

Spanish construction sector growing strongly, but challenges remain

Despite higher interest rates and prices of building materials, the Spanish construction sector started the year well, growing by 2.5% quarter-on-quarter between January and March. The biggest challenge for the sector is falling productivity. On the other hand, stricter building energy efficiency regulations will drive the renovation market



Despite a strong start to the year, we expect growth in Spain's construction sector to moderate in the second quarter of 2023

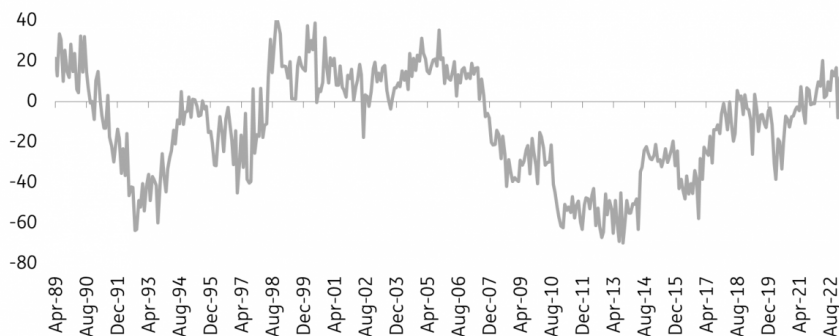
Spanish construction sector starts the year strongly

According to the latest data released by Spain's statistics service INE in late April, the country's construction sector expanded by 2.5% in the first quarter of the year, compared to the fourth quarter of 2022. This growth rate was significantly higher than the 0.6% quarter-on-quarter growth rate recorded for the wider Spanish economy, which was also robust. According to the breakdown based on the spending component of GDP, investment in housing increased by 1.3% quarter-on-quarter, while investment in other buildings and structures rose by 1.6%QoQ. In addition, net exports of construction-related products and services may also have contributed to the strong performance.

Despite the economic uncertainties, business confidence in the sector remains positive, as shown

in the chart below. This optimism is due to several factors, including well-filled order books, easing price pressures, improvements in global supply chains and a stable property market. Although the property market is cooling significantly, there is no indication that the country is heading towards a housing market crash. Given the close correlation between the prices of existing homes and new construction, a soft landing in the property market will also support the construction sector. Sharp falls in the prices of existing homes would put pressure on house builders to lower the prices of new homes, which would curb the new-build market.

Construction company confidence still positive

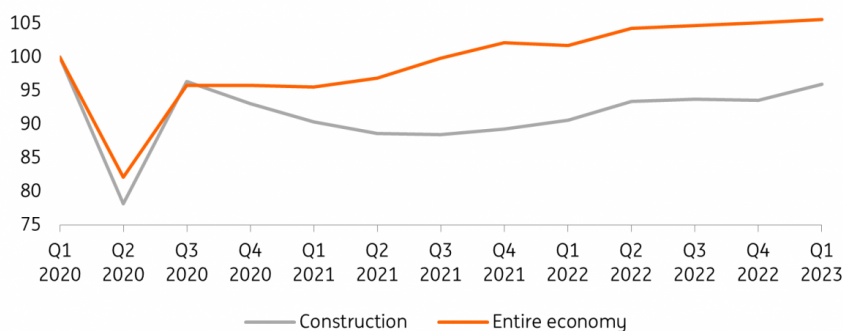


Source: Eurostat

Despite this strong performance in the first quarter, the construction sector has still not fully recovered from the impact of the Covid-19 pandemic, as illustrated in the chart below. Activity in the Spanish construction sector is still 9.2% below the level of the last quarter of 2019. This contrasts with the rest of the Spanish economy, which is almost back to its pre-Covid level: in the first quarter of 2023, economic activity was only 0.2% lower than in the fourth quarter of 2019.

The Spanish construction sector has been severely affected in recent years by a series of global events; the Covid pandemic, the war in Ukraine and the significant rise in interest rates. Moreover, sharp increases in the prices of construction materials and energy have led to many projects being postponed or cancelled.

Gross value added of the entire Spanish economy and the construction sector, Q4 2019 = 100

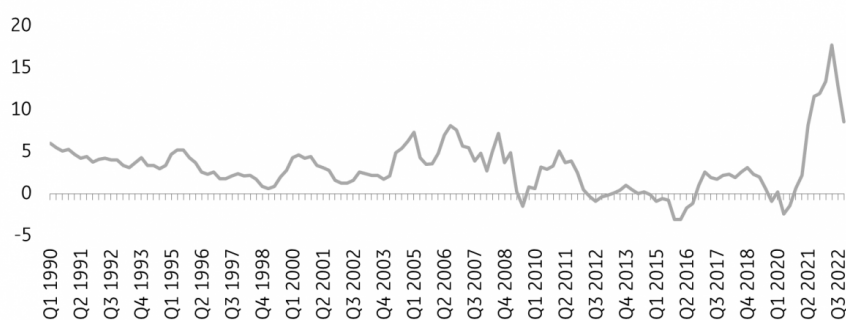


Source: INE

The pace of input price increases in construction will gradually slow

Since January 2021, the Spanish construction cost index has risen sharply, primarily driven by the strong global demand recovery and the conflict in Ukraine. The index showed that construction prices were on average 17.7% higher in the second quarter of 2022 compared to the same period the previous year. The index, which is based on a quarterly survey of construction companies, covers the costs of materials, labour, and other inputs that go into building new residential properties.

Spain's construction cost index peaked in the second quarter of 2022, but has since cooled



Source: Eurostat

After peaking in the summer of 2022, the prices of various construction materials, including wood and metals, have steadily declined. This can be attributed to improved global supply chains and reduced demand. Although the reopening of the Chinese economy early this year led to an increase in prices for materials such as copper and steel, they remain below their peak levels of the summer. On the other hand, the prices of energy-intensive building materials, such as concrete, cement and bricks, have continued to rise, despite falling energy prices – although we note that the pace of price increases has slowed down recently.

We expect price pressures for construction materials to ease on the back of a weakening global economy. With the US economy falling into recession, the European economy slowing significantly and China's manufacturing and construction sectors failing to pick up, it seems unlikely that global commodity prices will rise again later this year. Prices of energy-intensive building materials are also expected to start falling slightly soon due to lower energy prices. Although gas prices may rise during the injection season, they are unlikely to rise sharply for the rest of the year. The outlook for the energy market is more positive than last year, thanks to well-stocked European gas supplies, which would allow producers of these energy-intensive building materials to gradually lower their prices.

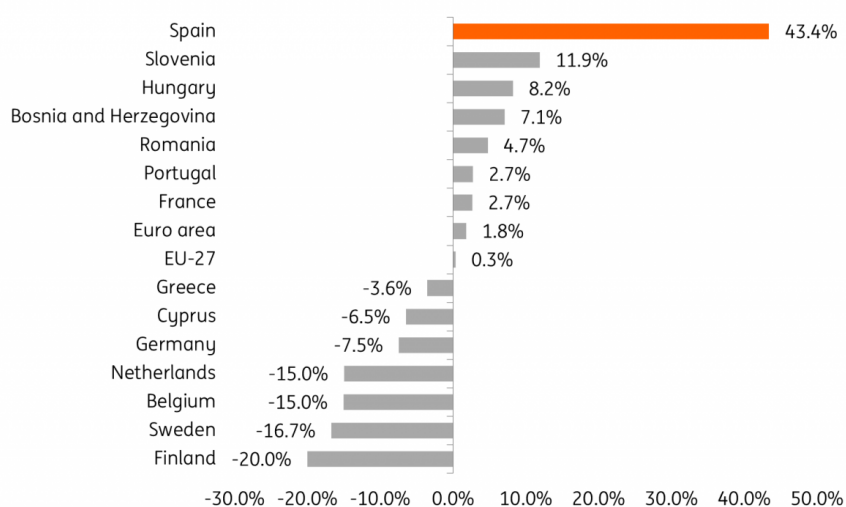
Building permits rose strongly in 2022 despite rising interest rates

Despite challenges due to higher interest rates and building material prices, the number of licensed square metres increased by 43.4% in 2022 compared to 2021, according to Eurostat data.

Building permits rose strongly in both residential (+44.2%) and non-residential building sectors (+41.7%). The growth in the number of licensed square metres for residential construction was mainly due to strong growth for single-family homes in the first half of the year.

The non-residential sector also recorded a strong increase in the permits issued, particularly in the office building segment. The number of licensed square metres for office buildings almost tripled in 2022 compared to the previous year. The Spanish office market was hit hard by the pandemic with many companies implementing remote work policies and reducing their office space requirements. However, there are some indications that the Spanish property market is picking up again.

Year-on-year growth in building permits in 2022, in m2 of useful floor area



Source: Eurostat

The number of residential building permits is likely to fall in 2023. In the residential construction market, strong growth was seen in the first half of 2022 but has been declining since last summer due to rising interest rates and the increased cost of building materials. As the property market cools, sales of new buildings will also decline, so the number of residential building permits is likely to fall further in 2023. In addition, growth in non-residential building permits is also likely to slow down this year due to a weakening economy.

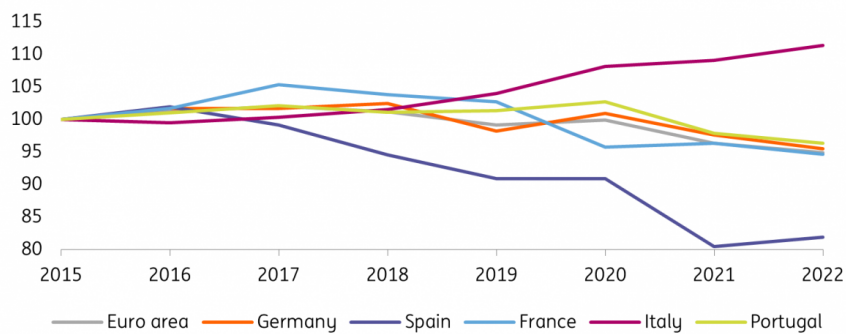
Productivity falls much more sharply than euro area average since 2015

The construction sector traditionally suffers from lower productivity than other sectors, such as manufacturing. One reason is that the sector consists of many small and medium-sized enterprises, making it more difficult to unify construction processes. Smaller companies are less inclined to invest in large digitisation and automation projects because of significant start-up costs, which hampers productivity growth.

Remarkably, since 2015, productivity in Spain has fallen much more than in other countries.

Eurostat figures show that Spanish labour productivity has fallen by 18% since 2015, compared with an average decline of only 5% in the eurozone. In Italy, it has actually increased thanks to a number of regulatory reforms that have led to more competition and less bureaucracy. There are several reasons for the downward trend. In recent years and especially during the pandemic, Spanish activity in the construction sector fell more sharply than in other countries. Since the workforce tends to fall more slowly than activity, this leads to falling labour productivity. Another possible explanation is that the number of non-registered workers in the sector has decreased in recent years, which also reduces the productivity of the legally registered workforce.

Real labour productivity in construction, 2015 = 100



Source: Eurostat

Stricter energy regulations will give renovation market a solid boost

In the coming years, the Spanish construction and real estate sector will be significantly affected by stricter regulations on the energy efficiency of buildings. The European Union aims for climate neutrality by 2050, and since buildings account for 40% of energy consumption and 36% of greenhouse gas emissions in the EU, they are a major focus of these regulations. However, the current European renovation rate is insufficient to meet the targets; estimates suggest an annual renovation rate of only 1%. To increase the renovation rate, the European Parliament adopted in March an ambitious revision of the 2010 Energy Performance of Buildings Directive, on which the European Council must now decide.

If adopted, the proposal would replace the current energy performance certification system with a more holistic assessment of the environmental performance of buildings. The proposal focuses on ambitious targets for the renovation of existing buildings, including the setting of minimum energy performance thresholds that all buildings must meet within a certain timeframe. However, the proposal goes beyond improving the energy efficiency of buildings. The proposal also envisages the creation of a certification for the environmental performance of buildings throughout their life cycle, taking into account emissions generated during the production of construction and insulation materials, the construction itself, and the renovation and operation of buildings.

In the coming years, developers will be required to meet higher standards of sustainability and energy efficiency throughout the entire life cycle of a building, which will lead to a shift in mindset, as the long-term ecological impact must be taken into account at every stage of a project. Stricter regulations may also drive up the cost of new construction projects due to the more selective choices of building materials. On the other hand, the regulations are expected to boost the

renovation market in Spain, as they will trigger a renovation wave, creating a greater demand for energy-efficient renovations. Overall, the stricter regulations are expected to support the Spanish construction sector in the near future.

Spanish construction sector likely to lose momentum later this year

The Spanish construction sector started the year on a positive note with a 2.5% increase in gross value added in the first quarter. Despite this strong performance, we expect growth to moderate in the second quarter, followed by a possible contraction later in the year, due to slowing economic growth and rising interest rates dampening demand for investment in construction projects. This trend is particularly evident in the housing sector, where a decline in building permits was already recorded in the second half of 2022 and is likely to continue.