2 The economic situation and construction sector developments in the UNECE region, 2010-2011

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Highlights

- The speed of the global recovery from the worst economic crisis since the 1930s varies significantly by region; growth is much faster in the emerging economies than in the advanced economies.
- Economic growth in the coming year is likely to remain weak in North America and western Europe, as austerity is implemented to address increasing sovereign debt levels.
- Given weak growth in the advanced economies, unemployment levels, especially long-term and youth unemployment, are likely to remain high for several more years.
- Growth is more robust in the emerging economies, but their declines during the crisis were greater and thus, their current income levels are only slightly above pre-crisis levels: growth has been exceptionally fast in Turkey.
- Increasingly, it is becoming apparent that the debt of the eurozone periphery economies is a solvency issue and not just a liquidity problem. As such, the remaining eurozone, and perhaps even EU members, will be required to absorb some of the losses associated with a debt write down.
- The eurozone is experiencing a governance crisis as its existing institutions have been unable to properly address the sovereign debt crisis in some of its periphery economies; significant reforms in several areas are likely.
- The significant variation in the economic situation in different countries, both within Europe and globally has created numerous policy conflicts between countries and has made policy coordination and cooperation more difficult.
- The US housing market, by all indicators, appears to have entered a double-dip recession with home starts and sales at levels not seen since the Great Depression.
- The Canadian housing market has rebounded from the recession, although housing starts are still well below 2008 levels.
- The European housing construction market is stagnant, primarily due to the collapse of the Spanish housing market though there is the prospect of a gradual improvement, possibly beginning in 2012 – most notably in Germany and Poland.
- The housing correction is far more advanced in the US than in Europe and it seems likely that European homes may be overvalued, which poses a possible risk to Europe's housing and economic recovery.

2.1 Current economic developments

The after-effects of the Great Recession of 2008-2009 continue to dominate the economic prospects of the UNECE economies in 2011. By mid 2011, despite two years of economic recovery, national income levels in most of the region's economies were only returning to what their peak levels were prior to the crisis. This is not particularly surprising given the depth of the crisis and the historical observation that recoveries from financial crises are generally much less vigorous than recoveries from more normal recessions. Unemployment in many countries remains elevated and is likely to stay that way for perhaps another two years. Sovereign debt levels have increased substantially in most of the advanced economies and have become problematic in some including, most notably, those in the periphery of the eurozone. As a result, economic policy has shifted towards austerity, which is further weakening the recovery. In the eurozone, the sovereign debt problems of several peripheral economies have raised fundamental issues about the design, operation and even the viability of the euro. The housing market busts in the US and several European countries (such as Ireland and Spain), which were at the core of the global crisis, have yet to stabilize. The Japanese earthquake, tsunami and nuclear catastrophe have disrupted manufacturing supply lines in some key technology industries worldwide. World trade flows, which declined dramatically in late 2008 and 2009, have expanded rapidly in 2010 and 2011. Uncertainties surrounding sovereign and housing debt and the need to further tighten monetary and fiscal policy pose significant downside risks for the region's economies in 2012 and beyond, although most analysts expect the recovery to strengthen gradually. The rapid appreciation of asset prices in China also poses the possible threat of a bursting bubble in that economy, which would have global implications.

In 2011, all UNECE economies are expected to have positive growth except for Greece and Portugal, which are implementing substantial austerity measures because of their high sovereign debt levels. Ireland, which is in a similar situation, is expected to have positive but meagre growth of about 0.6% in 2011. For the UNECE region overall, growth is expected to be 2.5% in 2011, which is roughly similar to the level in 2010 and to what is being forecast for 2012 (table 2.1.1). Thus, the region appears to have stabilized on a low growth path; between 1999 and 2007 growth averaged a somewhat faster 3.1%. This low growth path is too slow to create jobs for all of those who became unemployed during the crisis years of 2008 and 2009 and means that living standards will not be increasing as fast as they had been. The fastest growing of the UNECE subregions in 2011 is likely to be south-east Europe but this is due primarily to a robust 6.1% growth forecast for Turkey. The remaining (non-EU) south-east European economies are likely to grow only about 2.3%, in line with the UNECE average. Growth in the CIS is expected to be reasonably strong at about 4.6%, led by the central Asian economies with slightly lower growth of about 4.3% in the Russian Federation. Growth in the EU-27 is expected to be 1.8% led by the EU new member states (NMS) with weak or negative growth in the southern and western periphery of the eurozone. Growth in North America should be higher at about 2.5%; however, after controlling for this region's higher population growth, its per capita growth is likely to be quite similar to that of the EU. Average growth in the non-UNECE economies is expected to be about 6.1% in 2011 or over twice the UNECE average. In 2011, solid growth at this level should allow most developing countries to make substantial progress towards achieving the Millennium Development Goals.

Given the duration and depth of the crisis, as well as the varying strength of the recoveries, it is useful to compare countries' GDPs in 2011 to those in 2007 before the crisis, to get an overall picture of the growth effects of the crisis (see table 2.1.1). For the region as a whole, GDP in 2011 is only 2.3% above that in 2007; this compares to an increase of over 23% for the rest of the world. Some UNECE countries, however, did remarkably well. The CIS, excluding the Russian Federation, has grown 12.6%, led by Turkmenistan (41.4%), Uzbekistan (37.7%) and Azerbaijan (33%). Seventeen or approximately one-third of the UNECE economies will have lower GDPs in 2011 than in 2007. The largest declines occurred in Latvia (-19.1%), Estonia (-11.6%), Ireland (-11.2%), and Greece (-9.2%).

After declining by 0.6% in 2009, global GDP growth rebounded to 5.0% in 2010 and is forecast to be 4.4% in 2011 and 2012, a respectable figure by historical standards. As in the decade before the crisis, growth is expected to remain considerably higher (over twice as fast) in the world's emerging economies than in the advanced economies. This two-speed recovery has created a number of policy tensions around the world. The emerging economies are focused on raising interest rates to slow growth while the advanced economies are still dependent on keeping interest rates as low as possible to encourage private investment. In the US, interest rates remain at historic lows, near zero. Although the European Central Bank (ECB) began to slightly increase eurozone rates in early 2011, they nevertheless remain very low. As a result of this interest rate differential, capital flows have surged from the low interest rate advanced economies to the higher interest rate emerging economies. This has resulted in the appreciation of currencies in the emerging economies, which has negatively affected their international competitiveness. Consequently, policy disagreements have developed as countries find the actions being taken by other governments to be detrimental to their own economic interests. This has increased the need for global macroeconomic policy coordination, but at the same time has made achieving it much more difficult. A similar two-speed recovery has developed within the European Union and has created a similar policy conflict. The healthy centre (led by Germany) is fixated on inflation and the need for macroeconomic constraint while the periphery is suffering from extremely high unemployment and, in some cases, negative growth and needs further expansionary policies.

The global financial crisis and the advanced economies' slow recoveries have a number of important long-term economic consequences for the UNECE region. Most generally, the crisis further accelerated several longer-term trends. Much of the emerging world, especially in Asia, had been growing significantly faster than the advanced economies in North America and Europe. As a result, the share of the world GDP accounted for by the UNECE economies had been slowly declining. Due to the crisis, the growth rate in the advanced economies has declined significantly (and was even negative in 2009) for several years while the decline in the emerging world has been far more moderate. Consequently, the share of world GDP accounted for by the UNECE economies has declined even more markedly. It now is below 50% and is expected to continue to decline in the coming decades as its population and per capita income continue to grow more slowly than in the rest of the world. Therefore the region's political power and influence in shaping global developments is expected to continue to decline.

2.1.1 *Unemployment, inflation and exchange rates*

At the peak of the crisis, unemployment increased to over 10% in all of the major areas of the UNECE – the US, eurozone, the Russian Federation and Turkey. The recovery has been too subdued to reduce this appreciably as unemployment remains above 9% in each of these except for the Russian Federation where it declined relatively quickly and was only 7.2% by mid-2011. Just as there has been large variation in the GDP growth rates in the eurozone, unemployment rates also varied: in some economies (i.e., Austria, Denmark, Netherlands) unemployment rates were below 5% in mid-2011 while they were above 10% in Greece, Ireland, Portugal and Slovakia, and above 20% in Spain. Unemployment rates have also been rather high in several of the EU New Member States (NMS) that are not in the eurozone. They are over 10% in Bulgaria, Estonia and Hungary, and well over 15% in Latvia and Lithuania. Given the very steep economic decline in the UK, the increases in its unemployment rate have been surprisingly small; UK unemployment in the first half of 2011 was slightly above 7%. Unemployment, which was quite high in south-east Europe even before the crisis, remains relatively high with rates above 10% in most countries and above 20% in Bosnia and Herzegovina and The former Yugoslav Republic of Macedonia. In the CIS, unemployment has been especially severe in Georgia, which has a rate above 15%.

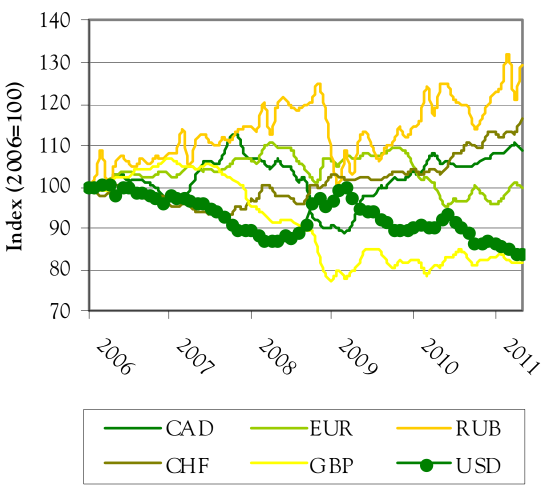
The current unemployment problem is more severe than the rate commonly reported. Official unemployment rates only measure those actively looking for work. If those who are working part-time but want to work full time, and those discouraged from looking, are also considered, then the unemployment rates may be 50% higher than the reported figures. Along with the increase in unemployment there has been a more than proportional increase in long-term unemployment. In the US, the unemployed have on average been out of work for 40 weeks, and more than 4 million (out of 14 million) have been unemployed for more than a year. In most countries of the UNECE region, the unemployment rates are two to three times higher for youths than for adults. This reflects the limited work experience of young job seekers and their greater vulnerability to economic downturns. The unemployment rates for disadvantaged ethnic minorities and indigenous groups are also especially high. The high levels of unemployment are a significant factor in explaining the difficulties in some UNECE housing markets, but it is also the case that the causality runs the other way as housing busts increase unemployment. When houses are underwater (i.e., the market value is less than the mortgage), owners cannot afford to sell them and thus are not able to move to new geographical regions where job opportunities might exist.

As a result of the rapid growth in the developing economies, the demand for some key commodities has increased sufficiently to raise their global prices substantially. Noteworthy for the UNECE region have been the large increases in the prices of oil and gas which have been especially beneficial for the energy-rich CIS. As a result, those countries have experienced a rapid bounce-back in GDP growth, declining unemployment and improving fiscal situations. The higher commodity prices, however, have been a negative development for the advanced economies as they are beginning to face inflationary cost-push pressures. Headline inflation in both the US and eurozone is likely to be above their central bank targets of around 2% in 2011. As a result, several central banks, including most importantly the ECB, have felt compelled to begin monetary tightening despite the economic slack and high unemployment in their economies. Some of this tightening seems premature, however, as inflationary expectations remain low. As a result, the increases in headline inflation have not translated into wage increases. Thus, the current price increases are most likely one-time price adjustments caused by changing conditions in world commodity markets and are unlikely to signify the beginning of a sustained increase in core inflation. In the CIS, however, inflation is in the high single digits, due to their more robust recoveries and higher food prices. Food represents a much larger proportion of expenditure in the CIS than in the advanced economies. Inflation is a valid concern for these central banks and further monetary tightening is likely.

Since the beginning of the global economic crisis there have been significant movements in the exchange rates of the major currencies (graph 2.2.1). During the peak of the crisis, somewhat perversely, the dollar appreciated as part of a global flight to safety, even though the US was at the epicentre of the financial crisis. With the stabilization of global capital markets and the beginning of the recovery, the dollar has been in continuous decline. Although this may be due partly to concern about the longer-term health of the US economy and its increasing sovereign debt, it is primarily the result of widening interest rate differentials favouring other currencies. The real value of the US dollar has now fallen to a level last seen in the 1970s. As the world's primary reserve currency, it is held in large amounts as a store of wealth, so that this depreciation poses some risks to the stability of the world economy.

GRAPH 2.2.1

Exchange rate indices of selected currencies, 2006-2011



Notes: CAD = Canadian dollar, EUR = Euro, RUB = Russian rouble, CHF = Swiss franc, GBP = British pound and USD = United States dollar

Sources: Bank for International Settlements and UNECE, 2011.

Relative to the US Federal Reserve, the ECB has been more conservative in its monetary policy. It reduced interest rates more slowly as the crisis developed, kept them higher at the height of the crisis, and began to raise rates earlier. As a result, the euro is expected to continue to strengthen relative to the dollar. The Swiss franc has appreciated even more than the euro as it is insulated from the eurozone debt crises. These exchange rate movements have been particularly significant for housing markets in central and eastern Europe, where foreign-currency denominated loans were widespread. As a result of the appreciation of the franc, the cost of servicing these mortgages in the local currency has increased substantially. This may result in increasing default rates, which could put additional strains on local banking institutions. Compared to the US or eurozone, interest rates have remained significantly higher in the faster growing UNECE emerging economies as well as in most developing countries. Consequently this interest differential has created strong capital inflows into these economies and their currencies have appreciated, often to undesirable levels. A significant exception to this pattern has been the Russian Federation which has continued to experience capital flight despite its economic recovery. Nevertheless, the rouble has appreciated on the strength of oil prices. The Canadian dollar, which depreciated sharply during the crisis, has strengthened considerably since 2009, as commodity prices have increased.

The globally coordinated fiscal expansions undertaken at the beginning of the crisis were a central component in averting a second Great Depression. Almost as soon as the fiscal expansions were implemented, however, concerns developed about the rising levels of sovereign debt, especially in the advanced economies. The average debt of the UNECE advanced economies is likely to increase by over 50% due to the crisis. This is due to both increased stimulus discretionary expenditures and reduced tax revenues. Although significant increases in debt are typical of countries experiencing financial crises, they have been particularly problematic for the UNECE advanced economies because, even before the crisis, there were fiscal concerns due to their ageing populations. In 2010, the sovereign debt of 14 of the EU's 27 members exceeded the 60% of GDP limit incorporated into the EU's own Stability and Growth Pact. In Greece and Italy, debt was above 100% of their GDPs. Of the 10 former transition economies in the EU, only Hungary was over the limit. The debt of the US was 98% of its GDP in 2010 although approximately one-third of this debt was owned by the government, largely in its Social Security Trust Fund. Canada's gross debt increased to 77% of its GDP in 2010. Like the US, Canada's net debt is much lower. The result of these concerns is that the advanced economies have significantly scaled back their fiscal policies. During a period when their economies need macroeconomic stimulus, the authorities instead are imposing contractionary monetary and fiscal policies. This explains why the medium-term outlook for the advanced economies is so weak and that a resolution of their employment and debt problems is expected to take so long. Although austerity might appear to be the logical response to growing indebtedness, there is nothing more detrimental to reducing debt than an extended period of slow growth. To the degree that the austerity reduces growth, which it appears to be doing, the austerity can ultimately prove to be counterproductive - not only is debt not reduced, but output is also lost.

2.1.2 *The eurozone crisis*

The sovereign debt problems of several of the periphery economies of the eurozone reached a crisis level in late 2010 and 2011; these included Greece, Ireland, and Portugal. Concerns about a possible default by these three countries caused their interest rates to increase to such a degree that they were forced to obtain rescue packages from the EU and the IMF. There were growing concerns about Spain, Italy and, perhaps, Belgium. The severity of the problem for all of these countries was due to several factors which differed by country. However, they shared two characteristics: their debt levels were particularly high and they were in the eurozone. It was their membership of the eurozone that exposed a serious design defect of that monetary union. Eurozone membership increases the default risk for sovereign debt because member governments do not have access to the usual policy options (depreciation, monetary easing, or a lender of last resort) for dealing with debt problems. To address this shortcoming and come up with alternative mechanisms for addressing debt problems, there has been quite significant institutional reform about the obligations and benefits of belonging to the eurozone and further initiatives are still to be agreed upon. More specifically the EU and IMF jointly established a European Financial Stability Facility to provide emergency financing for these economies although significant conditions were imposed on fiscal expenditures and taxes. In 2013, this temporary facility will be replaced by a permanent European Stability Mechanism with the objectives of reducing the possibility of future sovereign debt crises and providing a funding mechanism, if one should nevertheless occur.

Despite these institutional reforms and the assistance provided, it remains unclear if the sovereign debt of these countries will be fully repaid on the original terms. Ultimately the debt will be paid by either the taxpayers of the affected country, the taxpayers of the entire eurozone or the bondholders (through default). There is currently a disagreement amongst all the important participants about the amount each of these will contribute; there are serious downside risks to each option. Additional fiscal tightening (higher taxes and reduced spending) in the affected countries will only further depress their economies and, by lowering their growth, may actually reduce their ability to repay. If the eurozone were a normal monetary union, there would be a corresponding fiscal union. As a result, the taxpayers in the rest of the eurozone would carry a significant part of the burden. In the design of the eurozone, however, every effort was made to maintain each member's fiscal autonomy and avoid creating a fiscal union. It is becoming increasingly apparent that it is not possible to have one without the other. While the economic consequences of forcing the other eurozone taxpayers to pay are fairly benign, the political repercussions could threaten the entire eurozone project. Losses imposed on bondholders, which are largely European financial institutions, to pay could further weaken the banks before they have recovered from the financial crisis and thereby trigger yet another crisis. In such a case, the banks would have to be rescued by their governments, and thus the eurozone taxpayers would ultimately pay some part of the bill. The best option, where possible, is for affected governments to sell state-owned assets; however, there are not enough of these for this to be more than a component of any comprehensive solution.

The crisis facing the vulnerable eurozone economies is more extensive than just that of a sovereign debt crisis. These economies have also been running large current account deficits which means that they have been consuming (defined generally to include investment) much more than they have been producing. As a result, there is a need for a much wider set of adjustments in addition to fiscal tightening, including reductions in wages throughout the private sector. A factor that will significantly determine the economic consequences of these crises will be whether they are resolved in an orderly pro-active manner or if things are allowed to spin out of control and result in the type of market chaos that followed the collapse of the Lehman Brothers bank.

2.1.3 *Additional macroeconomic risks*

The dire situation of the EU periphery economies caused some to believe that a similar fate might arise for other indebted, advanced UNECE economies, including the UK and the US. As a result, political pressures developed in these countries to implement significant fiscal retrenchments. This viewpoint focused on their similarities with the EU periphery economies in their debt profiles. It failed to appreciate the role that being a member of the eurozone played in the crisis. In addition, it incorrectly interpreted the still difficult economic conditions as a sign that the expansionary policies had not been effective, when in fact they had been – given the severity of the economic shock, they simply were insufficient. As a result, these non-eurozone economies are currently undertaking needless austerity measures and reduced growth that will make it all the more difficult for them to address their very real longer-term debt problems associated with demographic developments. By taking the economic stance that monetary policy needs to be tightened to address global commodity price increases and that fiscal policy needs to be tightened to address debt concerns, despite the current state of high unemployment, governments effectively leave themselves without any macroeconomic policy tools. This situation creates a significant downside risk for the economic recovery in 2012. If the private sector is unable to substantially increase current levels of spending, or if there should be some unexpected shock (perhaps a eurozone default), a double dip recession would appear to be inevitable. This is, in fact, what happened during the 1930s and it will represent a considerable policy failure if the world were to repeat its previous mistake.

While the medium-run objective of the advanced UNECE economies is primarily to reduce unemployment and lower sovereign debt levels, the emerging market economies are more focused on structural reforms that are needed to diversify their economies out of natural resource sectors and into dynamic knowledge-based manufacturing and service sectors. Progress in this regard has been rather limited in the Russian Federation and central Asia as high energy prices have kept the incentives tilted towards resource production. Their dependence on commodities, however, is creating vulnerability for their development efforts, especially if the current global commodity boom turns out to have been a bubble. In addition, at current production levels the Russian Federation has only 20 years of oil reserves left, so there can be no delay in this transition process.

The housing sector remains a significant drag on several UNECE economies, especially the US economy. There is a significant oversupply of homes in the US which continues to depress home construction. In April 2011 seasonally adjusted housing starts declined by 10.6% from March to an annual rate of 523,000. Housing starts, a quintessential leading economic indicator, are now lower than when the recovery began two years ago. And it is all the more striking given the historically low interest rates and the fact that housing is one of the most credit-sensitive sectors. At June 2011, there are about 10 million vacant homes in the US. Housing prices have fallen 32% nationally from their peak in 2006, which is a greater decline than occurred during the Great Depression of the 1930s. Not all the excess supply of housing is actually due to overbuilding as there has been a significant decline on the demand side as well, due to high unemployment, difficult credit conditions and a hesitancy to buy, as long as housing prices continue to decline. An additional factor reducing demand, has been a substantial decline in the creation of new households, as people temporarily move in with friends and family. As a result there is developing a significant pent-up demand that at some point in the future will lead to rapid household formation and an above average demand for housing. A similar excess supply of housing exists in several European economies including most notably Spain. During the crisis, property prices fell considerably in many of the UNECE emerging economies, such as the Russian Federation where they fell 40% between 2007 and 2009. The Russian housing market, however, has recovered over the last two years in part because there is a strong relationship in Moscow between real estate and oil prices.

In conclusion, the economic situation in North America and Europe is particularly perilous at this time. Growth is positive but subdued, and as a result, unemployment, which is currently quite high, is likely to stay that way for some time. In addition, the region is facing some difficult challenges, such as addressing rising sovereign debt levels and commodity inflation, which will weaken the ability of government efforts to promote growth and employment. However, growth prospects are higher in eastern, central and south-east Europe and the CIS. The UNECE region's financial sector remains weak, and proposed tighter regulation may further limit its ability to restore investment levels in the coming year. Thus, the overall macroeconomic situation is not particularly supportive for a strong rebound in either the housing sector or for forest products more generally. The one bright spot remains the solid growth in emerging markets outside the region, and especially those in Asia.

Source: D. Torgerson, 2011.

TABLE 2.1.1

UNECE region real GDP growth rates (%), 2010-2011

Country	*2010*	*2011[f]*	*% Change 2007 to 2011*	*Country*	*2010*	*2011[f]*	*% Change 2007 to 2011*
Albania	3.9	3.5	19.7	Portugal	1.3	-2.2	-3.4
Bosnia and Herzegovina	0.9	2.5	6.0	Slovakia	4.0	3.5	8.4
Croatia	-1.2	1.1	-4.0	Slovenia	1.2	1.9	-1.7
Montenegro	-1.8	4.5	3.4	Spain	-0.1	0.6	-2.4
Serbia	1.5	2.9	6.8	Eurozone	1.7	1.6	-0.6
TfYR of Macedonia	0.7	2.5	7.4				
Turkey	8.9	6.1	10.8	Bulgaria	0.2	2.8	3.4
South-east Europe (non-EU)	7.2	5.3	9.4	Czech Republic	2.3	2.0	2.5
				Denmark	2.1	1.7	-2.6
Armenia	2.6	4.3	-1.7	Hungary	1.2	2.7	-2.3
Azerbaijan	5.0	4.6	33.0	Latvia	-0.3	3.3	-19.1
Belarus	7.6	3.9	23.5	Lithuania	1.3	5.0	-6.6
Georgia	6.4	5.2	10.2	Poland	3.8	4.0	15.4
Kazakhstan	7.0	6.4	19.0	Romania	-1.3	1.5	-0.2
Kyrgyzstan	-3.5	7.1	14.6	Sweden	5.7	4.2	3.7
Republic of Moldova	6.9	4.6	12.7	United Kingdom	1.3	1.7	-2.1
Russian Federation	4.0	4.3	5.1	EU – 27	1.8	1.8	-0.1
Tajikistan	5.5	5.0	23.6				
Turkmenistan	9.2	10.4	41.4	Iceland	-3.5	1.5	-7.5
Ukraine	4.2	4.6	-5.5	Norway	0.3	2.7	2.0
Uzbekistan	8.5	7.7	37.7	Switzerland	2.6	1.9	4.5
CIS	4.6	4.6	7.2	Israel	4.2	4.0	13.8
				Europe – 31	1.8	1.8	0.2
Austria	2.0	2.4	2.6				
Belgium	2.2	2.4	2.7	Canada	2.9	2.9	3.8
Cyprus	1.0	1.5	4.4	United States	2.9	2.6	2.8
Estonia	3.1	4.9	-11.6	North America	2.9	2.6	2.9
Finland	3.1	3.7	-0.9	**UNECE – 52***	**2.7**	**2.5**	**2.3**
France	1.5	1.8	0.4				
Germany	3.6	2.6	2.3	Memorandum items			
Greece	-4.5	-4.0	-9.2	South-east Europe (except Turkey)	0.6	2.3	4.0
Ireland	-1.0	0.6	-11.2	CIS (less Russian Federation)	5.9	5.5	12.6
Italy	1.3	1.0	-4.3	EU-pre 2004 - 15	1.7	1.6	-0.8
Luxembourg	3.5	3.4	4.6	EU NMS-12	2.1	3.1	5.5
Malta	3.7	2.0	7.6	UNECE emerging economies**	5.3	4.8	7.8
Netherlands	1.8	1.9	1.6	World	5.0	4.4	12.1

Notes: f = forecast. *This total excludes four countries within the UNECE region: Andorra, Liechtenstein, Monaco and San Marino which do not report GDP. **This total includes CIS and south-east Europe.

Sources: UNECE secretariat, 2011.

2.2 Construction sector developments

2.2.1 *United States construction market review*

The US housing market is still reeling from the recession and the global economic crisis. Between the peak of 2006 and May 2011, existing US home prices fell by roughly 41%, with new home values falling by 17.5% from 2007s high. Between 2010 and 2011, about 75% of US homes lost value and prices have now fallen for 58 consecutive months (Humphries 2010a, 2011b). This collapse also has erased 8 years of price gains.

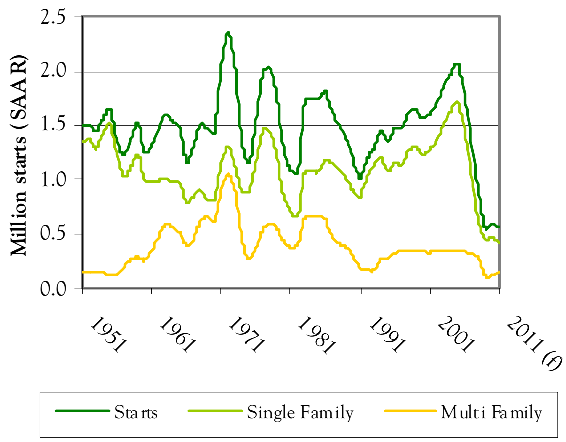
As valuations have continued to fall, there has been an increase in the numbers of homeowners falling behind with their mortgage payments (so-called 'delinquency'), reaching almost 10% of all mortgages by the end of 2010; even prime loans had a delinquency rate approaching 7% (Alexandre 2011). The term 'underwater' has been coined to describe the circumstance in which the value of a home is less than the mortgage remaining on it. There are various estimates of the number of properties currently 'underwater' (negative equity). By the first quarter of 2011, roughly 12 million or 28.4% of all mortgages were underwater. An outcome of negative equity is often foreclosure; from April to June 2011, nearly 2 million homes were in the foreclosure process, with another 1.5 million homes seriously delinquent (Humphries 2011b). US mortgage lenders own more than 872,000 foreclosed homes, and are in the process of foreclosing an additional one million homes, and may take possession of millions more in future years (RealtyTrac, 2011). It is estimated that there are over 5 million additional homes that could be placed on the market, if conditions were better (Humphries 2010a).

In April 2011, the US registered the lowest home sales since record-keeping began in 1963. By May 2011, existing US home sales declined approximately 27.3% from the 2005 high and new home sales have fallen 76.6% from their 2005 peak (SAAR). The National Association of Realtors reports that 37% of existing home sales in April 2011were foreclosed homes (NAR 2011a, b). In a historical context, US housing starts are at levels not witnessed since the Great Depression and are lower than the 1950s (graph 2.2.1). It is not all dismal, as reports indicate that home prices in 20 US States increased in May 2011, though these data do not include REOs[10] (CoreLogic, 2011a).

[10] "Real estate owned" or REOs are properties that are owned by the mortgage lender. This is typically a lending institution, such as a bank, government lending institution or loan insurer.

GRAPH 2.2.1

US housing starts, 1951-2011



Note: SAAR = Seasonally adjusted annual rate.
Sources: US Census, 2011.

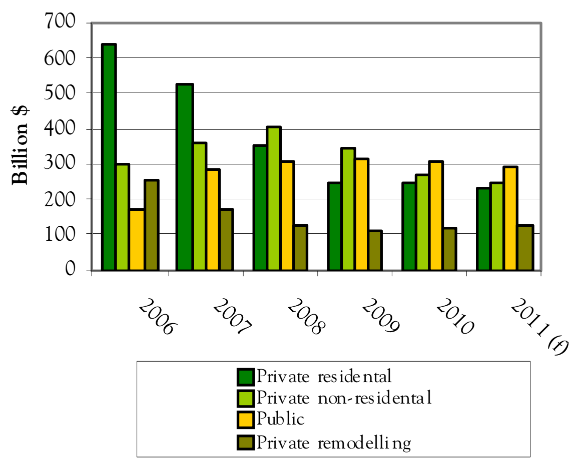
2.2.2 *US construction outlook*

Overwhelmed consumers, unemployment, inflation, fewer new households being formed, mortgage delinquencies, shadow inventory, stricter mortgage lending requirements, continuing foreclosures, and a potential for rising interest rates are all acting against any immediate revival in the fortunes of the housing market. Foreclosures drive down existing home prices substantially and so, all home sales and starts suffer due to the intensely competitive market. New housing starts data for April 2011 were disappointing, projecting an annual rate of ±550,000 units – the smallest number of starts for more than 60 years (graph 2.2.1). A key factor holding back housing starts and sales is the scale of 'shadow' homes: these are properties where the mortgage lender has foreclosed on a property but not yet placed it on the market. Estimates suggest there are between 1.8 and 5.1 million homes in the 'shadow' homes category (CoreLogic, 2011b; Ricciardi, 2011). Job losses among first-time home-buyers and would-be renters, coupled with a housing supply inflated by owners and banks trying to rent or sell repossessed homes is adding to an already difficult situation. A June 2011 report indicated that mortgage applications decreased by 3% in May 2011 and by 15% in the 12-months prior (Mortgage Bankers Association, 2011). A sub-sector with growth potential is multi-family housing and the construction of rental units; multi-family starts dipped below the past 40-years average in the past decade. Many may look more favourably on renting than owning in the present circumstances. Yet, all indicators suggest that housing may be in a 'double-dip' recession and that there is unlikely to be any significant recovery in the short-term.

Unsurprisingly, with housing starts at a record low, spending on residential construction has continued to fall (graph 2.2.2). Total private residential construction spending fell 8% to $ 238 billion during the 12 months from March 2010 to March 2011, a fall of $ 426 billion from a high of $ 664 billion in 2006 (US Census, 2011c). The Leading Indicator of Remodelling Activity (LIRA) estimated that $ 491.5 million was spent on remodelling in 2011, up 0.2% from 2010 (LIRA 2011). This appears to be another opportunity area, as 43.6% of US homes are 51 years or older (56.7 million units) and the median age of a home is 37 years. Nearly 25% of the US housing stock is 20 years old or less (32.3 million homes) and 31.6% of homes are 21 to 50 years old (41.1million units) (US Census, 2011d).

GRAPH 2.2.2

US housing spending trends, 2006-2011



Notes: f = forecast. Based on the most recent US Census data.
Sources: US Census, 2011.

2.2.3 North American construction materials

Historically, home construction and remodelling have been the primary market outlets for sawn softwood and structural panels; with prices typically tracking home starts. It has been estimated that, traditionally, the new housing sector consumed 40% of sawn softwood and 53% of structural panels' production (Schuler, 2010). Currently, industrial markets consume more sawnwood than new housing, about 35%, and new construction is nearly 22%.

The volume of sawn softwood used in new construction was estimated to be 20.3 million m^3 in 2010, roughly 25% of the volume used in 2005. Estimates for other sectors are: repair and remodeling 26.8 million m^3, non-residential 2.0 million m^3, and industrial 28.3 million m^3 in 2011. Western sawnwood output was 26.8 million m^3 in 2010, an increase of 9.2% from 2009 and Southern pine production increased 3.9% to 28.9 million m^3 from 2009 (Random Lengths 2011b). Sawnwood imports from Canada increased 8.9%, to 8.9 million m^3. Random-length composite dimension sawnwood prices improved marginally from $222 in 2009, to an average $285 per thousand board feet in May 2011 (Random Lengths, 2011c).

2.2.4 Canadian housing construction market

The Canadian housing market continues to rebound from the effects of the recession, with 189,930 new starts recorded in 2010, reflecting the strength of the Canadian economy, which escaped the problems that beset the US and many other countries (Canada Mortgage and Housing Corporation (CMHC), 2011). CMHC forecasts 179,500 starts in 2011 (range: 166,600 to 192,200) and 185,300 for 2012 – with increases in British Columbia, Alberta, and Ontario. Of this total, 82,700 single-family and 96,800 multi-family starts are projected for 2011. Overall, 452,100 existing home sales are expected in 2011 (range: 398,500 to 485,500) and 461,300 in 2012. Mortgage rates are expected to average 3% to 3.7% for 2011 and 3.5% to 5.5% in 2012. Employment is estimated to increase; reducing the unemployment rate from 7.6% to 7.3% in 2012; generally, new mortgages are 25-year instruments (CMHC, 2011).

2.2.5 European construction market

2.2.5.1 Review and outlook

The European housing market is at best a 'mixed bag.' House prices increased in 2010 in Belgium, France, Germany, Norway and Sweden, while prices in Greece, Hungary, Ireland, Portugal and Spain all fell and considering their economic situation, are expected to continue falling (Ball, 2011). In the UK, which also experienced an economic decline, home prices inexplicably rose by 9% between March 2009 and March 2010, and prices have continued to rise slightly in 2011 (O'Donnell, 2011). In the 10 years from 1998 to 2008, when the global recession struck, European house prices appreciated more than in the US, and have declined much less since the crisis began. It seems likely that European homes may be overvalued, and this poses a possible risk to Europe's housing and economic recovery (Just and Mayer, 2010). The level of mortgage debt in the majority of countries remains high (Ball, 2011). As in the US, housing sales and starts with variable rate mortgages may weaken rapidly if interest rates rise (e.g., Ireland, Spain, Sweden and the UK) (Just and Mayer, 2010). The prospect of Europe leading any international recovery appears fragile. However, Germany and Poland both have prospects of strong economic growth (Euroconstruct, 2010).

Throughout Europe, home construction is sluggish and lagging behind the overall recovery in most places (Ball, 2011). Between 2008 and 2010, European residential construction shrank by more than 20%, to \$795.5 billion (€555.2 billion) (December 31 2010 basis), with the gains of the preceding 13 years effectively erased in only 3 years. In 2009, demand in all construction sectors fell, but especially in the residential sector, resulting in an overall decline of Euroconstruct area building volumes (-8.4%, about \$2.0 billion (€ 1.4 billion). By comparison, the GDP for all Euroconstruct's[11] members declined on average by 4%. The severity of the slump differed among countries with Poland and Switzerland recording increased building activity; while Ireland and Spain suffered collapses of -32.2% and -21.5% respectively (Euroconstruct 2010). Current conditions indicate little signs of improvement; between March 2010 and March 2011, construction values dropped by 4.9% in the EU-17 countries and by 2.7% in the EU-27 (Allen 2011).

Nearly 75% of all home construction is in five European countries: France, Germany, Italy, Spain, and the UK In contrast to 2006, France, Germany, Italy, and the U.K. have increased slightly and Spain's share declined by 50% in 3 years (Euroconstruct, 2010). The overall value of the European construction market is steady; however, housing completions may soon decline to 1998 levels (206 million). Of great concern is the deterioration in Spain's housing market – where nearly 20% of Europe's home construction occurred during the housing boom. The collapse in Spanish housing construction is the foremost cause of the decline housing completions. In 2007, Euroconstruct region completions were more than 2.5 million units but are projected to fall to 1.4 million in 2011. In 2009, new residential construction as a percentage of investment in the construction sector was 40%, compared with more than 50% in 2006. Residential construction contracted by more than 20% (\$741.5 billion or € 554 billion), between 2008 and 2010 (Euroconstruct, 2010). In Europe, the home crisis was a result of several factors: 1) many homeowners used their homes as a source of cash (e.g., second mortgages and home equity loans, using the house as collateral), some purchased property beyond their ability to make payments. Once the real estate bubble burst, many owners were stressed financially. Thus, the housing overproduction in the past decade is likely to have a negative impact on new starts in the future (Euroconstruct, 2009).

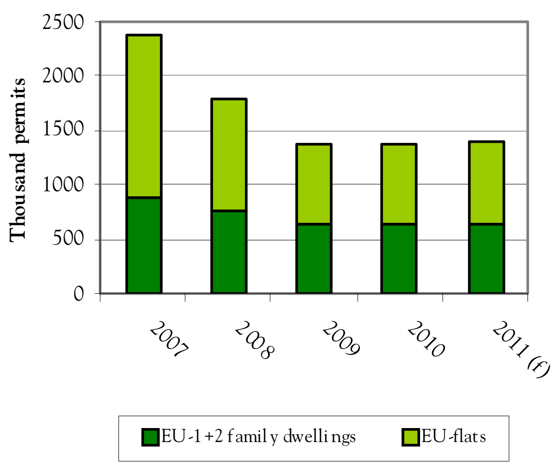
2.2.6 European construction trends

2.2.6.1 New housing

New home construction in the Euroconstruct region is following the same downward trend as in the US (graphs 2.2.3 and 2.2.4). Economic conditions, which include a mixture of weak and strong ecomomies in the EU, persistent high unemployment, consumer uncertainty, a potential for rising interest rates; are hindering a recovery in new home starts. Reviewing 2006 data, a record 2.38 million homes were completed: 1.55 million multi-family (flats) and 836,800 1+2 family homes. In 2011, it is projected that about 623,000 (927,000 fewer units, ±60% decline) multi-family units and 523,000 (314,000 fewer units, ±37% decline) 1+2 family dwellings are to be built, as compared to 2006. Projections for 1+2 family dwellings and flats are not expected to approach 2006-2007 levels in the near future. New residential construction growth clusters may arise; for instance, Germany, where nominal starts occurred in the past decade. In the medium-term, Germany may realize an increase in new home construction – from 153,700 in 2009 to a projected 218,000 units in 2013; \$190 billion (€131.1 billion) to \$209.4 billion (€144.5 billion) (Euroconstruct, 2010).

GRAPH 2.2.3

European building permits, 2007-2011



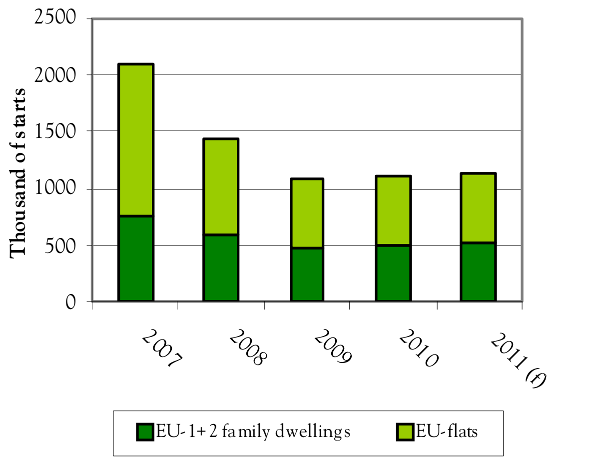
Note: f = forecast

Sources: Euroconstruct, 2010.

[11] The Euroconstruct region is comprised of 19 countries. The western region includes EU-17 member states (Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Hungary, Ireland, Italy, the Netherlands, Poland, Portugal, Slovakia, Spain, Sweden, and the United Kingdom), and Norway and Switzerland. Euroconstruct's western European countries are not the EU-27, but the first 17 countries listed above. Euroconstruct's analysis of eastern European construction also is based on the Czech Republic, Hungary, Poland and Slovakia.

GRAPH 2.2.4

Euroconstruct region housing starts, 2007-2011



Note: f = forecast.

Sources: Euroconstruct, 2010.

Future house building in Europe will be mixed, with construction flourishing in some areas while others flounder. In spite of the economic threats, a thin housing recovery is forecast for 2011 (1.6% to 2% gain), somewhat greater for 2012 (2½% to 3% gain), and the share of new home building will not increase significantly by 2013. In absolute terms, the 2013 housing market is expected to be \$815.2 billion (€602 billion), 8% less than in 2008 (Euroconstruct, 2010).

After a 3% decline in 2009, housing renovation and modernization is expected to improve in the next few years with growth of between 1% and 2% per year projected (Euroconstruct, 2010). Historically, renovation and home remodelling have been steady, and renovation and home remodeling have been supported by government renovation programmes. As in the US, caveats to home building are: housing may be susceptible to increasing interest rates in areas with housing needs; new home supply has been reduced greatly and current building is at low-levels; mortgage restrictions (loan ratios, reduced or elimination of government aid) affect several markets. The Royal Institute of Chartered Surveyors in its, “2011 European Housing Review” provides comprehensive detailed information about the housing situation in several European countries (Ball, 2011). Additional threats to a Euroconstruct housing recovery are the fiscal austerity moves by Greece, Ireland, Portugal and Spain.

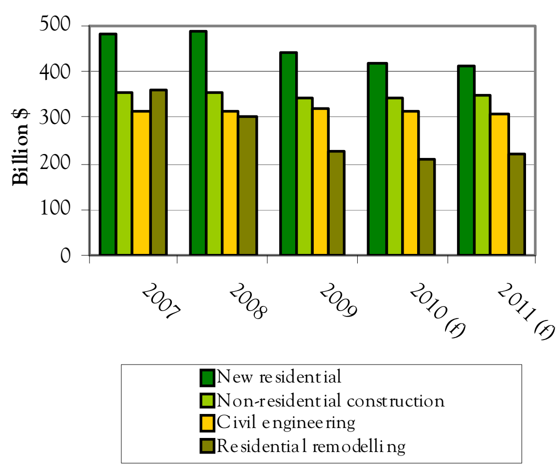
2.2.6.2 Non-residential buildings and civil engineering

The outlook for non-residential building in 2011 is negative, as overall spending on construction is forecast to fall by 5.1%, \$591.2 billion (€411.7 billion). Minimal growth in the non-residential sector is projected to begin in 2012 and by 2013, total nonresidential output is predicted to increase 2.5% from the 2010 level (Euroconstruct, 2010).

Activity in all construction sectors declined after the 2008 recession, though the residential sector suffered the greatest fall, with non-residential and civil engineering less affected. Spending in the non-residential building and civil engineering sectors is forecast to change little in 2010 and 2011 (graph 2.2.5). In the non-residential sector, the commercial, office, and industrial markets are projected to decrease substantially (combined, they are greater than 50% of this sector); while the miscellaneous, health, agricultural, and storage markets are projected to have a minimal decrease. Educational building is the only sector projected to increase over the next few years. Slight increases in the remodelling and civil engineering sector are projected through 2013. By 2013 civil engineering is projected to be the driver for all construction sectors in the Euroconstruct region, to \$452.2 billion (€314.9 billion). Home renovation was 27% of the total construction value in 2010 and is forecast to be \$515.7 billion (€ 359.1 billion) by 2013. Projections are for slow growth in all sectors (Euroconstruct, 2010).

GRAPH 2.2.5

European construction spending trends, 2007-2011



Note: f = forecast.

Sources: Euroconstruct, 2010.

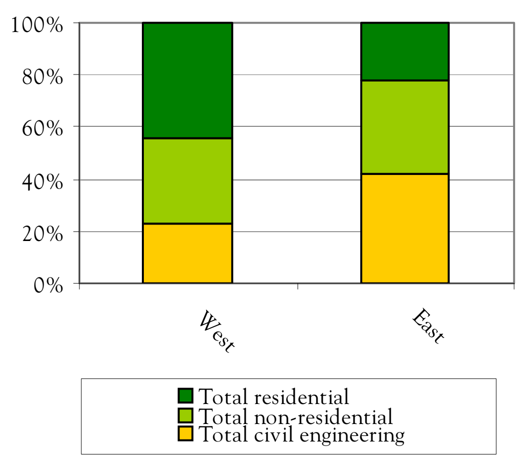
2.2.6.3 *Construction sector shares and growth in western and eastern Europe (Euroconstruct regions)*

Total residential construction in western Europe, is predicted to increase from $770.4 billion in 2010 (€575.5 billion) to $837.1 billion by 2013 (€625.4 billion), compared to the four eastern European countries, where the projected increase is to $23.5 billion (€17.5 billion) from $20.8 billion (€15.5 billion). As a proportion of overall construction, residential construction is projected to fall slightly from 2010 levels, from 43 to 40% in western Europe and by 1% in eastern Europe, by 2013 (Euroconstruct, 2010).

Civil engineering projects have been less affected by the recession than other parts of the construction sector. As a result the share of overall investment has increased in percentage terms, though not in absolute spending, since 2006. The three main factors leading to this change are the overall poor state of housing markets, an increasing need for civil engineering projects and the use of large infrastructure projects to give a stimulus to the economy. The same trend can be seen in eastern Europe, where spending on civil engineering and non-residential projects now accounts for 78% of all construction investment (graph 2.2.6) (Euroconstruct 2010).

GRAPH 2.2.6

Construction in Western Europe vs. Eastern Europe, 2010



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FOREST PRODUCTS ANNUAL MARKET REVIEW 2010-2011

Project Manager

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