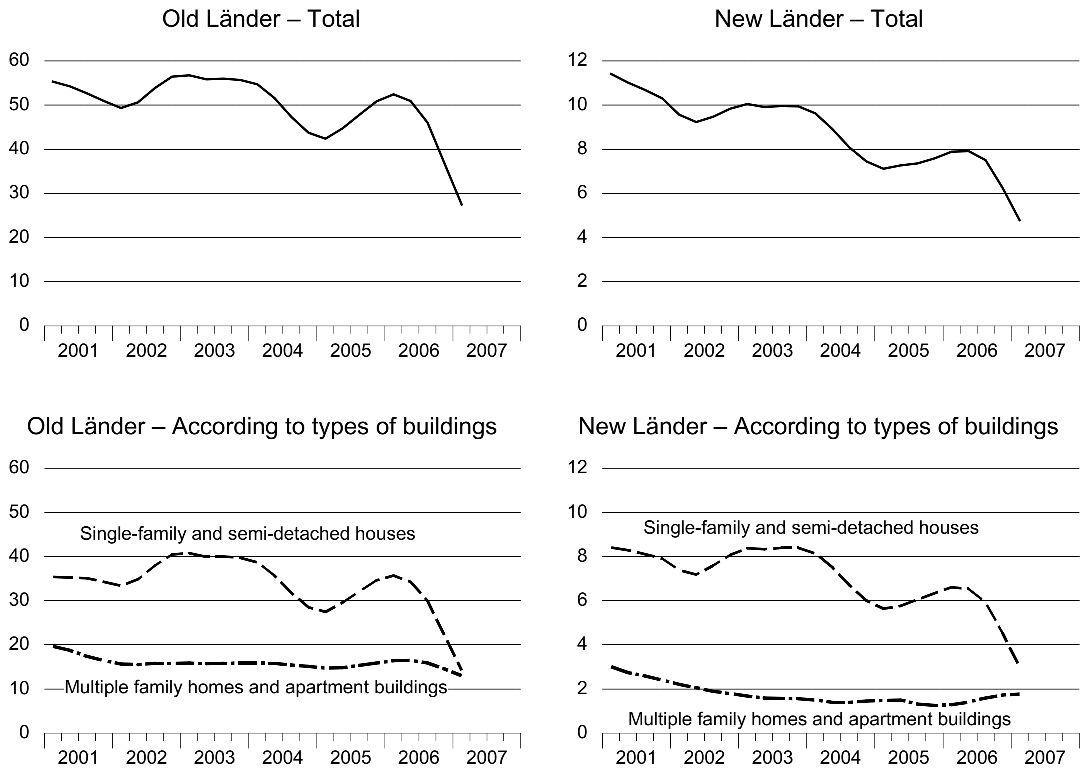
Housing demand, Construction industry, Forecast 2007

Figure 1

Permit for Housing Construction

In 1 000 apartments per quarter[1]



1 Seasonally adjusted by the Berlin Method.

Source: Federal Statistical Office, based on official statistics of the construction trade.

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Nevertheless, not only have costs of purchased materials and services been decisive, but after years of below average yields construction companies evidently allowed themselves a mark-up ("a fair whack"). This in turn supports the fact that the companies consider demand to be solid.

At present, the **economic conditions** for the current year are still difficult to assess, and this applies to housing construction in particular: on the one hand, in 2006, there were pull-forward effects that will slow down demand this year and, on the other hand, a recovery of demand is expected in the course of the general upswing owing to increases in income.

Construction of private housing will nevertheless presumably continue to follow a downwards trend, only interrupted in the previous year; this is indicated by the sharp decline in building permits in the first quarter (Fig. 1). Although this short span of time cannot be of great significance for the trend in the course of the entire year, it signals an intensified downwards trend for the time being. In any case, a large reduction in loan commitments from the savings banks in the first quarter also points to a decrease in demand for new buildings and overall demand in housing construction[4].

For a long time, the most important segment of housing construction has been modernisation and renovation work. This expanded particularly in 2006 (by 7.5% in real terms), clearly due to the increase in VAT. In view of the increase in construction prices – which rose much more drastically than estimated in the first quarter of this year – real demand is hardly expected to reach last year's level again. Theoretically, modernisation and renovation work in housing construction should continue to grow, however.

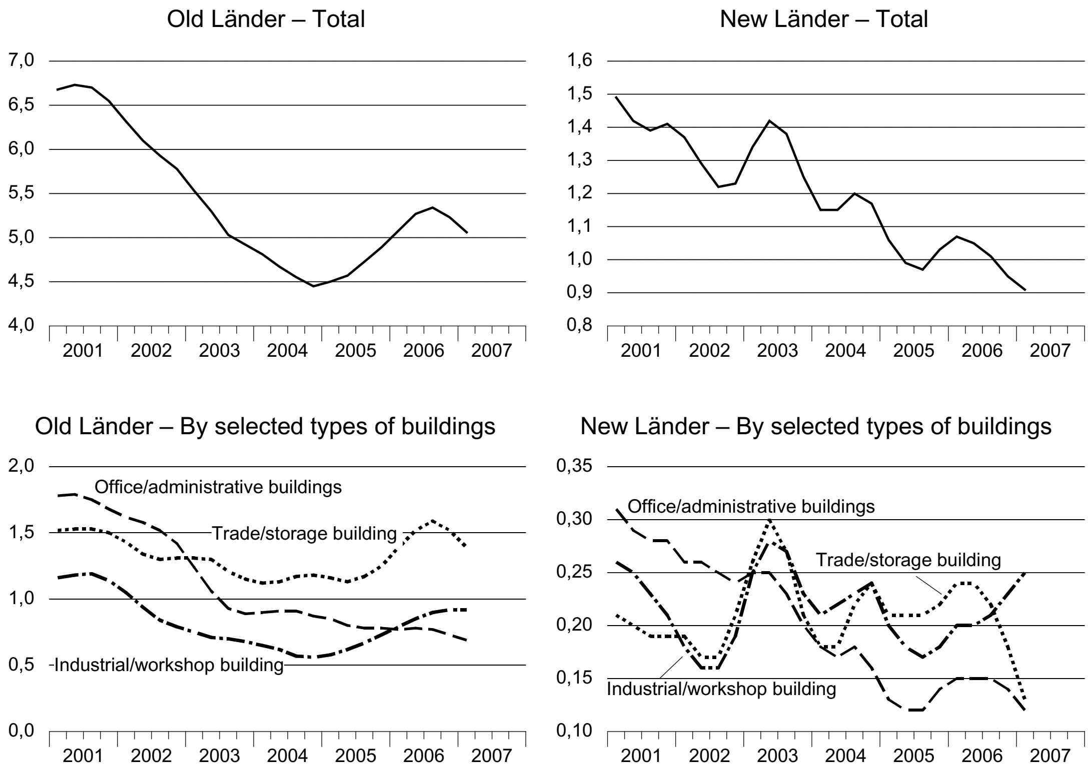
Construction records include data for the first quarter of 2007 as well as building permits from construction activity statistics. These show that the number of contracts awarded in housing construction in western and eastern Germany corresponded roughly to the level of the previous year (Fig. 3). This is still a somewhat favourable result in comparison with

4 Cf. loan statistics of the German savings banks association, last updated in the first quarter of 2007.

Figure 2

Permits in Non-Housing Construction

Construction costs in euro billion per quarter[1]



1 Seasonally adjusted by the Berlin Method.

Source: Federal Statistical Office, based on official statistics of the construction trade.

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the number of permits.[5] A continued increase in the number of permits (Fig. 2) and particularly the number of contracts awarded (Fig. 3) was to be noted for commercial construction on the other hand. The number of contracts for construction for the public sector has only increased slightly overall, with a gap between civil and structural engineering.

The **forecast** for construction industry development for 2007 that was drawn up in the previous year on the basis of data for the first half of 2006[6] has to be modified against the backdrop of these current trends.

For commercial construction, a further real growth of construction work and services had already been anticipated – as compared to the previous year (6.8%), albeit weaker. Meanwhile, current demand development – and the favourable weather conditions in the first quarter – point to a higher production target of around 6% this year. After a certain drop in the number of contracts awarded, demand had risen sharply again in the second half of 2006. Seasonally adjusted figures for civil and structural engineering in western and eastern Germany give a very similar picture. If permits in structural engineering are considered according to type of building, similar trends are also to be observed currently. For factory and workshop buildings, the trend is upwards, for office buildings, movement is sideward, whereas for commercial/storage buildings it shows a decrease.

The forecast for *construction in the public sector* has also become more favourable. Instead of stagnation, as was the case to date, production growth of over 3.5% is now expected. This is supported at present particularly by the positive development of contracts awarded in road construction and in other civil engineering; the demand for structural engineering continues to show a downward trend. However, it is to be expected that the improved tax revenue of all central, regional and local authorities will also be used for further investment. In the course of the year, there might also be an increase in the number

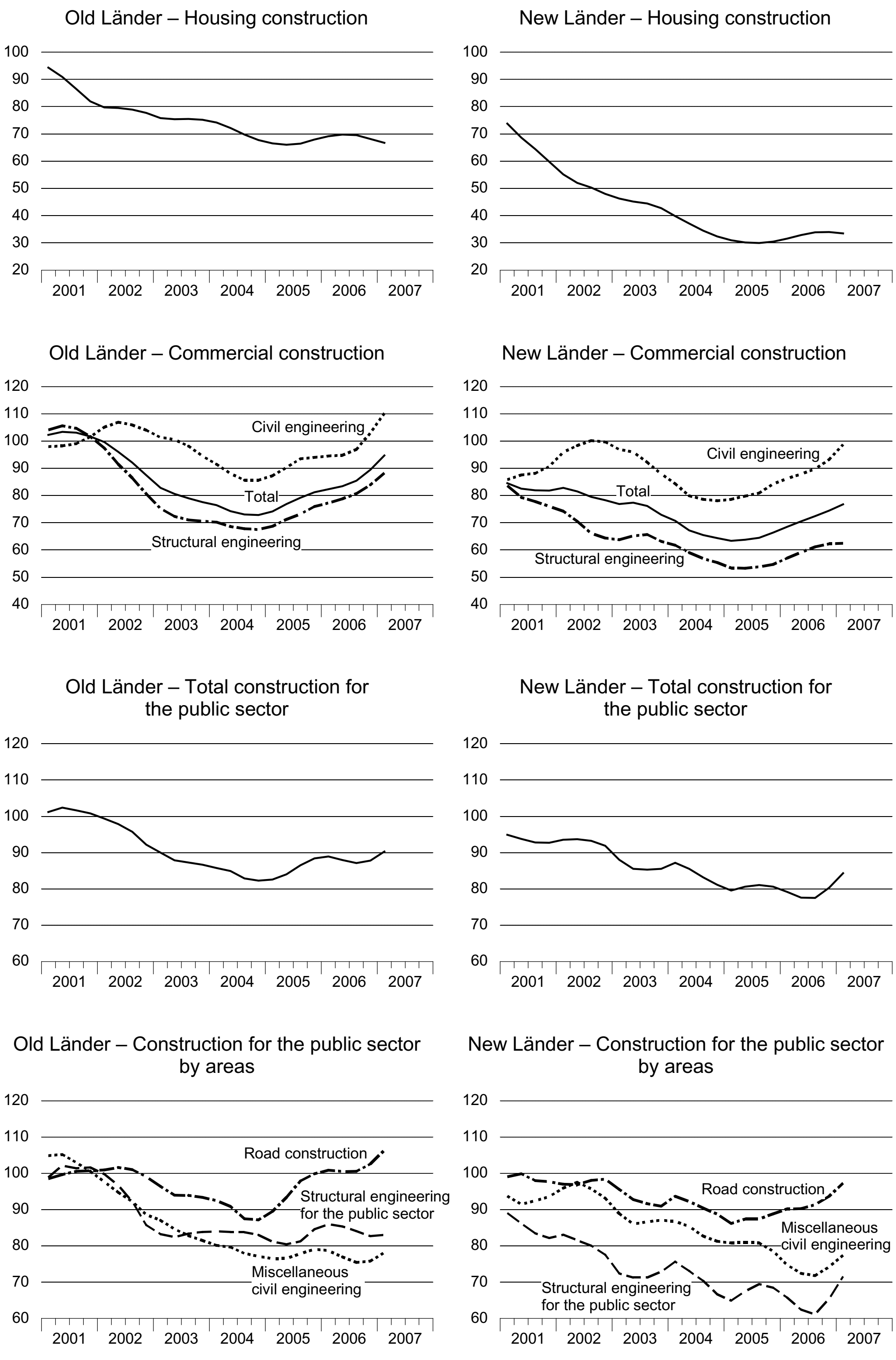
5 It should be taken into account that data is only collected for companies with 20 or more employees, which leads us to presume that construction of apartment buildings is more heavily weighted.

6 Cf. Bauwirtschaft auf Wachstumskurs. In: Wochenbericht 47/2006 of the German Institute for Economic Research. Revised by B.Bartholmai and M. Gornig.

Figure 3

Incoming Orders in the Main Construction Trade

Value index 2000 = 100[1]



1 Seasonally adjusted by the Berlin Method.

Source: Federal Statistical Office, based on official statistics of the construction trade.

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of contracts awarded in the structural engineering sector, primarily the responsibility of the *Länder* and local authorities.

Housing construction will significantly slow down the overall construction activity seen over the course of the year. In the first quarter of 2007, production

Table
Development of and Forecast for Construction Volume

	2004	2005	2006	2007[1]	2004	2005	2006	2007[1]
	In euro billions at current prices				Change (%) on the previous year			
Total construction volume	236,64	231,20	248,10	268,90	-1,2	-2,3	7,3	8,4
Old Länder[2]	189,20	185,60	200,00	216,30	-1,0	-1,9	7,8	8,1
New Länder and Berlin[2]	47,43	45,60	48,10	52,60	-2,3	-4,0	5,6	9,4
	Indices 2000=100							
Price development	101,80	103,10	105,40	112,00	1,2	1,3	2,2	6,3
Old Länder	101,60	102,90	105,10	111,60	1,0	1,2	2,1	6,2
New Länder and Berlin	102,30	104,00	106,60	113,90	2,0	1,7	2,5	6,9
	In euro billions at 2000 prices							
Total construction volume	232,51	224,20	235,40	240,00	-2,4	-3,6	5,0	2,0
Old Länder	186,16	180,40	190,30	193,90	-2,0	-3,1	5,5	1,9
New Länder and Berlin	46,36	43,80	45,10	46,20	-4,2	-5,5	3,1	2,3
According to construction areas:								
Housing construction	130,27	123,60	129,50	128,50	-1,7	-5,2	4,8	-0,8
Old Länder	110,58	105,60	111,10	110,20	-1,0	-4,5	5,2	-0,8
New Länder and Berlin	19,70	17,90	18,40	18,20	-5,7	-8,9	2,3	-0,7
Commercial construction	66,49	66,00	70,50	74,80	-2,5	-0,8	6,8	6,1
Old Länder	50,12	49,90	53,40	56,90	-2,6	-0,5	7,0	6,7
New Länder and Berlin	16,37	16,10	17,10	17,90	-2,3	-1,4	6,2	4,6
Construction for the public sector	35,75	34,60	35,50	36,70	-4,8	-3,2	2,5	3,6
Old Länder	25,46	24,90	25,90	26,70	-5,0	-2,2	3,8	3,4
New Länder and Berlin	10,29	9,70	9,60	10,00	-4,4	-5,7	-0,8	4,1
According to the category in the construction sector:								
Old Länder								
Construction trade: structural and civil engineering[3]	56,01	53,20	56,50	58,30	-3,8	-5,1	6,2	3,3
Structural engineering areas	36,47	34,20	36,70	37,30	-3,6	-6,1	7,0	1,8
Civil engineering	19,54	18,90	19,80	21,00	-4,1	-3,2	4,7	6,2
Construction installations, miscellaneous construction trades[4]	71,87	69,30	73,00	74,00	-1,1	-3,6	5,4	1,3
Other areas[5]	58,27	58,00	60,90	61,60	-1,3	-0,5	5,0	1,2
New Länder and Berlin								
Construction trade: structural and civil engineering[3]	18,40	17,30	17,80	18,60	-5,4	-6,1	3,2	4,4
Structural engineering areas	10,20	9,40	9,80	10,00	-6,9	-8,0	4,0	2,7
Civil engineering	8,20	7,90	8,10	8,60	-3,3	-3,9	2,1	6,4
Construction installations, miscellaneous construction trades[4]	16,58	15,40	15,90	16,10	-4,6	-7,1	3,2	1,2
Other areas[5]	11,37	11,10	11,40	11,50	-1,8	-2,3	2,7	0,7

1 Forecast.- **2** According to the location of construction sites in the Old and New Länder.-**3** Including preparatory construction site work (was previously included in the main construction trade, excluding pre-cast concrete construction method and other partial areas that have separated).- **4** Corresponds to the former (definition of) finishing trade, supplemented by divisions predominantly added from main construction trade.- **5** Manufacturing trade (installations, system-built structures and prefabricated constructions), construction-related services, investor' own work and services.

Source: DIW Berlin calculations, based on official statistics for the construction trade.

in housing construction also increased dramatically, but at the same time, as a result, the number of potential contracts from the volume of unfinished building projects (that have been approved, but not yet started) should shrink further. Consequently, demand for new buildings, which has been falling for a long time, will become increasingly noticeable in the output. It is difficult to assess whether demand in the further course of the year will be influenced more by increases in costs (interest and construction prices), or whether improved income expectations will give new impetus, particularly for private housing construction. For the time being, retarding influences prevail, also including the pull-forward effect in the previous year, and there is still no sign of a trend reversal. The anticipated decrease in the housing construction volume should turn out to be similar in western and eastern Germany at almost 1% in each case. In both areas, the performance of the construction industry is affected more than that of the finishing industry, since the reduction is primarily in the new building sector, while a relative constancy can be anticipated in the modernisation/renovation segment.

The **overall construction volume in 2007** will reach a real value of 240 thousand million euros this year and thus, after adjustment for price rises, again record a growth of 2% (Table). In the east, it is anticipated to be higher (2.3%) than in the west (1.9%). This is because the declining housing construction industry there is not as heavily weighted as in western Germany. In theory, the construction volume in Germany overall will again increase more dramatically than in the previous year at almost 8.1/2%. The average annual price increase is estimated at around 61/2%, with, as previously, a higher increase in the east than in the west.

Examination of the summarised (real) construction work and services according to groups of producers reveals that also in 2007 the construction industry can again expect a higher growth rate: over 3% in the old *Länder* and over 4% in the new *Länder*. In structural engineering, dynamics are lower in both parts of the country, however. Conversely, civil engineering should record strong growth at over 6%. For the finishing industry, real production growth in eastern and western Germany will only be just over 1%. Development of the sector of miscellaneous construction work and services is also below average. Another factor that comes into play here is that for private households, the estimated borrower's capital resources in housing construction should fall significantly with the decline in private housing construction.

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