

Weathering the Storm: The Impact of the Global Economic Crisis on the Construction Sector

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Abstract

Since the end of 2008, countries in both the developed and developing world have begun to feel the effects of the current global 'credit crunch'. Whilst the epicentre of the financial crisis has been the U.S.A., the U.K. and the rest of Europe have also experienced a rapid decline in the level of confidence in the financial sector and the consequent slowdown in the economy with its devastating effects on the demand for construction activity. The fact that the housing market was at the root of the initial financial problem had a major impact on the construction industry and, because a major issue in the recovery packages is infrastructure stimulus spending, the construction sector is at the heart of both the initial economic decline and the recovery. By reference mainly to the U.K. (but also the wider international) experience, the basic causes of the economic crisis can be explained, the effects on the construction sector considered, and the alternative approaches to solving the problems can be examined.

Keywords

Financial crisis, Construction sector, Economic recession, Infrastructure stimulus spending

1. Introduction

The current crisis in the world's financial system has left the construction industry facing its toughest challenges for a generation. No country is immune from this and the U.K. and much of the rest of the world is in recession. Boom and bust cycles are a normal part of living in a world of inexact balances between supply and demand but the current recession appears wider-ranging and deeper than the 'usual' cyclical one. The United Nations (2009) predicts that world economic output will decline by almost half a per cent in 2009.

The U.K. construction industry, which is the second largest in the European Union, contributes about 8.2 per cent of GVA and employs almost two million people, is, consequently, facing its toughest challenges for decades and the impacts are likely to be felt over a prolonged period. The challenges facing the industry are several-fold:

In the short-term, companies must seek their own survival in an increasingly competitive market place, with an emphasis on cost savings and greater efficiency.

In the longer-term, the industry must not lose sight of its commitment to issues, such as sustainability and improved building standards and it must contribute to the recovery by maintaining skills and retraining workers and retaining standards of quality.

2. Root of the Financial Problem

Whilst the inevitability of an economic slowdown after the strong economic growth of recent years fuelled by cheap money from emerging economies, risky lending by financial institutions and outdated regulatory practices (initially in the U.S.A. and the rest of the developed world) was accepted, the suddenness and speed of development of the financial crisis caught most observers by surprise. There were, however, some commentators, who had the prescience to foresee the crisis. The following quotes are from Chancellor (2005):

Referring to a root cause of the boom: *‘An Englishman’s home is no longer just his castle – it is ... also a pension fund, a cash machine and the source of limitless credit creation’.*

Referring to the likely end of the boom period: *‘A restriction in the supply of credit might cause a crisis’.*

Referring to the difficulties of imposing policy measures to solve the resulting financial crisis: *‘Once a bubble starts to deflate, it cannot be revived by monetary policy ... When it faces the next crisis, the central bank may find that it has run out of bullets’.*

The reality of the last reference is pertinent to the situation facing many governments, who, having reduced interest rates to virtually zero per cent, are now resorting to quantitative easing as a previously considered drastic step in their anti-recession armoury.

2.1 The Effects on the Economy

As can be seen from Figure 1, a sustained period of economic growth in the U.K. economy came to an end in the third quarter of 2008 and, at the end of the year, the economy ‘officially’ entered recession following two quarters of negative growth. The Figure also illustrates the lagged relationship between growth and unemployment, with a forecast potential rise in unemployment rates in 2009 beyond even the 1992 peak of 10%.

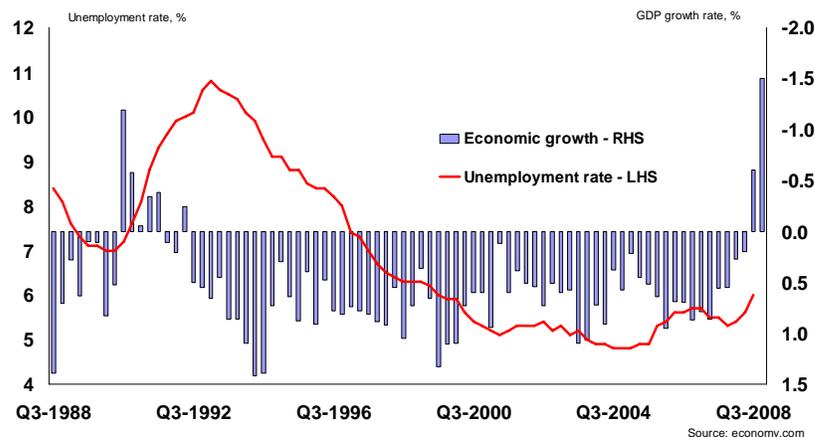


Figure 1: Economic Growth and Unemployment in the U.K. (1988 -2008)

The other major consequences of the downturn are:

- An increasing budget deficit as tax revenues decline.
- A fragile consumer sector with reduced credit availability and fears over job loss.
- Interest rates at a historic low point.
- Sterling has weakened significantly against other major currencies.
- A reduced appetite for risk within both the financial sector and the wider economy.

3. Recovery Policies

There are a number of theories to explain the nature of the boom-bust cycle. For instance, there is orthodox classical economics - monetarist, Austrian Economics and neoclassical economic theory. Then there are structural theories (most importantly Keynesian but also including those of institutional economics) that point to under-consumption, malfeasance by bankers and industrialists or incompetence by government. In practice, the two major platforms of government regulatory policy have been, and continue to be, monetary and fiscal policy.

The use of monetary policy in attempting to promote demand in the economy has meant that the Bank of England has reduced (in February 2009) interest rates almost to 0% (0.5%) and quantitative easing (QE) was introduced in the following month. As the name implies, QE aims to increase the amount of money in the economy through the creation of central bank money to buy up assets such as government gilts and commercial paper - which is like a corporate bond, or an IOU used by companies to raise funds. Since the onset of the credit crunch, banks worried about the strength of their finances have tightened up lending dramatically. So, the Bank of England has decided to spend £150 bn of newly created central bank money on corporate and government bonds to be used in two stages. The initial £75 bn represents 5.4 % of GDP. Nevertheless, it is the Keynesian-type policy of fiscal stimulation, based on the undertaking of government projects in an attempt to manage demand through public investment, which is now at the forefront of government recovery policy.

The pre-budget report (for 2009-10) switched spending priorities to areas that make a difference such as housing, energy and small businesses. Fiscal policy also incorporated a minor reduction in VAT (by 2.5%) but the main fiscal stimulus policy is based on public investment.

Proposed projects will be paid for by raising government borrowing and this raises the risk that, at 6% of GDP, the budget deficit comes close to the level when the UK had to be bailed out by the IMF in 1976. There is also the danger that a dramatic Keynesian-style spending spree could drastically worsen the Sterling exchange rate, pushing inflation higher.

3.1 Stimulus Investment Projects

The areas of education and housing figure prominently in the proposed stimulus package announced by the U.K. government, with medium-term plans for expenditure on schools, in particular, being brought forward in the budget plans. Other projects relating to energy and transport and the infrastructure for the 2012 Olympic Games in London will also provide stimulus investment.

The possibilities for stimulus investment are several and the chief characteristics of feasible projects are indicated below:

- Upgrading and refurbishing the entire secondary school building stock. *Cost: £45 bn*
Jobs created: The 'Building Schools for the Future' (BSF) programme could create 300 000 jobs: 10 000 construction jobs a year for 15 years and 10 000 indirectly supplying materials.

Chances of the project happening: Started in 2005 and expected to continue until 2020. So far, 20 BSF deals worth more than £2.5 bn have been signed by public authorities with the private sector. The Government promised that the project would not be halted by the credit crisis.

- The London Olympics. *Cost:* £9.3 bn

Jobs created: 15 000 in creating the Olympic park and village.

At the time of the Games, more than another 100 000 jobs.

Chances of the project happening: No chance of abandonment but the credit crunch is hitting the Olympics. Venues are being reviewed, scaled back and even abandoned.

- Crossrail: Plans approved for a railway link through the centre of London. *Cost:* £16 bn

Jobs created: 30 000

Chances of the project happening: Work expected to start in 2010. London businesses pledged last year to contribute £150 mn through a special levy but now may be less feasible.

- Severn Tidal Barrage: Building a 10 mile barrage across the Severn estuary to generate electricity would be one of the world's biggest construction projects. *Cost:* £10 – 23 bn.

Jobs created: 35 000 jobs

Chances of the project happening: Feasibility study to be concluded by 2010. There are strong environmental concerns but the ability to generate 5 % of the UK's electricity from a reliable renewable resource makes it worth consideration

3.1.1 Stimulus packages: A universal solution

The form of fiscal stimulus is similar in many other countries. U.S. President Obama has promised a stimulus package of between \$675bn (£460bn) and \$775bn (£519bn) over two years, largely geared to construction spending. In Spain, Prime Minister Zapatero has launched a €10bn (£9bn) public works and infrastructure programme. German Chancellor Merkel has unveiled two stimulus packages worth almost €60bn over two years, with about €18bn earmarked for infrastructure projects. The German government also announced tax incentives for home repairs, largely focused on greening homes, and overall reductions in business taxation. French President Sarkozy has promised a €26bn (£23.5bn) stimulus centred on infrastructure and public works projects.

At the European level, aspects of the European Commission's proposed *Recovery Plan* (European Commission, 2008) have considerable implications for the construction sector, through the following proposals:

- Improving energy efficiency in buildings, with building owners encouraged financially to make the necessary investment in enhanced energy efficiency measures.
- Financing infrastructure (particularly the TEN-T) with an estimated need of €500 billion until 2020.
- Research & Development, Innovation, Education. Important to ensure that not only basic research is facilitated, but also the project and application related research which is more common in the construction industry.

4. The Major Issues Affecting the Industry in the Recessionary Period

4.1 Macroeconomic Issues

At the macroeconomic level, there are negative aspects of the depressed economic climate, which pose several problems for the construction industry:

- The global nature of the recession. Tight credit, consumer retrenchment and falling business investment are combining to deliver a synchronised global slowdown. The recession in many developed countries will be one of the deepest and longest in the post-war period and growth in emerging markets is decelerating sharply.

- Disinflation. 2008 started with fears over runaway inflation and ended with concerns about deflation and this could result in a cycle of sinking demand, declining profit and credit and rising unemployment, leading to continuing downward pressure on prices.

- De-leveraging. Leveraging has powered growth in recent years. Banks and consumers are now cutting debt to repair balance sheets. De-leveraging has begun and will continue as long as the credit crisis persists.

- Global markets hit heavily. The lack of credit has hit global construction markets hard, with the U.S. and Western Europe worst affected. The announced increased investment on infrastructure is unlikely to offset the decline in private demand. Asia is also expected to see a slowdown.

In counterbalance, however, as well as the growth in demand for infrastructure work from the large-scale fiscal stimuli, there may be positives to be gained for the construction sector from the changing economic climate:

- Global balance shifts. Global economic balances are beginning to change. The decrease in materials and commodity prices signals a shift in the terms of trade, benefiting importing countries and balancing growth in favour of developed economies. In the U.K., weak Sterling should help export competitiveness.

- Commodity prices to remain low. The commodity price boom has ended, with prices collapsing during the second half of 2008, owing to a drop in demand. Oil prices could fall below the \$30 mark in 2009. This will result in a drop in energy prices and falling investment, so the seeds for the next boom are already being set.

4.2 Microeconomic Issues

At the microeconomic level, the impact of tightened credit conditions and downgrading with regards to credit insurance has a devastating impact. As also, must an increasing trend of late payment by clients and a risk of 'cascading bankruptcies' throughout the supply chain.

The move towards negotiated arrangements in defining cost and price may be reversed as buyers try to take advantage of more competitive conditions. Latham and Egan recommendations on partnering and cooperation were supposed to have been got rid of the adversarial nature of the construction process but that was a doctrine of more benign times. Some contractors are returning to the days of 'buying work' or working at a loss just to boost cash flow.

In the world of consultancy, many partners face not only a freeze on profit-taking but also a need for further equity injections, which is the equivalent of self-funding in lieu of available cash injections from banks.

The impact on purchaser-supplier relations produces a change in behaviour, with a reduction in risk taking and a desire to exert greater control. The supply chain is being squeezed, with a renegotiation of contract terms. There is a shift and rationalisation in procurement approaches and terms, such as value for money and lowest bid, take on a different complexion. Firms are experiencing difficulties in retaining clients and disputes will grow in number.

Companies must inevitably review strategy and risk management, simplify processes and identify and tap latent and changing demand. There is pressure to provide services that not only add value but do so at less cost.

4.3 The Industry's Needs

The European contractors' organization (FIEC) has identified a set of needs for the industry, in order that assistance is provided to assist contractors in these conditions. They view (FIEC, 2009) the policy needs from national governments and the European Commission to be:

- Maintain and possibly extend the application of reduced VAT to the whole house building sector;
- Complete projects which are already in the pipeline;
- Invest in infrastructure by facilitating the participation of private capital;
- Prioritise infrastructure projects (give the priority to those already funded and ready to start);
- Promote private investments in renovation and retrofitting of buildings (through specific incentives);
- Accelerate public procurement procedures, in particular the time necessary for obtaining decisions, permits, certificates etc. from public authorities, in order to speed up the commencement of large-scale public projects: This is already proposed in the E.U. and in some national recovery plans for 2009 and 2010, and provided for by the public procurement directives, although the principle that the deadlines have to be such as to allow the submission of good quality tenders must not be jeopardised under the pretext of urgency;
- Facilitate access to financing (in particular for SMEs);
- Ensure swift payment of public contracts;
- Ensure that the banks actually use the state guarantees and funds they receive for lending to enterprises and citizens.

Some of these measures are already in the process of being addressed in the some member states' national stimulus programmes.

4.4 Skills and Training Issues

In all parts of the industry, the massive reductions in workload have inevitably produced concerns about the maintenance of sector skills to meet demand, once the upturn arrives. SummitSkills (2009) has identified four key areas to work on with the building services sector with the aim of reducing the impact of the recession on the sector:

- Redeployment and maintenance of the training of redundant apprentices - transferring or sharing apprentices between employers to allow them to complete their training, preparing them for an upturn in work following the recession.
- Supporting employers to develop the skills of existing workers in new market areas – helping employers exploit emerging markets which are likely to grow (such as microgeneration, sustainable buildings and meeting zero carbon aspirations) as we come out of recession, by encouraging course provision and funding availability.
- Supporting the education and training delivery infrastructure – exploring ways to maintain course provision for new entrants and extending training provision to develop existing workers' skills.
- Maintaining the stream of new entrants in preparation for the sector coming out of recession – looking at ways to manage the training of new entrants who are not in employment, to prepare for an upturn in employers' labour requirements.

5. Conclusion

Economic forecasting will remain, for the foreseeable future, an almost impossible activity. The length and depth of the recession must be open to considerable speculation. Nevertheless, the Bank of England (2009) forecasts a recovery in the economy towards the end of 2009. As indicated in Figure 2, the relationship between the construction sector and the economy is such that, in times of decline, the construction sector feels the effects before most parts of the economy but in periods of growth, the industry should be a lead sector in terms of recovery.

Even in Europe, construction markets are far from homogeneous and the specific exposure of a country's economy to the financial and economic crisis, will inevitably determine the extent to which recovery measures will succeed and operate in the construction sector.

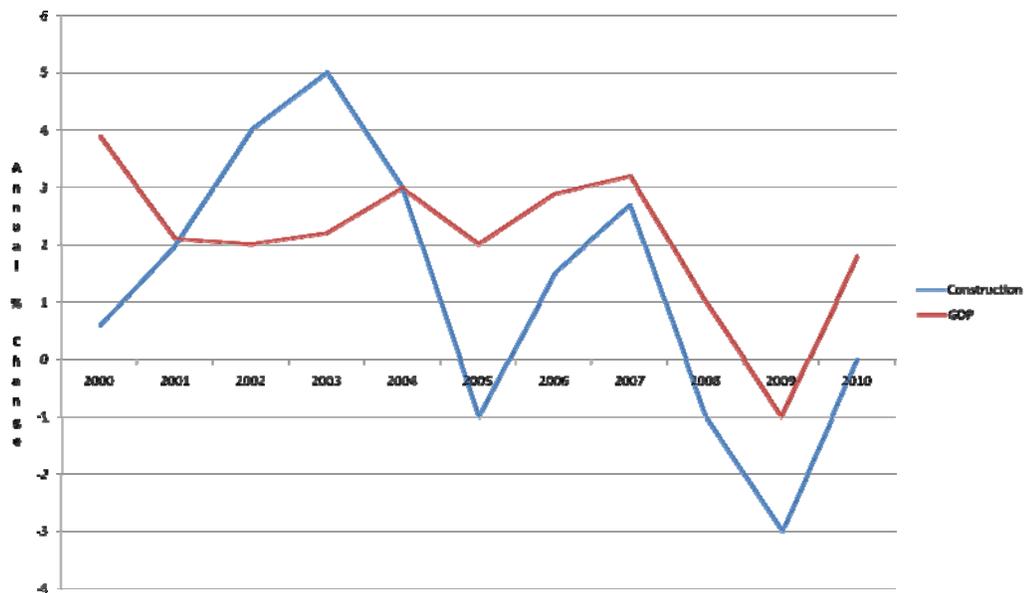


Figure 2: Trends in GDP and Construction Activity in the U.K.

Certain countries in Europe (particularly the U.K., Ireland and Spain) are still experiencing major corrections in the housing market and so, with a weak demand for new build in the residential sector, there is reliance on renovation work, which could lead to a boost in activity if stimulus measures in favour of energy efficiency are fully implemented.

In the private non-residential sector, activity is mainly influenced by the business climate. Here, the success of governmental measures to ensure that confidence and liquidity is restored to the financial sector, will determine the level of investment.

In the civil engineering sector, recovery plans will provide a stimulus to public works. The degree to which the effects of the boost are temporary in nature, however, will be tempered by the ability of authorities below central government to maintain their spending levels in the face of reduced fiscal revenues.

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