Growth, What Growth?

BY JOHN CROSS, P.E., LEED AP

A number of interrelated factors have kept GDP growth low, stifling any resurgence in design and construction.

2011 WAS TO BE THE YEAR that the construction market began the march to recovery from the depressed levels of the "Great Recession." Instead, construction activity remains at historically low levels and a march to recovery is more of a slow crawl than a triumphant march.

What happened?

Let's look at the facts.

- ➤ Construction start activity in the private non-residential building sector is up 10% compared to 2010 particularly with respect to manufacturing and warehousing facilities.
- ➤ At the same time, publicly funded non-residential building starts are down 13%.
- ➤ Multi-story residential structures, primarily apartments, are up 60% albeit from a very, very low level. The demand for apartments is being fueled by foreclosed home owners and a reticence of new home buyers to enter the marketplace.
- ➤ Overall this translates to a growth rate of building construction of 5%.
- ➤ Non-building industrial activity remains strong and is up in the range of 15% to 20%.

In a normal construction economy growth rates of this magnitude would be seen as being good news, but at the current level of depressed construction activity a 5% increase is hardly noticeable. The volume of construction activity required to generate a 5% increase in 2011 would have only accounted for a 1.5% increase in 2007!

The hope of 2011 was based on the premise that growth in construction activity following a recession begins when the gross domestic product (GDP) recovers to a level equal to the level at the beginning of the recession. At the end of the 4th quarter of 2010 GDP stood at $13.4 trillion, the same level as it had reached at the beginning of the recession in the 4th quarter of 2007. What does this have to do with construction activity? The stock of buildings in the U.S. at the end of 2007 was adequate to support the level of economic activity present in the marketplace. As economic activity decreased the only demand for new construction came from replacement buildings, not from a need to actually expand building inventory. During most recessions this over-supply of buildings lasts for less than a year before the economy not only turns around but actually expands to historically high levels of activity. In the case of the Great Recession it has taken 12 quarters for the economic output as measured by GDP to reach the prior high watermark.

But just as GDP recovered its previous high, economic growth weakened. GDP growth rates during the recovery period beginning in mid-2009 hovered near 3%. But as 2011 began, the GDP growth rate plunged to 0.4% in the first quarter and only recovered to a tepid 1.3% in the second quarter. Historically growth rates less than 3% do little to inspire investor confidence and encourage expansion in building inventory. The result is that construction activity remains stalled.

Why has the recovery stalled out? There is not one single reason why the economy stalled out at the point of recovery, but rather several interconnected reasons for the lack of substantive growth.

First, the impact of the federal stimulus program ended just as the economy got back to break even. The stimulus program was estimated to have added 1% to 2% to GDP growth during 2009 and 2010. Independent of one's opinion of the merit of federal programs, the reality of that short-term push to the economy can be clearly seen in the corresponding decrease in growth when the stimulus program ran its course.

Second, the front end cost of federal programs is at least partially offset by a subsequent reduction in federal spending on discretionary programs in an attempt to minimize federal deficits. It is often the discretionary programs such as federal building construction and transportation funding that can have the greatest positive impact on GDP further eroding GDP gains.

Third, the housing market typically experiences a pent up demand during a recessionary period as new home buyers defer home purchases. However, in the previous economic cycle new home buyers were drawn into an out of control home construction market with the promises of easy money and low interest rates. The result has been a lack of growth in demand for new homes, a loss of home values, a glut of foreclosed or short sale homes on the market and tightened lending standards. All of which point to a continuing

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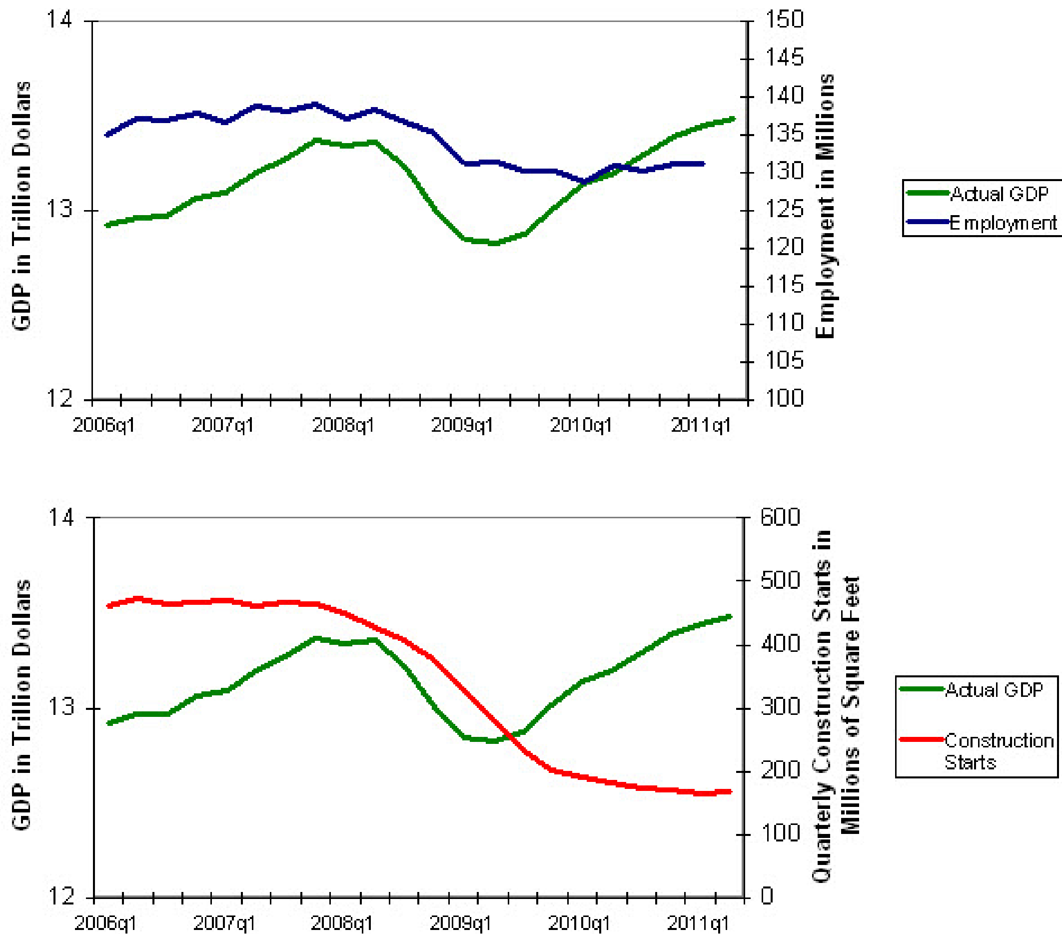

Growth in the U.S. gross domestic product stalled just as the GDP reached its previous high, and just as it should have started boosting the demand for new construction.

depression in the housing market and the corresponding lack of a push from housing to the overall economy.

Fourth, GDP gains at the front end of a recovery period are often fueled by productivity gains rather than employment expansion. This was particularly true in this recessionary cycle in that GDP recovery to the previous high watermark was accomplished with 8 million fewer jobs. Increasing productivity is good as it makes goods and services more affordable and increases the opportunity for exports. However, there comes a point where productivity gains become more difficult to achieve and in order to grow the economy requires an expansion in the labor force. It seems likely that the economy has now reached that point, but businesses are hesitant to hire additional workers stalling GDP growth.

Fifth, the hesitation on the part of the business community to expand the workforce is probably less related to actual economic conditions than it is the perception of the economic climate. Uncertainty clouds the business horizon in terms of energy costs, government deficits, tax rates, state and federal defaults and bond ratings, consumer confidence and equitable global competition. Unlike individuals, businesses react to the anticipation of these challenges, not to the actual events themselves. The result is a conservative and cautionary attitude toward business expansion.

All of these factors have combined to minimize GDP growth. Historically, significant growth in the building construction market occurs when annualized GDP growth exceeds 3%. It is unlikely that the domestic economy will achieve that growth level during the remainder of 2011. Therefore, expansion in construction starts will remain at or near the current 5% level for the remainder of the year. Certainly, this is not good news for the design and construction community.

So what about 2012? Will 2012 bring the recovery hoped for in 2011? It's hard to say.

In past recessions home building has led the way for construction out of the recession with non-residential construction lagging. Home construction is not positioned to lead in 2012. If a construction recovery is to occur in 2012 it will be led by an expansion in the manufacturing sector generating additional employment and demand for expanded facilities. Can private non-residential construction in general and manufacturing construction in specific lead the construction industry out of this quagmire? Only if today's uncertainty surrounding business issues begins to dissipate and confidence increases. It is too early to make a prediction, but 2012 is going to be a most interesting year. MSC