Building costs and building activity:

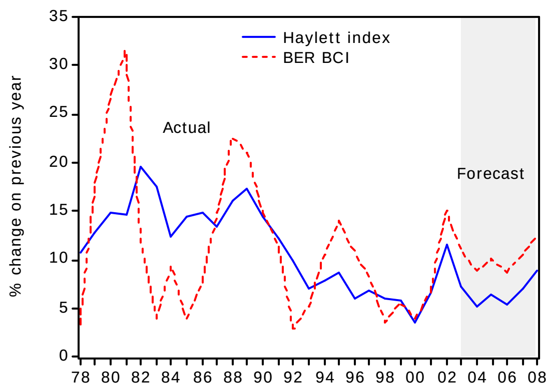
Dead man starts walking again

This chapter examines the building-construction sector of the economy in more detail, and more specifically, the anticipated growth in building costs, as well as the expected fixed investment in buildings (new buildings put in place). Building costs are measured using the Bureau for Economic Research's (BER) Building Cost Index (BCI), which reflects tender prices, and the Haylett formula, which measures input-cost growth within existing contracts.

Building costs

The building construction industry in South Africa has been under severe pressure for at least two decades. Evidence of the difficult times can be found in the sector's declining contribution to the country's gross domestic product — from 4,3% of GDP in 1980 to 2,8% in 2002.

Forecast growth: BER BCI vs Haylett index



Source: Rode's Time Series; BER; JBCC CPAP Haylett Formula; MFA

The accompanying graph clearly shows the secular downward trend in building-cost inflation since the late 1980s — the result of decelerating consumer inflation from 1990 (which retarded input-cost growth) and dwindling building construction work after 1982. The latter led to tough tendering competition, which put pressure on the profit margins of contractors.

> Note: a secular trend is a long-term trend, as distinct from a cyclical trend, which refers to the shorter business cycle.

Before we deal with the forecast in building costs, it is important to understand the various building cost indices. The Haylett index is a measure of all input costs in the building industry, especially material and labour costs. The BER's Building Cost Index (BER BCI), on the other hand, measures movements in pre-contract non-residential prices, and as such it includes the profit margin of contractors. This index is one of the best indicators of the health of the building industry: if the BER BCI index accelerates faster than input costs, then it implies that contractors are able to stretch their profit margins, and vice versa.

Input costs, as reflected by the Haylett index, accelerated sharply in 2002. This was due to the lagged effect of the rand's depreciation on the prices of building materials and plant and equipment, of which a sizeable percentage is imported. According to Medium-Term Forecasting Associates (MFA), the Haylett is projected to decelerate to an average of 7% in 2003 (2002: 11,8%) compared to expected consumer inflation, as measured by the consumer price index (CPI), of 8,4%. The lower forecast for 2003 is a direct result of the rand's appreciation as well as comparative-base effects.

A further slowdown in the Haylett is expected in 2004 (5,3%), whereafter a more-or-less sideways movement in the growth rate is forecast to 2006. However, the last two years of our forecast are expected to be met by accelerated growth in input costs. On average, the Haylett is set to come in at 6,7% p.a. for the forecast period, compared to the CPI's 5,6%. This means that building costs are expected to grow faster than consumer inflation, which implies that the building industry is expected to perform better than the economy in general.

As for the BER BCI, 2002 also saw a further acceleration in tender prices, reflecting the higher input costs. Good news for the building industry, though, is that tender prices have been accelerating slightly faster than input costs since 2002, an indication that contractors are stretching their profit margins.

This encouraging situation — from the building industry's point of view — is forecast to continue for the rest of the forecast period, with tender-price growth expected to remain in excess of the growth in input costs. The main reason for the better forecast lies in the boost expected from the increase in Government's infrastructure investment. Although the private-property sector is still faced with a serious oversupply of space, this is only expected to last for another two years or so. This implies that this sector should start seeing an increase in building construction from 2006/2007, which explains the projected accelerated growth in both input costs and tendering prices from 2007 onwards. The BER BCI is set to average 10,3% p.a. from 2003-2008, compared with a CPI growth of 5,6%.

The accompanying table gives a detailed summary of our forecast of the movements in building costs, as well as the CPI, until 2008.

Building activity

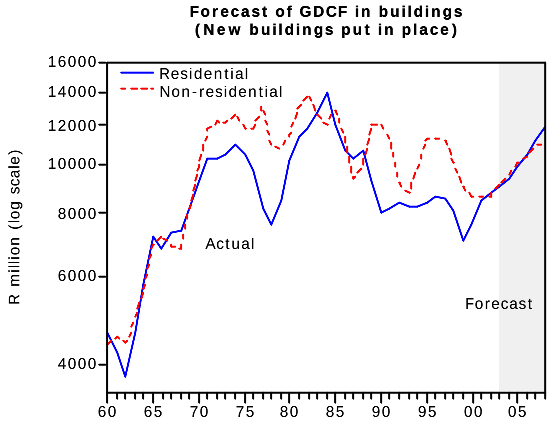
Our forecast for residential and non-residential gross domestic capital formation (GDCF) is quite bullish, with encouraging *real* growth expected for both sectors. A big boost for building activity is set to come from the lower forecast interest rates. Furthermore, the non-residential sector should benefit from Government's expected increase in infrastructure expenditure as well as a recovery in the private–property sector from 2006/2007.

The best performance over the forecast period is expected to come from the residential sector, which has already experienced real growth in building activity from 2000. According to Stats SA's data for residential buildings completed, the increase in building activity has come from all the different housing sectors, i.e. dwelling houses smaller and larger than 80m², flats and townhouses as well as other residential buildings, which include hotels, guesthouses, holiday chalets, old people's homes, entertainment centres and casinos. GDCF in the residential sector is set to average 5,2% p.a. over the forecast period, whilst 4,2% p.a. is projected for the non-residential sector.

Forecast of building costs (VAT excl.)
% growth per year

	2002	2003	2004	2005	2006	2007	2008	03-08
BER BCI	15,1	11,0	8,9	10,1	8,8	10,6	12,6	10,3
Haylett*	11,8	7,0	5,3	6,3	5,5	7,0	9,0	6,7
CPI**	9,3	8,4	4,6	5,1	5,3	5,0	5,0	5,6

** Forecast as per MFA*
*** CPI data for 2002 reflects the downward restatement of figures announced by Stats SA in June 2003. Forecast as per our panel of economists.*



Source: Rode's Time Series; BER; SARB

The accompanying table sets out the forecast for both residential and non-residential GDCF for the forecast period.

Forecast of GDCF in buildings % real growth		
	Residential	**Non-residential***
2002	3,9	0,6
2003	2,9	5,5
2004	3,7	4,0
2005	5,6	6,0
2006	5,9	3,0
2007	6,5	5,0
2008	6,4	1,4
03-08	5,2	4,2

* Forecast as per BER

In sum...

To sum up, our forecasts show a recovery in building construction activity in both the residential and non-residential sectors. The recovery will be led by residential building activity, which already has been in an upswing since 2000. In essence, this upbeat outlook implies more building work, which not only equates to upward pressure on building costs, but also more subdued tendering competition, which should allow contractors to widen their profit margins.

This concludes our section on building activity and building costs. ■