

Still going strong - A look at economic activity in Canterbury

22 October 2015

In this report we take a look at economic conditions in Canterbury, drawing on our recent talks with businesses in the region.

- The current economic situation in Canterbury is very positive, with strong construction activity providing a significant boost to the labour market and other industries.
- While still strong, reconstruction activity is levelling off, with spending shifting from residential to non-residential projects.
- The level of construction activity is expected to remain elevated through the coming year, before starting to wind down from late 2016.
- The eventual wind-down in reconstruction spending will pose significant challenges for the Canterbury and national economies, particularly in terms of labour market conditions.
- Canterbury also faces the risk of a boom-bust cycle in construction.

Our latest round of talks with businesses in Canterbury left us with a very positive picture of current conditions in the region. Economic activity has risen to an elevated level, supported by continuing reconstruction activity, as well as gains in associated sectors such as professional services, manufacturing and retailing. This strength is activity is expected to be sustained over the coming year.

But while conditions will remain positive for the next while, the region will face some challenges when rebuild spending starts to gradually wind back from late-2016. These include the risk of oversupply of both new homes and commercial space, and the associated risk of a boom-bust cycle in the building sector, house prices and rents. There are also related questions around how the labour market will evolve.

From a macroeconomic standpoint, even though economic activity remains strong, the levelling off of activity is significant. It means that going forward the rebuild will no longer be adding to growth or employment, and as reconstruction winds down it will become a drag on national GDP growth.

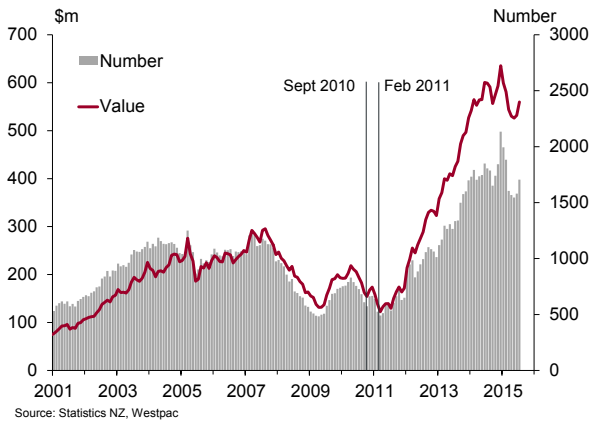
Unlike many other periods where there has been a slowdown in activity, there is a high degree of visibility around work streams in Canterbury. This will give business and others in the region the opportunity to prepare for the coming change in Canterbury's economic conditions.

In what follows we provide a brief rundown of what we heard from businesses in Canterbury, and some of the key take-outs from recent data.

Reconstruction spending remains strong

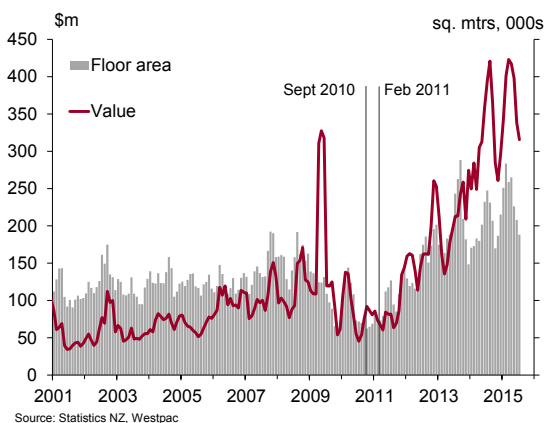
Residential reconstruction is now well advanced. The vast majority of EOC's repair program is complete. In addition, a large number of homes with damage over the EOC cap have been repaired or rebuilt. As this has occurred, we've seen residential building consent issuance in Canterbury pull back by around 10% from its peak (figure 1).

Figure 1: Residential building consent issuance (3 month totals)



With residential construction well advanced and the labour market stretched (regional unemployment in the June quarter was just 3.3%), it's only natural that growth has levelled off. But this doesn't mean that construction activity is about to drop away. There's still a lot of work to be done repairing and rebuilding damaged homes. On top of this, non-residential construction is taking off, with the value of non-residential consent issuance up 16% over the past year (figure 2). That includes continuing work on public assets (including anchor projects) and increasing work on privately funded commercial projects in the central city. The ramping up of spending on non-residential construction means that the overall level of construction activity in Canterbury will remain at an elevated level through the coming year.

Figure 2: Non-residential consent issuance (3 month totals)

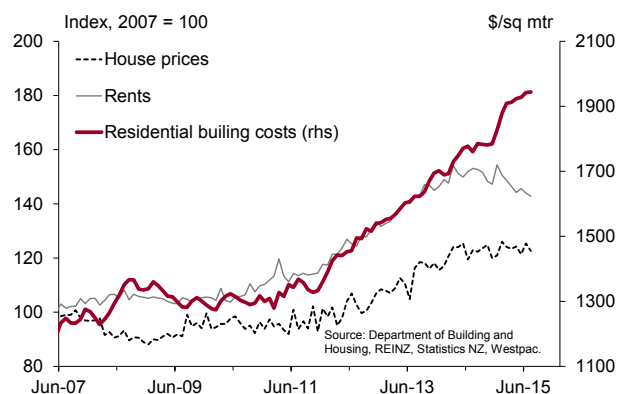


There will be some challenges over the coming years

Although construction activity is currently firm, we do have some concerns about how conditions will evolve over the coming years.

First of all, there is the risk we've previously highlighted of over building in both the commercial and residential sectors. Recent months have seen house price inflation level off, and residential rents have continued to decline (figure 3). At the same time residential building consent issuance has remained at elevated levels, and building costs have risen. It's a combination of conditions that's likely to give many developers reason to pause, especially given the relatively modest expectations for population growth after the rebuild.

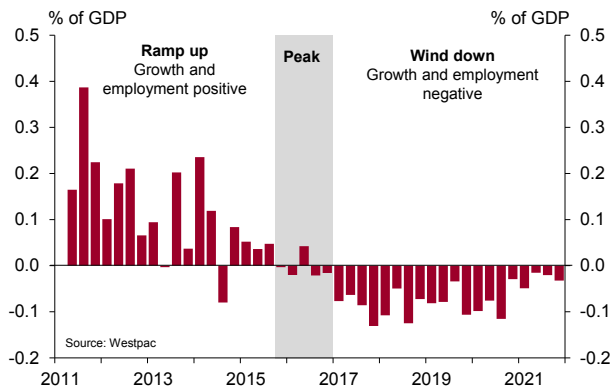
Figure 3: Building costs, house prices and rents



We've also heard several comments about downward pressure on commercial rents and the build-up of office space outside of the central city. Coming on top of strong increases in commercial building costs in recent years, this raises a number of concerns about how much new building is required, and leads us to expect that the amount of non-residential construction in Canterbury is likely to be at the more modest end of expectations.

An even more pressing concern is how economic conditions more generally will evolve when the rebuild starts its gradual wind down. In recent years, increases in the amount of reconstruction work completed each quarter provided a significant boost to GDP growth and employment. But from the end of next year, the rebuild will become a drag on growth (figure 4), which will have important implications for both the regional and national economies.

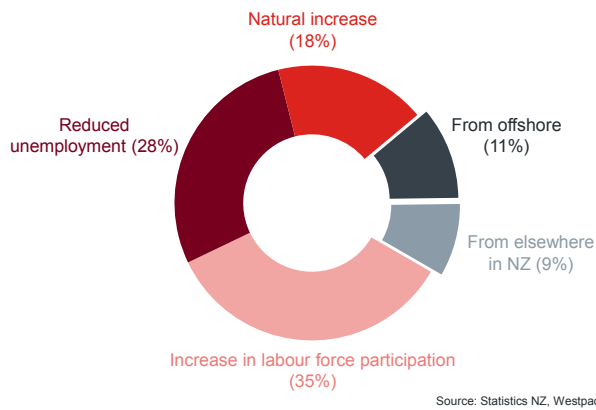
Figure 4: Quarterly changes in reconstruction spending



A particular area of concern is the labour market. As discussed in our report “Forewarned is forearmed”¹ the number of people employed in Canterbury increased by around 22,000 between 2011 and 2014. Around 80% of these workers came from within the region (figure 5), and the majority of them (around 63%) have been employed in the construction industry. Over the coming years, many of these workers are likely to find labour market conditions tougher.

It’s also important to remember that the rebuild didn’t just boost economic conditions in Canterbury. Demand and employment in related industries such as architectural services and manufacturing rose around the country.

Figure 5: Where has labour in Canterbury come from? 2011 to 2014

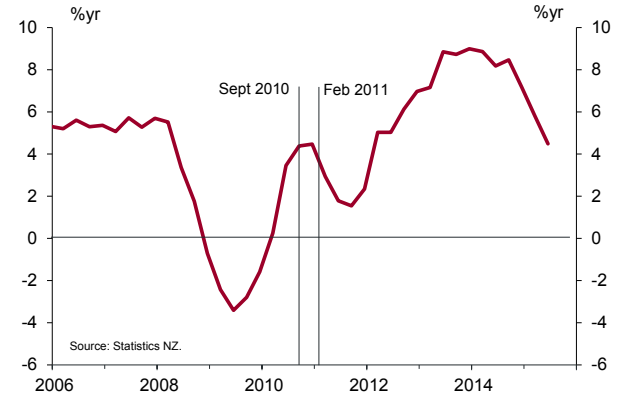


Given the massive size of the rebuild (we estimate that spending will be equivalent to around 15% of annual nominal GDP), its eventual wind down will result in a significant pull back in overall activity in the region. A key question for the region is whether other sectors can pick up some of the slack as reconstruction winds back, resulting in a more moderate slowdown.

Conditions will vary between sectors, and looking at some of the big sectors in the region, we see challenges and opportunities. Nevertheless, we expect that the coming construction related downturn will be pronounced, and will dampen nationwide GDP growth.

In the retail sector, we’ve seen strong growth in spending in Canterbury over the past few years (figure 5). Much of this has been associated with the rebuild, with increases in spending on homewares and DIY supplies. The strengthening of the labour market has also boosted spending more generally. This robust picture will continue for the next while. But as the rebuild winds back and the related strength in construction sector employment dissipates, it is likely we will see a pull-back in overall retail spending. Spending on durables is likely to be particularly soft. However, at the same time, the ongoing revitalisation of the central city will be a boon for parts of the highly flexible hospitality sector.

Figure 6: Retail spending



The manufacturing sector has enjoyed robust growth in recent years. However, much of this growth has been linked to demand for construction inputs which will ease over time. Looking outside of construction, the lower NZD will support demand for other non-agricultural exports, though there are risks around the strength of global demand.

Tourism activity has picked up in recent years. International arrivals have increased, supported by efforts from providers of travel services to target higher value customer segments in overseas economies. There’s been particularly strong growth in arrivals from China and other parts of Asia. However, a lack of hotel accommodation remains a stumbling block.

Figure 7: Growth in tourist arrivals – year to June 2015



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1 Available here: <http://www.westpac.co.nz/assets/Business/Economic-Updates/2015/Bulletins-2015/Forewarned-is-forearmed-August-2015.pdf>

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