Global Construction Research Briefing | Global

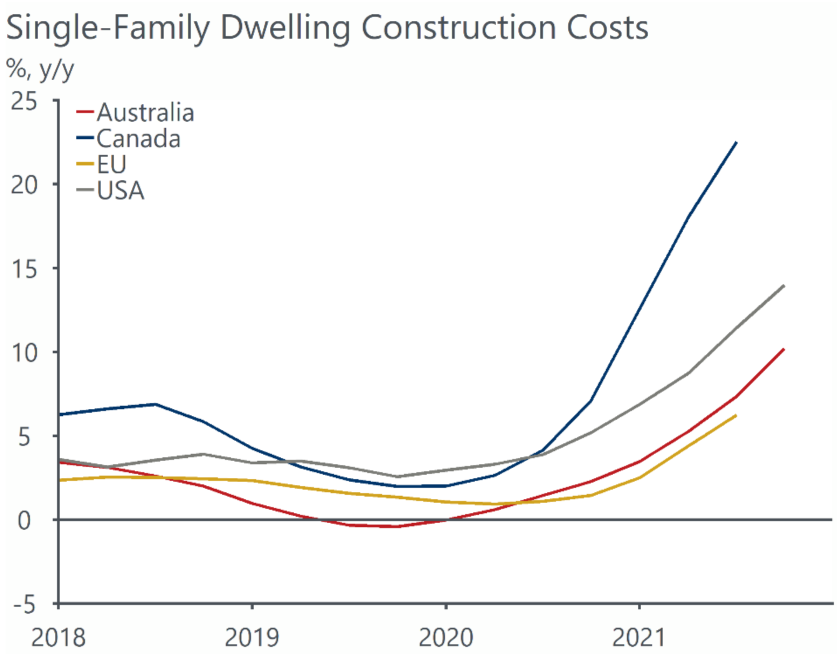
Construction costs to remain high in 2023

- **The global rebound in construction activity is set to continue over the coming years, supported by a wave of publicly funded infrastructure projects. This investment is coming at a time when global supply chain disruptions are hampering the delivery of construction materials, and tight labour markets are limiting the supply of labour. The resulting supply-demand mismatch has driven up construction costs, increasing the risks of cost-blowouts as well as project delays and cancellations.**
- **Lockdowns in China and the Russia-Ukraine conflict have intensified global supply chain disruptions which means that input costs are likely to remain elevated for some time. While we write about national averages in our various construction service, there are sub-national and sub-sector variations. Please contact us if you would like more granular information.**

Construction costs jumped in 2021

A boom in residential construction activity across advanced economies saw the real value of global construction work done rebound 2.3% in 2021. Residential investment boomed, particularly in the Americas, as low interest rates, strong household finances, and shifts in household spending boosted the appeal of single-family dwellings. The ramp up in demand, however, coincided with Covid-induced supply chain disruptions and mobility restrictions. This mismatch between supply and demand drove a jump in construction costs across the globe, particularly for single-family homes.

Chart 1: Housing construction costs jumped over 2021



Source: Oxford Economics / Haver Analytics

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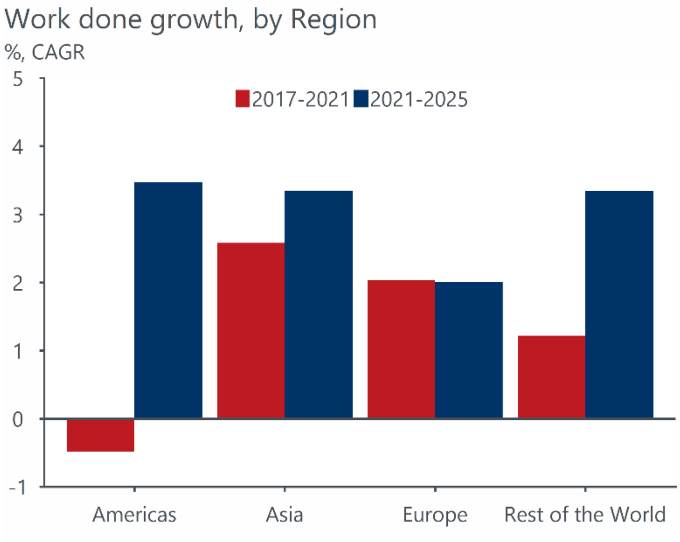
Construction demand remains strong

The upswing in global construction activity is set to continue over the coming years. Governments around the world responded to the coronavirus pandemic by fast-tracking major infrastructure projects, as investments in the economy's productive potential has proven to be a key driver of economic recoveries in the past. The Infrastructure Investment and Jobs Act in the US provides US$500bn in new spending over the next decade, with significant funding going to new highways, railways, and bridge projects. The European Union's Next Generation EU fund will support a 'renovation wave' as the EU works towards decarbonising the continent's building stock. In Asia, China is set to undergo an infrastructure boom, as the authorities look to infrastructure investment to not only help offset the real estate downturn, but also to help the economic recovery following the Shanghai lockdown.

Chart 2: Strong outlook for construction activity



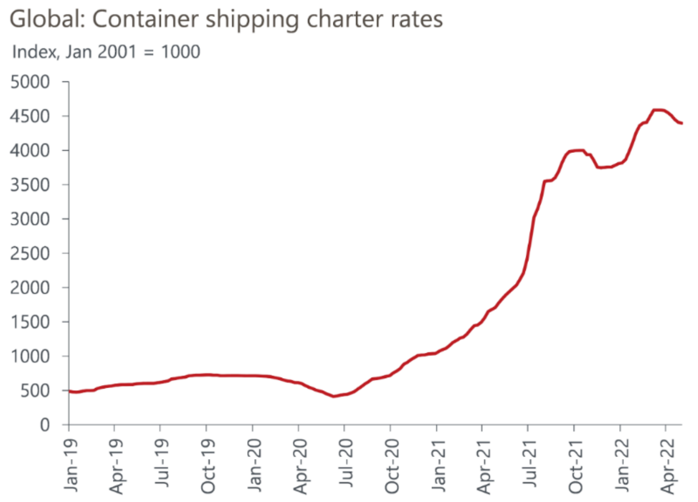
Source: Oxford Economics / Haver Analytic

Supply chain disruptions have intensified in 2022

Global supply chains have remained stretched since the middle of 2020 and, with strong consumer and industrial demand for goods, has driven a jump in global container shipping charter rates. The construction sector is much more exposed to transportation costs than other parts of the economy due to the relatively low value-to-weight ratio of construction materials. Many countries also rely on global supply chains for vital construction equipment and parts. Delays in the delivery of materials and equipment can have a cascading effect across projects, pushing out delivery timelines.

Supply chain disruptions have further intensified over 2022 following lockdowns in Shanghai and other regions in China as well as the Russia-Ukraine conflict. While the situation in Shanghai is improving, the war in Ukraine looks set to continue for some time. We think the sanctions on Russia will continue even if the conflict were to end, and so we expect global supply chain disruptions to persist into 2023.

Chart 3: Transportation costs have soared post Covid

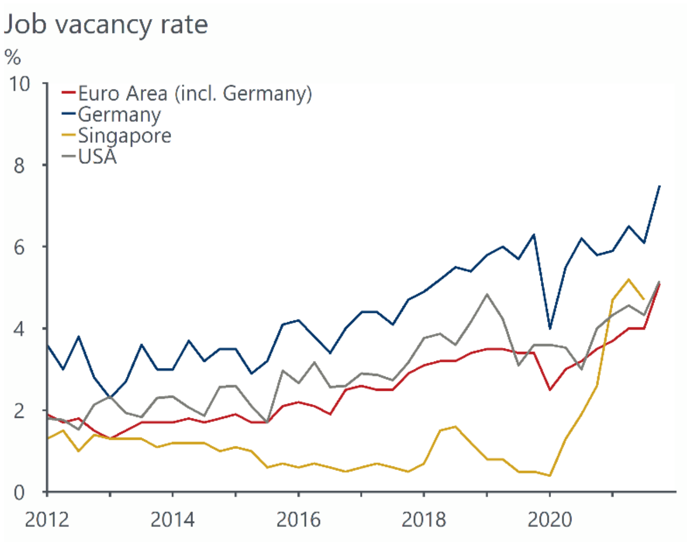


Source: Oxford Economics / Haver Analytics / Harper Petersen & Co

Construction labour markets remain tight

The construction sector is also grappling with labour shortages as Covid-induced restrictions limit the movement of workers across international borders. Countries that rely on migrant workers such as Singapore, Malaysia and the United Arab Emirates have been hit particularly hard. We expect these shortages to ease as Covid restrictions unwind. Germany and the Benelux countries, however, face shortages that threaten to be much more structural, as employment and vacancies in construction have already passed their previous peaks. Unless there is an increase in migration to help fill these jobs, or a sustained burst in productivity, there is a risk that companies will have to pay more to attract workers, or delay work on the existing pipeline of projects.

Chart 4: Construction labour market tightness has increased

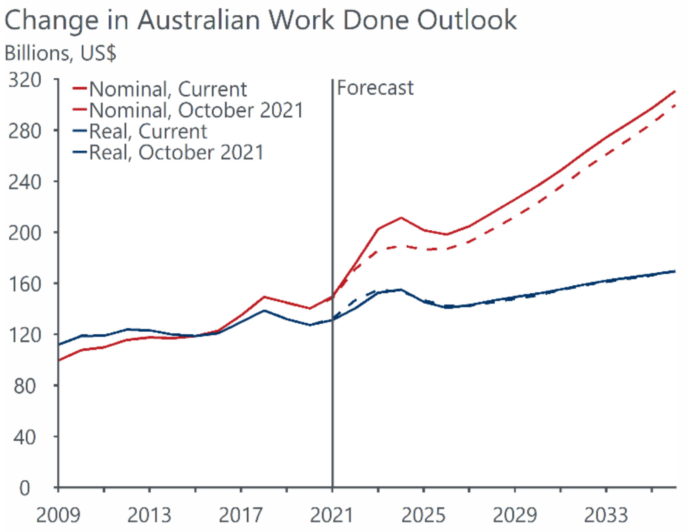


Source: Oxford Economics / Haver Analytics

Construction costs will remain high into 2023

Government stimulus will ensure demand for construction activity will remain strong over the coming years, while supply side disruptions are set to hamper industry capacity. The mismatch between supply and demand point to construction costs remaining high into 2023. As a result, the divergence between nominal construction spending and the actual volume of construction activity is expected to widen further over the coming years. This impact isn't just limited to new construction work. Renovation work and the maintenance of existing physical assets are also affected as they utilise similar material inputs and skillsets.

Chart 5: Divergence between nominal construction spend and the volume of activity set to widen



Source: Oxford Economics / Haver Analytics / Australian Bureau of Statistics

Periods of high input cost inflation typically lead to project cost overruns, project delays, and project cancellations. We are already seeing a growing lag between building approvals, commencements, and completions in a number of geographies, and also an increasing drop out rate as a growing number of approved projects are delayed or abandoned.

Historically, periods of high price growth are usually followed by a period of relatively flat price growth, as the gradual correction comes through in real terms. Ultimately, higher prices encourage a supply response, as higher wages attract more workers to the construction sector and stronger material prices encourage suppliers to bring more capacity online. The strong global demand for construction activity over the coming years ensures that the supply side response to high prices is unlikely to create a 'whipsaw' effect, whereby we see a sharp fall in construction costs.

A prolonged period of construction cost inflation threatens to overshadow the upswing in activity and reduce the efficacy of government stimulus. From a social perspective, higher costs erode the cost-benefit equation for the delivery of new infrastructure; while from the construction company's perspective, high input cost inflation risks creating a profitless boom. We have seen a growing number of construction company insolvencies in the face of rising costs - particularly for firms which are locked into prices that were fixed up to a year ago - and there are likely to be more to come. The challenge for the construction industry is limiting potential contagion effects of these failures, as unpaid suppliers and subcontractors themselves face further hardship.