

HOW DOES THE ECONOMY INFLUENCE  
THE BUILDING INDUSTRY REGARDING  
RESIDENTIAL PROPERTY  
DEVELOPMENTS?

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**HOW DOES THE ECONOMY INFLUENCE THE BUILDING  
INDUSTRY REGARDING RESIDENTIAL PROPERTY  
DEVELOPMENTS IN SOUTH AFRICA?**

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## **Declaration by student**

I, the undersigned, hereby confirm that the attached treatise is my own work and that any sources are adequately acknowledged in the text and listed in the bibliography

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Signature of acceptance and confirmation by student

## **Abstract**

**Title of treatise:** How does the economy influence the building industry regarding residential property developments?

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Everybody in the country are struggling to keep head above water and trying to save their businesses from liquidity. Taking an interest and understanding of how the economy is influencing the world and especially South Africa at the moment can be very important for any type of business.

The objective of the treatise is to give an understanding of how certain factors of the economy influence the residential property market and solving the problems occurring.

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# **CHAPTER 1**

## **INTRODUCTION**

### **1. BACKGROUND**

During the year 2008 there was a lot of talk about the economic crisis hitting the world. World markets dropped to their lowest point in years, small and new businesses could not survive and closed down, large companies started to feel pressure and some even had to let go and are still busy to let go of their employees. Not even to say the closing down of businesses all over the world.

Some Economists believe that the South African economy's pain is just at the beginning stages of its fall down, but then there are optimists that believe South African markets will escape the worst even if there are some businesses closing down.

Since the last economic crises in South Africa in 1998, the property market has risen to great heights with several ups and down lasting for a month or two. Since 2007 there has been a drop in the real estate index and because of the economic problems occurring in the



United States of America and the rest of the world, the real estate market could not recover itself and is still heading for a downward fall.

People say that it is a financial crisis and not a property crisis, but the financial effects will have an influence on the property market and home buyers or investors.

South Africa becomes more unsafe each day and people are looking more and more for security for their families at home. The development of such a security estate can be done with 2 reasons in the mind of the developer.

- A) Developer can develop such an estate and sell the different units to property investors.
- B) Develops the security estate to keep the units for himself. This option will be great if money is no problem for the developer himself.

This tend to be a major problem with the economy taking such a dip, because home buyers can't buy or even sell their properties or doesn't want to take the chance of investing in a property which will cost them more at the end of the day. This makes it difficult for developers to take on such development in the economic crises.

As a development usually runs over a few years( from nothing to where buyers can move in), how can a developer foresee to not get

himself into a situation where he will run out of finance or not be able to get the individual units sold to make his profit?

A major part of taking on such a project is to do feasibility studies. This will give the developer assurance to which market to cater for etc. But foreseeing the economic crises will rather be unpredictable if development markets can not be seen in the form of the macro economy.

Macro economy factor will influence the property development of the building industry, in a good or bad way. In the research to be done these factors will be explained in terms of the property development in the building industry.

How do these factors all fit into one another? How it works? How it influences the developments? How can we know that especially the building industry is taking a major knock because of the economy?

Some believe that money can still be made in South Africa, despite the fact of the talk of staring an economic crises in the eyes, in fact they say that it is during these times that properties shows it's best qualities.

The markets have fallen but in the end the private buyers are the one's buying property now and not companies who invests in the development sector of the building industry.

## **2. STATING OF THE MAIN PROBLEM**

How does the Economy influence the building industry regarding residential property developments?

## **3. STATING OF THE SUB PROBLEMS**

**3.1** How do the Interest rates influence the residential development sector in the building industry?

**3.2** What effect does the exchange rate have for foreigners wanting to invest in a residential development?

**3.3** How does the new credit act affect residential home buyers?

**3.4** What is inflation and what role does it play in property developments?

## **4. THE HYPOTHESIS**

#### **4.1 How do the Interest rates influence the development sector in the building industry?**

With high interest rates the property market in South Africa is very slow and people are struggling to pay all their expenses. Some even sold their homes to survive because they just do not have the money to buy new homes. This causes a chain reaction on developments and developers trying to provide the people with their needs, and makes them hold back all development and projects until the interest rates drop and people can start buying again.

#### **4.2 What effect does the exchange rate have on foreigners wanting to invest in a security development?**

The higher the exchange rate the more foreigners can or want to invest in South Africa. With the Economic crises hitting the whole world, foreigners are holding investment in their own pockets because of all the risks involved. They will not invest as long as the economy fluctuates that much. Although there are some investors that will take the chance in investing in such a development, usually with extra money they have so that if they fall, it won't matter that much for them, but if they win they score huge with the investment and make a huge profit.

#### **4.3 Does the new credit act affect residential home buyers?**

The major cause of creating a new credit Act in South Africa is to get less credit in the land itself. More credit raises inflation and causes prices to go up, and at the end it becomes unaffordable to the consumer. More and more people are now struggling to get loans from banks because of the high criteria that they need to approve of before they can even get into account for a loan. Developers can try to get exterior finance without the help from banks by getting businesses to invest in such a development. This new Credit Act influences the demand market for residential developments and is the main reason why the supply market for a developer starting a development is also affected. The developer will only commit himself to this if he can make a huge profit on the development.

#### 4.4 What is inflation and what role does it play in property developments?

Inflation in short is the value that money loses over a period of time. Inflation causes prices to increase and thus for the spender of that money to have less to spend and will in the long run result in people buying things on credit. This will cause inflation to rise even more. House prices increase because of inflation, building costs increase because of inflation. This becomes a problem as during tough times no one can afford to build because of these high prices. These results

in people not being able to afford the high cost of newly build residential properties.

## 5. DELIMITATIONS

The research scope will extend to the developments of residential property complexes in South Africa. It will not be limited down to the specific location or specific development as the influences on the Economy affects all, possibly in the same manner and it will be widely implemented on all developers across Southern Africa.

## 6. DEFINITION OF TERMS

**6.1 Development:** The process of using an area of land and building on it to make a profit.

**6.2 Building industry:** Industry where various structures are erected with different materials. These structures have a roof and walls.

**6.3 Investment:** To buy property shares within a company.

**6.4 Economy:** The relationship between production, trade and the supply of money in a region.

**6.5 Inflation:** A general rise in the prices of services and goods in a particular country, resulting in a fall in the value of money.

**6.6 Property:** Something that is owned by someone or something.

**6.7 Exchange Rate:** Process of changing an amount of a certain currency for an equal amount of another currency.

**6.8 SARB:** South African Reserve Bank

**6.9 MPC:** Monetary Policy Committee.

**6.10 Foreigners:** An outsider who is not a citizen in the country of South Africa.

**6.11 Finance:** The management of money whether peoples own money or another persons.

**6.12 Investors:** Persons who give or put money in usually a business to earn a profit or some time of revenue.

## **7. IMPORTANCE OF THE STUDY**

Most developers in the Building Industry today, develops estate for instance to make profit. This becomes an issue when the developers

build the units in the development, but they can't get them sold to the investors at the end of the day.

Without a buyer the developer cannot make any profit and without economic markets looking positive the buyers won't buy and the investors will not invest.

The question to be asked is how the markets can foresee to plan such a development for the perfect time, so the developer can attract buyers and investors.

## **8. RESEARCH METHODOLOGY**

Research will be done by study components of articles and case studies, Literature reading through books, internet data and Journals.



## **CHAPTER 2**

### **HOW DO THE INTEREST RATES INFLUENCE THE RESIDENTIAL DEVELOPMENT SECTOR IN THE BUILDING INDUSTRY?**

#### **1. INTRODUCTION**

If the interest rate is going up another fifty or a hundred basis points, people are getting more worried about their properties. How or where are they going to get the money to pay their bonds, not even to say that first time home buyers must get huge salaries to start thinking of buying any type of property?

The purpose of this chapter will be to identify the interest rate, where does it come from? Why is there something like an interest rate?

Firstly a clear picture of the interest rate and how it works so that people can understand what the impact can be of higher and lower interest rates should be established. Then people look at how interest rates affect house prices and test the hypothesis from the result.

Everything in economy is subject to money. There is an English phrase which says: "Money is a good servant but a bad master". In South

Africa, even in the whole world money is the first priority of many people's lives. Aphra Behn (2006) quoted in "*Ekonomie vir Suid Afrikaanse Studente*" that: "*Money speaks in a language all nations understand.*"

Without money in today's world we can really achieve nothing. Money has an great effect on everything and in the end it works like a chain reaction causing great wealth or the opposite.

## **2. BODY OF THE CHAPTER**

### **2.1 THE ECONOMY**

The important things of the economy are supply and demand. The whole economy revolves around these two terms. How much is demanded from the user and how much will the supplier be able to supply to the user. These factors are influenced by the following factors:

#### **2.1.1 Money**

In the end, how much money will the SARB be able to supply to the user, and how much money will the user be able to ask from the financial institution?

Money has different functions in the world, where the most important function is the value that it carries, for people to use it as form of wealth. There should be a certain amount of money in the country that is worked out by a formula, to the amount of people inside that land. The South African Reserve Bank supplies money to the financial institutions in South Africa, the banks as we know them. This money is supplied at a rate determined by the SARB effect the interest rate of the money borrowed by the normal working person.

The bank borrows the money from the SARB at an interest rate, usually 2% lower than the rate at which they lend money to the user. The interest rate that we are talking about is the SARB rate (repo rate) plus the 2% on the prime rate. This is how banks make their money so they can make a living.

The SARB is a monetary government in South Africa and has different functions relating the money reserves within the land.

### **2.1.2 Inflation**

According to Mywage.co.za (2009) inflation is: *“the rise in prices caused by an increase in money supply and demand within a country.”*

Inflation is determined by the consumer prices (CPI) and the consumer price index (CPIX).

With higher inflation money could become worthless. The monetary policy in South Africa will try to keep inflation as low as possible, but it can only be done by cutting down the rate at which people lend or borrow money from any type of financial institution.

### **2.1.3 Interest Rates**

As stated earlier the interest rates are the rate at which the bank lends money to the users of that money. This is the rate of the prime rate plus additional rate of 2% which the bank charges for their services.

The interest rate is determined by the Monetary Policy in South Africa. This is then the function of the SARB to decide on what the interest rates should be. In "*Ekonomie vir Suid Afrikaanse Studente*"(2006) the Monetary Policy Committee (MPC) of the SARB consists of the governor of the bank, his two deputy governors, a chief economist, a marketing director and four external members. They all sit once a month to decide on what the interest rate should be.

Their main interest is to maintain and control inflation according to a target set by the government, set aside in the Minister of finance budget each year at the end of February.

Interest rates increase then to control inflation. People will demand more pay if the inflation goes higher and higher.

This put together mean that the issue of borrowing money should be held as low as possible, and saving of money should increase. People borrow too much money and this pushes inflation up, then the Monetary Policy pushes up the interest rate to decrease inflation.

## **2.2 ECONOMY INFLUENCES PAY INCREASES**

Increased salary demand according to mywage.co.za (2009) is linked to inflation. The increase in a salary of a employee should not exceed the inflation rate within that country. Thus the MPC should try to keep inflation at a sensible level, to avoid low salary increases.

For developers to start new developments should have a demand for the type of development that they planned to do. If the users of the final product don't have the money to buy new houses from developers the developers will have an over supply of developments and will get themselves into financial problems at the end of the day.

Interest rate reduces as the inflation rate reduces. There will always be inflation within a country and thus there will always be an interest rate connected to that.

## **2.3 INTEREST RATES AFFECT HOUSE PRICES AND THE HOUSING MARKET**

According to [propertyinvestmentproject.co.za](http://propertyinvestmentproject.co.za) (2008) there are many factors that can influence house prices, but the interest rates are one of the most important and key factors for this.

We can bring high unemployment factor in as well. People can't buy properties or even get mortgages if they do not have work.

If the interest rates go higher, the first thing people would think about is how they will pay back their mortgages at the end of the month because their salaries stay the same.

If people do not have money to pay for houses, it will mean that the developers will at the end of a development also sit with an over supply of houses in their possession.

This could happen if the interest rates rise, the property market loses the demand for housing from the people or the users, with the opposite effect if interest rates go down.

### **3. SUMMARY/ CONCLUSION**

In this chapter we looked at what the most important factor in people's lives can be, namely money. Without money people are struggling to move forward in the world.

Inflation, high or low interest rates effect the money people will want to save or spend.

At the end of the day this all form a major chain reaction on all businesses.

Developers in the building industry like to have a positive and clear foreseen future for any new development they want to develop. With macro economic factors changing so much they do not want to take the risk, while some of them take the risk and end up with huge sum of financial dept.

We also looked at influences of inflation on any type of pay increase for the user of properties. The interest rates influence house prices at the end of the day, and become a problem when properties become a type of luxury only for people who have money.

### **4. STATING OF THE HYPOTHESES**

With high interest rates the property market in South Africa is very slow and people are struggling to pay all their expenses. Some even sold their homes to survive because they just do not have the money

to buy new homes. This causes a chain reaction on developments and developers trying to provide the people with their needs, and makes them hold back all development and project till the interest rates drop and people can start buying again.

## **5. TESTING OF THE HYPOTHESES**

According to the hypothesis on how the interest rates influence the developments, it is true and can be concluded that the interest rates influence a development negatively in both high interest rate cases and low interest rate cases when looking at the theory behind the whole test.

With high interest rates people will try to hold on to their money, and try not to make any credit. This puts pressure on the developers because they can't afford to develop residential units for instance without the people buying the units from them so they can make their money too.

With low interest rates the people will buy properties more, usually on credit, and this pushes up the inflation rate. High inflation means higher interest rates and everybody is back where they started. This also means a rise in the prices of houses, which will then become unaffordable for the normal class people.



## **CHAPTER 3**

### **WHAT EFFECT DOES THE EXCHANGE RATE HAVE ON FOREIGNER WANTING TO INVEST IN RESIDENTIAL PROPERTY IN SOUTH AFRICA?**

#### **1. INTRODUCTION**

Foreigners wanting to invest money in a land like South Africa will first look at the exchange rate of their money against the South African rand. This is a very broad term in the world which is determined mostly by the gold trading in South Africa to other countries. Looking at the current exchange rate system in the country it will reveal how the exchange rate is determined and how it is controlled.

South Africa will want Investors to invest but not to an extent where they take over.

The gold price is the main concern for our international reserves to build up because it is South Africa's main and probably strongest export at the moment.

## **2. BODY OF THE CHAPTER**

### **2.1 DETERMINATION OF THE EXCHANGE RATE**

South Africa has a unitary exchange rate system. This is where the exchange rate is determined by market forces where only control is used over capital movements.

There is no fixed buying or selling rates for dollars. The exchange rate is mostly determined on one of the other countries money values, like the dollar. This then depends on the supply and demand for such an exchange.

The Reserve bank intervenes on the initiative in the spot foreign exchange market to influence the supply and demand of such a market directly, but with all these broad macro- economic objectives of the MPC, the exchange rate is not influenced to protect certain sectors of the economy.

As a short term measure for the depreciation of the exchange rate of the rand the Reserve bank will buy and sell dollars in a domestic market for foreign exchange.

## **2.2 EXCHANGE CONTROL IN SOUTH AFRICA**

According to Van der Merwe (1996:10) exchange control in South Africa is principally applicable to capital movements. In order to ensure that capital transfers are not distinguished as current payments, limits are placed on transfers of a current nature such as travel allowances for tourists and for business purposes, subsistence allowances for educational and other purposes and gifts to non residents.

A non resident may at any time sell foreign currency to a bank in South Africa for any kind of investment or current expenditure and may then at any time sell his investment to others.

There are no restrictions for foreigners wanting to invest in anything, for instance property. It depends on the price they want and the risk they want to take on themselves if markets suddenly fall to a major low.

## **2.3 RESERVES**

Munshi in the Financial Mail of September (2009:72) says that the Reserves Bank foreign exchange holding received a boost in August of 2009. This was with the introduction of the International Monetary Fund's special drawing rights.

The gross reserves raised to 37.9bn US Dollars, from 35.7bn US Dollars. The IMF hopes that they can inject liquidity into the cash strapped global economy. The SDR is an international reserve asset designed to supplement official reserves. South Africa received about 2.17bn Dollars worth of SDR of the 250bn Dollars distributed in August.

A higher gold price caused the value of gold reserves to rise to 3.79bn dollars from the 3.75bn dollars previously. Foreign deposits dropped by 10.6 per cent, while the international liquidity position rose by 6.5 per cent.

Economists believe that signs of recovery are emerging, but economists say the amount say that the outlook on global economy is still uncertain. According to this the South African Reserve Bank will tend to accumulate the reserves.

#### **2.4 EXCHANGE RATE ISSUES**

According to Mboweni (2008:9), the president of the South African Reserve Bank, in Perspectives on the economic and financial environment for exporters, South Africa runs a sizeable current account deficit on its balance of payments. This means that the country imports more from the rest of the world, than what they export. In 2007 this deficit was about 7.3 per cent of the GDP. This deficit has been sustainable because foreign

investment attracted to the country exceeded the deficit on the current account.

The weaker exchange rate has been welcomed by exporters. The rand has depreciated by about 10 per cent against the US Dollar since the beginning of 2008. It is sometimes argued by some that a weaker exchange rate is in the long term interest of the export sector, but no business can build a long term strategy on a one- way bet on the exchange rate of the currency or on the short term exchange rate movements. This will lead to higher petrol and chemical prices and because of the higher cost lead to higher inflation. A weak exchange rate is usually a sign of high inflation rate.

A weak exchange rate can only benefit exporters if the exchange rate change is not offset by price increases. Stable macroeconomic policies also contribute to more stable capital inflows, and the higher gold level and foreign exchange reserves should also make the currency less vulnerable to attacks.

### **3. SUMMARY/ CONCLUSION**

Investors are more than welcome to invest in a country like South Africa. In fact South Africa will welcome them up to a certain point.

The investor investing in a property in South Africa will obviously go for the highest profit margin, but that is the risk he must be willing to take. Taking a look at the figures of our reserves the country looks like it's going to overcome the financial crises.

All South Africa and maybe the whole world need is stability in the economy for a longer than usual period of time.

#### **4. STATING OF THE HYPOTHESES**

The higher the exchange rate the more foreigners can or want to invest in South Africa. With the Economic crises hitting the whole world, foreigners are holding investment in their own pockets because of all the risks involved. They will not invest as long as the economy fluctuates that much. Although there are some investors that will take the chance in investing in such a development, usually with extra money they have so that if they fall, it won't matter that much for them, but if they win they score huge with the investment a make a huge profit.

## **5. TESTING OF THE HYPOTHESES**

It is true that there is a type of a restriction for investors to invest in South Africa. This restriction is not put in place by South Africa, but rather by the investor himself. If the exchange rate is not right the investor will not invest. If the exchange rate pleases the investor he will invest without anything holding him back. The risk will totally be on him. All South Africa as a country do is to regulate and control the amount of investors and foreigners and tourist within the country.

## **CHAPTER 4**

### **DOES THE NEW CREDIT ACT AFFECT RESIDENTIAL HOME BUYERS?**

#### **1. INTRODUCTION**

This aspect is quite important when it comes to a point where the buyer wants to buy a residential unit and financing is needed by them for a specific unit.

This comes to a point of financial stability. Loans will be provided to persons who are the most financially stable. In the fluctuating economy it becomes almost impossible for the average person to be in an financial stable position. Interest rates are going up and down, petrol prices doesn't stay the same for two months in a row, inflation rates pushes prices up, but the employee salaries do not change on a monthly basis.

When applying for a home loan or a mortgage bond, the provider of that loan takes a risk, and they will want to make sure that the risk stays fairly low. How do you foresee such a risk if you can't predict what the economy will be like tomorrow, in two weeks or even in 3 months? Risk will also be discussed in this chapter.



Is the new credit act helping people or is it just causing problems?

## **2. BODY OF THE CHAPTER**

### **2.1 FINANCIAL STABILITY**

#### **2.1.1 What is Financial Stability?**

“I am financially stable”. What does it mean if you are financially stable? People might argue that they are financially stable but then the opposite presents itself when looking deeper into the finances of a person.

Charles Goodhart wrote (2004): “There is currently no way to define financial stability”.

Is to receive a large salary, making plenty of money, having a lot of real estate, etc. making a person financially stable?

Our economy today is so unpredictable that anything can happen, whether a person is rich, have a successful business or just living on all the necessary things.

Andrew Crockett (2000) argues that financial stability has 2 dimensions.

1. Micro prudential
2. Macro prudential

He says that the macro objective is to “limit the costs to the economy from financial distress, including those that arise from any moral hazard induced by policies pursued.” This would mean to limit the risk and the cost which could lead to failure of the financial system. The micro objective is to limit the likelihood of the failure of the individual institutions.

A stable financial system whether it would be a business or some individual home buyer, would be one that can provide a function or service under a huge amount of stress and a wide range of adverse circumstances.

### **2.1.2 Why does Financial Stability matter?**

An unstable financial system can transmit problems from one part to the other part, or even to the economy as a whole. Macro financial instability can limit the lending of funds from savers to borrowers.

Over the last few years the frequency and size increased. This also increases the size of the crises. It is better to provide for a stable financial system to make sure it can stand in crises times.

## **2.2 FINANCING DEVELOPMENTS**

The growth in the economy during the last couple of year was mostly because of the construction industry's contribution. According to The South African Housing Foundation (2008, vol. 4, 1): "The finance and Construction industries have been identified as the most significant contributors to South African's economy growth."

The concern is that if the construction industry or the developers of developments, which drives the construction industry, can not get finance from a credit provider the contribution to the economy will fall and maybe end up in an unstable financial system.

If we take a look at the fact that because of all this housing prices is becoming more and more affordable. Report on Fn.com on 2008/11/04 the steady interest rates is increasing housing affordability.

This is good news for anybody who invests or even buys in the housing sector, but with the new credit act the average income person cannot get loans or mortgages for bank, as they do not fit the requirements for it.

### **2.3 NEW CREDIT ACT**

(GOVERNMENT GAZETTE; *National Credit Act*; vol.489; 2006).The purpose of this act is to promote and advance the social and economic welfare of South Africans. This in a way makes good sense as it will be better for the economy at the end of the day. They want to create an accessible credit market and industry and protect the consumer by:

- Promoting a credit market accessible by all South Africans.
- Ensuring consistent treatment of different credit products.
- Promoting responsibility in the credit market
- Promoting equity in the credit market.
- Addressing and correcting imbalances in negotiating power between consumers and credit providers.
- Improving consumer credit information and reporting.
- Preventing over-indebtedness of consumers.
- Providing for a consistent system of consensual resolution.
- Providing a consistent system of debt restructuring.

Basically what is happening according to wizardmidrand.com (2009,1) is that: home loan credit applications are taking two to three times longer to approve on a new system which the banks are starting to use.

Geffen (2009) is saying that banks will not decline people more because of the new credit act, but that they will just price it better for increased risk. He believes that people should start finding out where hidden cost are and that they should leave luxuries for people who can afford them, although it does appear that credit lenders, furniture shops and vehicle financing are the people starting to take strain due to the new credit act.

Moola (2009:14) said in the financial mail that in the case, house prices is a major threat. Mortgage debt has risen from 30% to 40% since 2002. Therefore if house prices begin to fall, the value of mortgages on the bank balance sheets becomes less certain. Banks have tightened up mortgage lending because of the fact that this is the last thing they need and want. Previously prospective home owners could access bonds that covered 100 per cent of their sale prices where it is now down to 80 per cent.

Banks need to build in leeway for any fall in asset values.

Credit conditions haven't tightened to the point where companies cannot access working capital. If the prices of houses fall the loan valuations will follow and thereafter the solvency of banks will come into question.

### **3. SUMMARY/ CONCLUSION**

Financial stability is an important aspect for any person buying a home. No person can really say whether he is financially stable or not. Looking into all of this, it is possible for people to get financing for housing units, but also that it is limited and therefore trying to help the bigger percentage of South Africans to create a better economy in South Africa itself.

### **4. STATING OF THE HYPOTHESES**

The major cause of creating a new credit Act in South Africa is to get less credit in the land itself. More credit raises inflation and causes prices to go up, and at the end it becomes unaffordable to the consumer. More and more people are now struggling to get loans from banks because of the high criteria that they need to approve of before they can even get into account for a loan. Developers can try to get exterior finance without the help from banks by getting businesses to invest in such a development. This new Credit Act influences the demand market for residential developments and is the main reason why the supply market for a developer starting a development is also affected. The developer will only commit himself to this if he can make a huge profit on the development.

## **5. TESTING OF THE HYPOTHESES**

According to the hypothesis stated, it is true that the credit act were put in place to regulate credit and help people organise their debt. Bank loans are taken much longer to approve and not necessary declined to a point were no loan will be given to a person or developer. It's true that there is an affect on the financing because of the new credit act, but it can also be said that people spend too much on luxuries when they know they cannot afford it.

## **CHAPTER 5**

### **WHAT IS INFLATION AND WHAT ROLE DOES IT PLAY IN PROPERTY DEVELOPMENTS?**

#### **1. INTRODUCTION**

The term inflation can be misleading and wrongfully interpreted by many people. It is understandable that there is inflation on every single item whether people buy it or even sell it.

Why is it that in 2000 a person paid R2.50 for a can of cold drink and today in 2009 that same cold drink will cost you R6.50? This is due to inflation rising on the prices of cold drinks since 2000.

How can people measure inflation if they don't know what it implies, what causes inflation and how it can be prevented?

This can be a very serious issue for any developer as it can influence the prices and demand and supply market of any development which he wants to do. Irving Fisher said (2006, 565): If all prices and income rose equally, no harm will be done to any one. But the rise is not equal. Many lose and some gain.



Developers do not develop any developments with the idea of losing all that they have. They obviously want to make a huge profit out of it for the next development or for savings to go to retirement one day.

In this chapter we will be discussing all the basics around the term inflation for a clear understanding of it.

## **2. BODY OF THE CHAPTER**

### **2.1 DEFINITION OF INFLATION**

Art Buchwald had the perfect description for the word “inflation” (Ekonomie vir Suid Afrikaanse Studente, 2006, 566) he said that in 1887 there was a bar and grill owner named George Inflation. One day he failed to receive a shipment of booze. The demand for booze was great during that time. George Inflation decided to charge 15 cents for a shot of whiskey, instead of the regular 10 cents and he also made his shot glasses smaller. This did not stop his customers from buying booze, so he raised the price to 20 cents, then 25 cents. The surrounding bars raised their prices accordingly and when their customers complained, the surrounding bars owners will say, “Blame it on Inflation”. (MacEwan, A & Weisskopf, T.E, 1973, *Perspectives on the economic problem*, 2<sup>nd</sup> Edition, Englewood Cliffs).

According to mywage (2009:1) inflation is actually a rise in the prices caused by an increase in money supply and demand.

In Property investment (2008:2). This means that every day that as inflation rise, every rand a person owns buys a smaller portion of a good or service.

## **2.2 MEASURING INFLATION**

Inflation is measured by using the CPI and CPIX Index prices. The CPI Index is the cost of things and services that an average South African household will need over a period of time, while the CPIX Index is the same with the exclusion of mortgage bond interest rates. This is excluded because of the fact that: if the South African Reserve Bank increase the interest rates it will have a direct impact on the inflation rate, which will also increase.

The economists want to know what happens with the inflation, because if prices on products and services increase the average South African spending decreases. In determining the inflation rate they will be able to determine the power of the South African rand of the user.

The CPI and CPIX Index prices are produced by Statistics South Africa on a monthly basis. If the index value is for instance 120.5 for December 2007 and 107.2 for December 2008 the inflation rate will be determined by:

$$120.5 - 107.2 / 107.2 * 100 = 12.4\%$$

The Inflation rate is expressed as a percentage value.

### **2.3 GLOBAL AND DOMESTIC INFLATION**

According to Mboweni (2008:8) Global Inflation appeared to be relatively under control in 2007, where it averaged about 4 per cent per year. In 2008 it was expected to increase to 4.8 per cent for that year. Emerging market economies are expected to experience even higher inflation because of the higher weight of food. Inflation is therefore expected to increase to 7.4 per cent in developing economies.

With inflation increasing, it can lead to unfavourable conditions in the economy. In 1970 the slower growth combined with the fast accelerating inflation resulted into stagflation.

Domestically the year on year inflation accelerated to 10.4 per cent in April of 2008. The MPC of the Bank has increased interest rates by a cumulative 450 basis points from June 2006. Food and petrol prices are the main contributors to inflation. Food prices increase on a basis of 15.9 per cent per year, while petrol increased by around 30 per cent up to 2008. Inflation is expected to increase above the target of 3-6 per cent and will only return within range by the end of 2009.

## **2.4 BUILDING COST INFLATION**

According to John Loos in the Financial mail (2009:14), the inflation index for the fourth quarter of 2008 has shown a mild decline in the residential building cost inflation. This index shows the building cost per square metre as it is charged by building contractors when winning tenders in the residential property sector. This will be because of a combination of the contractors pricing power as per market conditions, and their input cost for the construction of a building.

The slow down in the inflation in 2008 was because of the weak residential demand, although the recorded building costs were still increasing despite the weak residential market, and contractors dealing with strong input inflation.

The difference between input cost inflation and house price deflation makes it a problem for contractors to deliver new stock to the residential market. This has positive and negative implications: From the developers side it is a bleak situation and could go on for most of the year 2009. Ongoing input cost inflation, may result in ongoing building cost inflation. The maintaining of a higher replacement cost of housing and the prices of existing properties should be so that it should keep the market in some sort of balance.

Building cost inflation is expected to decline more in 2009, as contractors struggle to reduce input costs and to keep up with the house price deflation.

## **2.5 BUILDING INDUSTRY SLOWDOWN**

According to Claasen in the financial mail of April (2009:61) the Construction Industry will not save the economy. The latest statistics had shown a continued weakness in the building sector. The BER and FNB Building Confidence Index fell 12 index points to 28 for the first 3 months of 2009. This is expected to fall even more to the end of 2009.

The Building Contractors surveyed saw building activity fall from -68 points to -77 points. The question to ask is why are building industry still producing good results? Its argument is that the results are backward looking, but even looking to future growth projections these are not poor.

Industry executives talk about the construction sector continuing to grow until 2014 because of the R700bn to be spend on infrastructure, but the possibility arises that 2010 will be the tipping point, depending on the impact of the financial crises on new projects.

### **3. SUMMARY/ CONCLUSION**

If we look at inflation, there will always be inflation within a country or land, no matter where you are prices will always increase because of inflation. It is true that inflation should be controlled so that it will not eventually take over the majority of prices.

If inflation is expressed as a percentage of the CPI and the CPIX Index provided each month by Statistics South Africa.

If inflation raises the banks loses money. It is therefore essential to keep inflation as low as possible for a period as long as possible, like cutting down the interest rates will reduce the inflation at keep it at a safe level/percentage.

### **4. STATING OF THE HYPOTHESES**

Inflation in short is the value that money loses over a period of time. Inflation causes prices to increase and thus for the spender of that money to have less to spend and will in the long run result in people buying things on credit. This will cause inflation to rise even more. House prices increase because of inflation, building costs increase because of inflation. This becomes a problem as during tough time no one can afford to build because of these high prices. This result in people not being able to afford the high cost of newly builds residential properties.

## **5. TESTING OF THE HYPOTHESES**

According to the hypothesis stated it is true that inflation is the percentage, which increases prices over a period of time. It is true that banks lose money the higher the inflation rate goes. In the housing market this will all mean that mortgage applications will not be approved and that people will not be able to buy residential properties, whether it is new or old properties. This matter is kept under control by the president of the Reserve bank.

## **CHAPTER 6**

### **SUMMARY CHAPTER**

#### **1. BACKGROUND**

##### **1.1 Stating of the main problem**

How does the Economy influence the building industry regarding residential property developments?

##### **1.2 Conclude**

There is a link between all of the factors in the economy. When one of them changes the other will change as well. Taking a look at the financial crises, everything from the interest rates to the exchange rate and inflation all affects one another.

The factors then have a influence on the development of new residential units.



The main concern is the instability of all the factors. This can be seen as the economy as a whole, which also influence the residential developments.

## **2. SUMMARY OF SUB PROBLEMS**

### **2.1 How do the Interest rates influence the development sector in the building industry?**

Without money people can't live or achieve their goal in life. The problem is the spending of money, which leads to high inflation and therefore there is this fluctuations in the interest rates in South Africa for instance. High interest rates affect everything, especially the housing sector. People can't or do not want to buy properties because they can't afford it. This causes a bad chain reaction to every professional involved in the building industry.

### **2.2 What effect does the exchange rate have on foreigners wanting to invest in a security development?**

The exchange rate as well depends mainly on the perspectives of the inflation rate. Weak exchange rate is the cause of a high inflation rate. Although the weak exchange rate is not always a

bad thing because it makes foreign investors interested in the properties or some investment opportunity in South Africa. The exchange rate is not manipulated by the South African Reserve Bank, but depends majorly on the markets in it self.

### 2.3 Does the new credit act affect residential home buyers?

The new credit act also got a big influence on the property market as the home loan applicants can't get home loans or just get part of that home loan finance that they need. There is no financial stability anymore because of these major fluctuations in the market. Not every person can buy a property with cash out of his back pocket. There is finance needed. Another major reason for the instability of the markets is the amount of credit that people buy for. This means that they spend money that they or even the country doesn't have.

Because of this the new credit act were implemented in 2007, to reduce the amount of credit within the country. Less credit will reduce inflation and keep markets at a stable position.

## 2.4 What is inflation and what role does it play in property developments?

Inflation is the cause of all this instability and fluctuations in the economy. Inflation is measured from the CPI and CPIX indexes produced by Statistics South Africa. The interest rate is presented as a percentage per year.

The inflation rate is the cause of the influence of all the other factors in the economy. This will mean that the inflation rate has an influence of the residential property development as well.

### **3. CONCLUSION**

To finalise the above mentioned sub problems and taking a look at the main concern, the fact that there is a huge influence of the economy on the building industry. Only a few of the aspects of the economy were discussed and there is still many aspects that can be discussed.

The building industry's residential property market, also fall under the economic influences that influences the building industry.

It can be said that the research was done, the main problem was solved by explaining all the other factors. Therefore the economy has a great influence on residential property markets in South Africa.

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