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Nonresidential Construction Recession Expected to Continue Into 2003

AIA Consensus Forecast Panel feels that modest gains on institutional side not enough to offset continued weakness in commercial/industrial sectors



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Nonresidential construction activity will likely see its steepest annual decline in a decade when the final 2002 numbers are calculated. This comes on top of a drop of almost the same magnitude in 2001 and a small dip in 2000. All told, nonresidential construction slumped almost 20 percent from the end of 1999 through the end of 2002, according to construction contract figures from McGraw-Hill Construction.

While a very substantial decline, it has not yet matched the early 1990s construction recession that saw almost a 25 percent fall in nonresidential construction contracts. Also, the nonresidential downturn in the early 1990s was more than matched by a residential construction recession, which saw housing starts decline more than 40 percent from their late-1980s high to their early 1990s low. In contrast, residential construction in 2002 should prove to have been the best year in over a decade, so firms that are involved in residential design can cushion some of the weakness from their nonresidential business.

Even in the nonresidential markets, not all sectors have been weak. To the contrary, the AIA Consensus Forecast Panel expects a 4 percent to 5 percent increase in institutional construction in 2002, on top of a small gain in 2001.

That means that the nonresidential construction weakness has been concentrated in the commercial/industrial sector. However, the downturn in commercial buildings is expected to approach 20 percent in 2002, led by a 28 percent downturn in office construction and a 27 percent decline in hotel construction. The commercial sector downturn, however, pales in comparison to the weakness in the manufacturing sector. Manufacturing construction declined by 40 percent in 2002 according to estimates from the AIA forecast panel, and has dropped each year since 1997. Current construction levels for manufacturing buildings are only about a third of their 1997 levels.

Economy slow to recover

Comparisons of this downturn to the early 1990s recession also apply to the recovery from that recession and the current period in the economy. The early 1990s recovery unfolded very slowly. Even though the recession officially ended in early 1991, employment growth returned only gradually, and it took

the nonresidential construction sector until 1993 to see any improvement.

Likewise, even though the recent recession probably ended in late 2001 or early 2002, there have been only modest signs of improvement. Payrolls have not grown since early 2002, and the national unemployment rate has increased over that period. Even though the economy as measured by gross domestic product has been growing since the end of the third quarter of 2001, growth has been erratic.

Growth in the economy has been sufficiently slow and uneven that businesses are nervous about the economic outlook. A quarterly survey of business executive confidence conducted by the Conference Board indicates that business confidence levels jumped in the first quarter of 2002, but have been slowly declining since. With this nervousness about the economic outlook, businesses have been hesitant to make major investments. Business investment levels have declined every quarter since the fourth quarter of 2000. However, business investment in equipment and software reversed and began to grow in the second quarter of 2002, so the prospects for a turnaround in investment in structures are brighter than they were six months ago.

Commercial/industrial outlook still negative

The commercial/industrial construction sector historically is the most volatile nonresidential sector. Our forecast panel estimates a 19 percent decline in commercial construction in 2002. All but one of the panelists predicts this sector to fall even further in 2003, although by a much more modest 4 percent.

The weakest piece of the commercial sector is office construction. Declining payrolls over the past two years, coupled with businesses freeing up space that they had leased for anticipated future growth, have significantly reduced demand for office space. The third quarter of 2002 was the seventh consecutive quarter of negative absorption of office space nationally, according to figures from Colliers International. Nationally, the vacancy rate for office space stood at 15.2 percent (14.1 percent for downtown locations and 17.2 percent for suburban facilities) at the end of the third quarter of 2002. This figure is up 0.5 percent from the second quarter and 3.7 percent from a year ago.

The net decline of rented space in downtown locations totaled 11.4 million square feet during the first three quarters of 2002, according to Colliers International, led by a 3.2 million-

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square-foot loss in downtown New York City and a 2.5 million-square-foot loss in Chicago. Partially offsetting these losses were gains of 1.7 million square feet in Washington, D.C., and 1.2 million square feet in Milwaukee.

Suburban office buildings lost a net 20.5 million square feet nationally over this period, with Dallas, Chicago, Detroit, and San Diego showing the biggest losses, and Las Vegas, Westchester County, and the Maryland suburbs of Washington, D.C., showing the biggest gains.

Retail construction has not been as weak as the office market, but the consensus is that a recovery is still a few quarters away. Six of the forecast panelists are predicting another decline in 2003 for the retail sector, with the consensus forecast for a 2.5 percent drop in construction activity.

A recent national survey of retail executives sponsored by the National Retail Federation and the Bank of Tokyo-Mitsubishi showed that 42 percent of respondents felt that retail conditions would be weaker over the next six months, and 53 percent felt that they would be stable. Over half of these executives felt that Christmas sales would be weaker in 2002 than a year ago, and 37 percent felt that they would be about the same.

The hotel market continues to be weak due to reduced travel. After a steep decline in construction in 2002, most panelists are predicting an additional small reduction in 2003. Reduced exports of manufactured goods are a principal reason for the decline in industrial construction activity in 2002, and most of our panelists are predicting another reasonably significant decline in 2003.

Growth expected to continue for institutional construction

Although the commercial/industrial recovery is still quarters away, institutional construction continues to show stability and modest growth. Our forecast panel expects this sector to increase by more than 4 percent in 2002 and under 1 percent in 2003. All panelists expect the change in institutional activity to be modest in 2003.

Health care was the strongest category in 2002, and the consensus is for another gain in 2003. While private health-care providers are reinvesting after years of consolidation, public spending is expected to ease due to pressure on municipal budgets.

Education construction continued its strong growth string in 2002 and is expected to see another small increase in 2003. Demographic trends point to more need for space at high

schools and colleges, but budget problems in state and local governments will reduce the willingness to build and rehabilitate these facilities. However, low interest rates continue to make bond programs attractive.

Public buildings—corrections, courthouses, and post-office facilities—are one of the few weak parts of the institutional sector. Much of this is due to the decline in post-office construction resulting from financial problems at the U.S. Postal Service. Declines are expected to continue in 2003, but at a much slower pace.

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