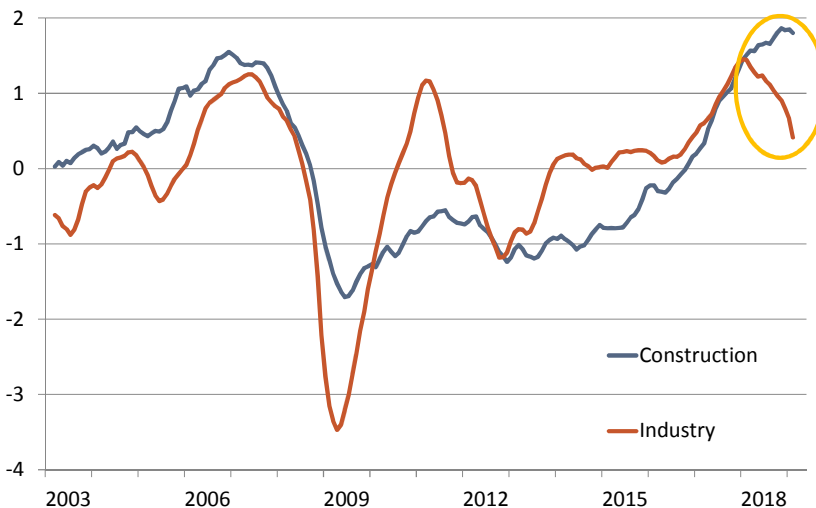




15 March 2019

## Eurozone construction: a stabilising factor

### Construction and industry confidence in the Eurozone



Values normalised by long-term average and standard deviation. Three-month average (two-month average for February value). Source: European Commission, Berenberg

- Industrial recession not over yet:** A series of external shocks, ranging from trade tensions to the plunge in Chinese imports and the risk of a hard Brexit, has derailed the Eurozone upswing. Despite a temporary rebound in January, industrial output has fallen by 1.8% between its H2 2018 two-month peak in August-September and the average of December and January. Forward-looking indicators such as Ifo business expectations in German manufacturing suggest that the industrial recession will still worsen in the next few months. Our call of 1.1% annual growth in Eurozone real GDP in 2019 remains below the 1.3% Bloomberg consensus. Near-term, risks are tilted to the downside.
- A split economy:** Unlike export-oriented manufacturing, the domestic economy is still holding up fairly well. Despite the damage caused by high oil prices last autumn, final domestic demand rose at a quarterly annualised rate of 1.4% in Q4 2018. Employment expanded by 0.3% qoq at the same time. Compensation gains per employee of 2.2% yoy in Q4 underpin a solid increase in disposable incomes. A modest fiscal expansion of roughly 0.2% of Eurozone GDP in 2019 – led by more German spending on pensions, public sector wages and investment plus French tax cuts – helps to limit the downside risks.
- The brightest spot:** Whereas business confidence has tanked in manufacturing and receded more modestly in the service sector, construction has so far bucked the downtrend. Gains in household income and wealth, rising public investment, still high capacity utilisation, low borrowing costs and a housing shortage in many urban areas in Germany and beyond keep construction confidence close to a record high (see chart). After a 1.7% gain in real construction output last year, the sector looks set to add nicely to GDP again this year.
- Construction matters:** Construction accounts for 5% of gross value added and 6% of employment in the Eurozone. While this is dwarfed by industry (20% of gross value added), it still serves as a major stabilising force today. In the post-Lehman mega recession and the euro crisis, weaker construction exacerbated the downturn. This time, construction is acting as a buffer, offsetting some of the industrial pain.
- Likely to hold up long enough:** Of course, construction cannot decouple forever from industrial output. If the industrial recession deepens for much longer, the domestic economy will weaken significantly as well. We look for production to bottom out in the next three months if the US and China defuse their trade tensions, China's economic stimulus starts to work and the UK avoids a hard Brexit, as we expect. If so, the domestic and external sectors should reconnect through an upturn in industry rather than a downturn in services and construction.

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