Infometrics
Economics put simply
construction update
BCITO He Hunga Hanga Mātou building people | Te Pūkenga
August 2023

Interest rates peak as recession hits and labour market softens

New Zealand has entered recession, as the effects of interest rate rises both here and overseas weigh on economic growth. Household spending has been squeezed by higher debt-servicing costs and other cost-of-living pressures, and export prices are declining due to weaker world demand. The official cash rate is on hold at 5.5%, as the Reserve Bank waits for further evidence that inflation is slowing and labour shortages are becoming less acute. We expect inflation to slow from its current rate of 6.0% to 4.2%pa by the end of this year and 3.0%pa by December 2024.

	Latest	*Dec 2023*	*Dec 2024*
Gross domestic product(1)	2.9%	0.4%	0.3%
Residential consents(1)	-12.2%	-21.1%	-11.1%
Non-residential consents(1)	10.8%	5.4%	-5.4%
House prices(2)	-10.8%	-4.8%	-0.9%
Unemployment rate(3)	3.6%	4.2%	4.9%
Net migration(4)	77,809	82,431	37,563

(1) Year-end % change (2) Three-month annual % change
(3) Quarterly level, seasonally adjusted (4) Annual total
Data source: Statistics NZ, Infometrics forecasts

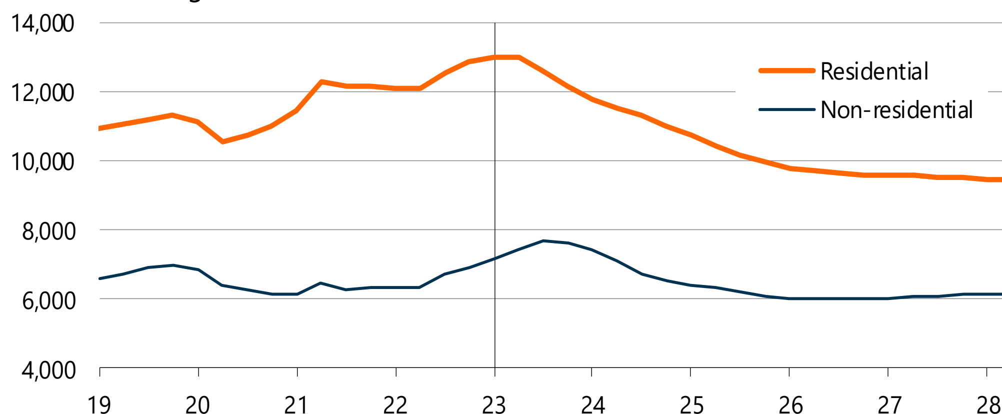
Unemployment has edged up to 3.6% from its low of 3.2% in early 2022, and sharper rises are expected over the coming year as job growth slows and fails to keep pace with growth in the labour force. However, at this stage, employment growth is still running at a strong 4.0%pa, as businesses take advantage of access to foreign workers to fill longstanding vacancies. A more definite softening in the labour market is required if further interest rate rises are to be avoided, enabling the Reserve Bank to start cutting the official cash rate from mid-2024.

Residential consents falling, non-residential yet to follow suit

Residential consent numbers have continued to soften in recent months, and they are on track to ease to around 40,000pa by the end of this year. Further declines in consent numbers are expected during the next couple of years, taking the annual consent total down to around 31,000 by the end of 2025. However, strong net migration in the near term and signs of a stabilising housing market present upside risks to this forecast.

Residential work put in place has held up better than consents so far, due to the large backlog of consents still in the pipeline. Delays to projects are easing as supply chain disruptions dissipate and capacity in the industry becomes less stretched. There are also increasing risks of projects being cancelled given less favourable demand conditions.

Non-residential work put in place has hit a new record high on the back of solid consent growth over the last 2-3 years. This consent growth has taken time to flow through into construction activity due to capacity constraints, supply chain disruptions, and COVID-19 restrictions. Factory and warehouse construction is a key driver of growth, as is government investment across hospital, social, and education building. However, more difficult economic conditions will weigh on private sector work during 2024 and 2025, leading to a 22% decline in non-residential construction from its 2023 peak.



Lingering pressures despite slowdown in cost increases

The moderation in inflation over the last 6-9 months has not been limited to the consumers price index. Building cost inflation across all three construction types has now peaked. However, this softening in inflation does not imply that prices are falling, or that a decline in prices is imminent. Apart from a selected few materials inputs, prices are stabilising rather than falling.

In part, the moderation in building cost inflation reflects a softening of demand in the industry. This softening is primarily the case for residential construction, with consents in the first half of this year down 20% from the first half of 2022. Although work put in place has yet to follow consents lower, firms involved in the residential market are conscious of reduced demand levels and a shrinking pipeline of work. However, demand pressures remain strong for civil and non-residential activity, particularly the latter, providing less scope for more competitive pricing.

Arguably the biggest change for the industry in recent times has been the improved labour supply following the border reopening in mid-2022, and the inclusion of several construction roles on the government's immigration Green List. The critical labour shortages during the pandemic have been at least partly addressed by this increased access to workers, reducing staff poaching and labour turnover. Labour cost pressures are expected to ease throughout the next 1-2 years, reflecting an improvement in the balance between demand and supply for workers in both the construction industry and across the economy more generally.

Another key driver of the slowdown in building cost inflation has been softening price growth for key materials inputs. International prices for steel, forestry products, plastics, and diesel declined in the second half of 2022 in line with slowing global economic growth. These price falls were accompanied by a return of shipping costs towards pre-Covid levels. However, prices for other materials, such as aggregates and concrete, continue to come under upward pressure, which will mitigate the effects on overall input prices for materials and componentry.

We also note that some businesses within the construction supply chain are experiencing high inventory levels, having increased their stock levels when possible during the pandemic to protect themselves against supply chain disruptions. With demand now softening, some firms could come under pressure to discount their stock and shore up their cashflow.

Across the economy as a whole, cost pressures are expected to continue easing throughout the next 18 months, but it will be a gradual process to get headline inflation back within the Reserve Bank's 1-3%pa target band. Domestic price pressures are likely to prove to be somewhat sticky, with the less disciplined cost and price-setting behaviour of the last few years taking a while to bring back under control.

The labour market is likely to be one of the areas of most persistent pressure. Although we have noted above that these pressures are becoming less intense, large minimum wage rises have flowed through into higher wages for other workers that are relatively low-paid. Significant cost-of-living increases are also likely to continue to affect workers' wage demands through into 2024.

We forecast that construction cost inflation will be below 5.5%pa across all three building types by the end of this year. There is some scope for a brief bounce in prices during 2024 as the recent price falls for some materials drop out of the numbers, but apart from this blip, construction cost growth is expected to continue easing through until 2026.

Over the medium term, the realignment of demand with supply provides scope for weaker cost growth, effectively unwinding some of the larger-than-average cost increases that have occurred over the last couple of years. Nevertheless, there is no expectation of building costs, or prices across the economy more generally, actually falling from current levels. The increase in construction costs since COVID-19 struck is effectively a permanent lift in costs that is here to stay.