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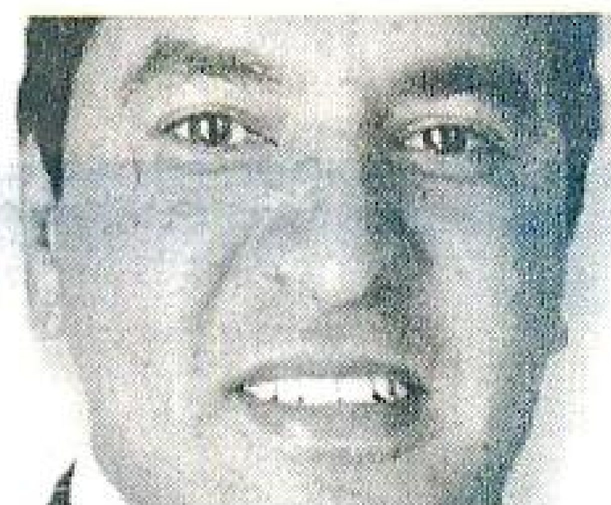
The dangers of costs inflating like a soccer ball



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IT IS with some concern that I recently discovered that the cost for the proposed King Shaka airport, north of Durban, has escalated 172% (from R2,5bn to R6,8bn) over the past year. The escalation was attributed to the Airports Company of South Africa's (Acsa's) large capital expenditure adjustments, occasioned almost exclusively by the rising cost of imports.

At the same time, I have been reading about how the government's R400bn infrastructure programme and preparations for the 2010 Fifa World Cup are affecting the current account of the balance of payments.

The current account is the difference between a nation's total exports of goods, services and transfers, and its total imports of them. At present, SA is importing more than it is exporting, leading to a current account (or trade) deficit of 5,4% of gross domestic product.

Deputy Finance Minister Jabu Moleketi has cited the import of specialist construction inputs, infrastructure skills and capital goods (like cement) as the main reasons for the recent surge in the deficit. Indeed, the expenditure of R1,9bn for 2010 stadium construction from next year's budget has had to be brought forward to this year's because, as the treasury puts it, "construction was running ahead of schedule".

A large portion of this R1,9m, no doubt, would be expenditure incurred through the import of goods and services, again affecting the balance of payments.

SA's macroeconomic fundamentals have been soundly in place over the past few years. Only two things really concern me in maintaining the kind of austere levels of fiscal discipline that Trevor Manuel has presided over in recent years: the first, which only became apparent two weeks ago, was whether inflation would breach its 3%-6% band in the short term and whether this would be attributable to internal or external fiscal conditions, including, for example, the impact of rising imports.

As it turns out, inflation in the second quarter of this year rose to 6,3% and a combination of high fuel, oil and food prices, along with strong consumer consumption and credit demand, was to blame. An interest rate rise followed. The implications for the domestic economy, when this happens, are well documented.

A second and more overt concern is a rise in the current account deficit. Rising imports — whether oil, petrol, consumer goods and/or skilled personnel — have grown significantly over the past four years, with the trade deficit ranging anywhere from 4,9% to 7,8%.

Imports are likely to increase appreciably over the next five years as the infrastructure and the 2010 public works programmes gain momentum.

This will have a negative impact on the current account, which a further increase in the interest rate will only partly mitigate. This is because demand for imports in the years ahead is likely to come from raw materials, specialist construction and infrastructure skills, and less from demand for consumer goods.

Exacerbating the above trend is the government's proposal to reduce import duties on products needed for its infrastructure development programme. This was put forward after a recommendation from the Harvard Group — which advises the government on economic policy — to liberalise trade in order to boost competitiveness.

'The longer-term benefits from importing... do not always materialise'

Such a move — while easily understandable — will have a further negative impact on the current account and could well undermine SA's bargaining power in future rounds of the post-Doha trade talks.

Ultimately, rapidly increasing imports to drive development programmes and the fast appreciating costs of such imports can make an economy less competitive (especially if importing finished consumer goods implies local production of more sophisticated final products is to suffer). This poses risks to the inflation outlook and can often lead to currency depreciation. High current account deficits simply do not bode well for a country!

The longer-term benefits from importing capital goods to expand the capacity of the economy, create jobs and increase exports, do not always materialise.

Coming back to 2010, all nine host city stadiums are likely to experience a significant increase in costs, especially the stadiums to be built anew.

While on a slightly smaller scale than the King Shaka airport, they will all feel the pressure of rising import costs specific to large public works undertakings.

Moleketi has set a benchmark of 5% for cost escalation related to construction. That would mean that the R8,4bn treasury allocation for stadium construction and upgrading would rise to a maximum of R9bn.

If, however, we use the King Shaka example and similar capital expenditure adjustments are made by construction consortiums and utility groups like Eskom and Transnet, the cost would rise to R22bn. That would be on par with the Gautrain, and then we would have a serious problem!

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