Westpac

Institutional Bank

Peak or plateau? Update on the Canterbury rebuild

17 July 2015

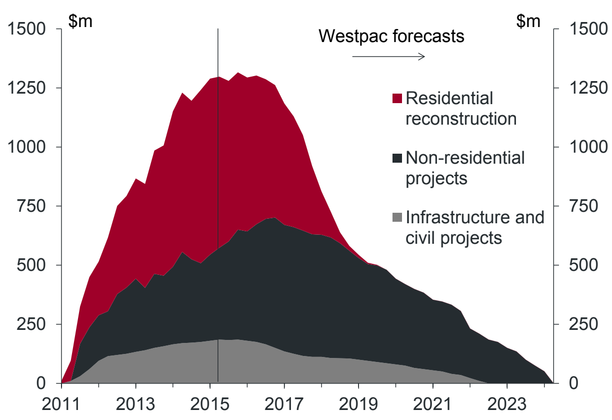
- Reconstruction activity in Canterbury is now well advanced. We expect that construction spending in the region will remain elevated for some time. However, work is shifting away from residential reconstruction and towards non-residential projects.
- Importantly, reconstruction spending appears to have reached a peak. As a result, going forward reconstruction isn't going to provide the same sort of boost to growth and employment as it has in recent years. And eventually the rebuild will become a drag on economic conditions.

Reconstruction led growth to slow, before turning down

A key driver of growth in recent years has been spending associated with the Canterbury rebuild. Reconstruction following the major earthquakes in 2010 and 2011 (not to mention the thousands of subsequent aftershocks) has resulted in our nation's largest ever construction project. Spending on reconstruction work is expected to total around $35bn (in 2012 dollars), which is equivalent to around 17% of annual nominal GDP.

But irrespective of how large it is, the rebuild was always going to be a finite project. It is now almost five years since the first of the major quakes that struck the region, and reconstruction is well advanced. We estimate that around 40% of the planned spending is now complete (figure 1).

Figure 1: Reconstruction estimates

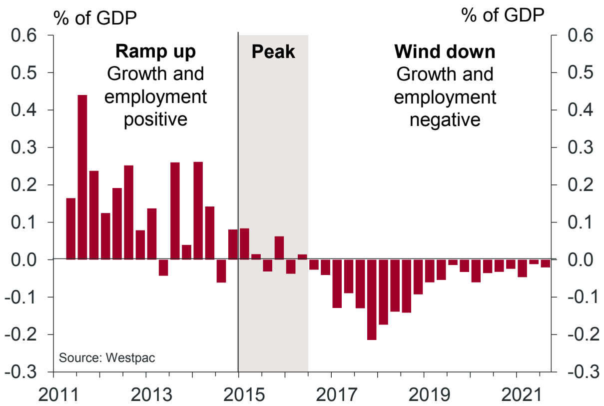


Source: Westpac

We are now entering a new phase of the rebuild. There is still a large amount of work to be completed. However, we no longer expect to see the very large increases in construction activity in Canterbury that we saw in recent years. Instead, we expect that rebuild related construction activity will continue around current strong levels over the next year or so, before it starts to gradually wind down from about mid-2016. By that point, the majority of residential reconstruction and infrastructure repairs will be complete, and non-residential reconstruction will also be well advanced. That doesn't mean there will be absolutely no further increase in activity. In fact, we are continuing to see new residential and non-residential construction projects being announced. But the boost from this new spending will be much more modest than what we've seen over the past few years.

Even though reconstruction activity is expected to remain strong, the levelling out that is occurring will have important implications for the regional and national economy. In recent years, increases in the amount of reconstruction work completed each quarter provided a significant boost to GDP growth and employment. And this boost wasn't limited to Canterbury's construction sector. Rebuild activity also boosted demand and employment in related industries around the country, including professional services such as architecture, and manufacturing. But as shown in figure 2, going forward we won't see the same sort of increases in construction spending that we have in recent years. And the eventual slowdown in rebuild spending will pull down nationwide GDP growth. This is likely to pass through to softer employment and spending in the economy through the latter part of the decade.

Figure 2: Quarterly changes in reconstruction spending



While the rebuild has been a key driver of growth in recent years, we can't say for sure how strong or weak the economy would have been if this spending didn't occur. The increases in demand associated with the rebuild pulled in resources from other parts of the economy. This resulted in strong upwards pressure on costs in the housing and construction sector, including upwards pressure on wages. It also reduced the scope for interest rate cuts. In other words, the rebuild crowded out economic activity that would have otherwise occurred.

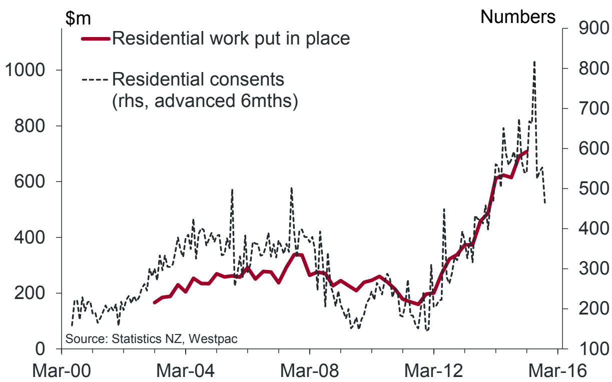
Rebuild progress

It's important to remember that what is commonly referred to as 'the rebuild' is actually several major work streams, and these are made up of thousands of smaller projects. As we are seeing some work streams peak and start to wind down, other areas are still picking up.

Looking first at residential reconstruction, it's estimated that there were around 69,000 homes with claims for damage of up to $100,000 (referred to as 'under-cap repairs'), and around 24,000 homes that required major repairs (i.e. repairs costing over $100,000) or complete rebuilding. Work on the under-cap repair program is nearly complete, with around 97% of jobs complete and many of the remaining jobs underway. In addition, there have been around 3,400 major repairs or rebuilds completed by insurers, with a number of other repairs completed by private home owners. All up, we estimate that residential reconstruction is now a little over 50% complete.

With a large amount of work complete, we are seeing signs that residential reconstruction is starting to ease back. This has been seen most clearly in residential building consent issuance in Canterbury, which has declined by around 20% in the early part of 2015. As shown in figure 3, this points to a likely pull back in residential construction activity over the coming year. Such a softening in activity is consistent with our talks with builders in Canterbury that have highlighted waning demand for new subdivisions.

Figure 3: Canterbury residential work put in place and building consents issued



Providing some offset to the moderation in residential construction activity, is a pick-up in non-residential reconstruction spending. This includes:

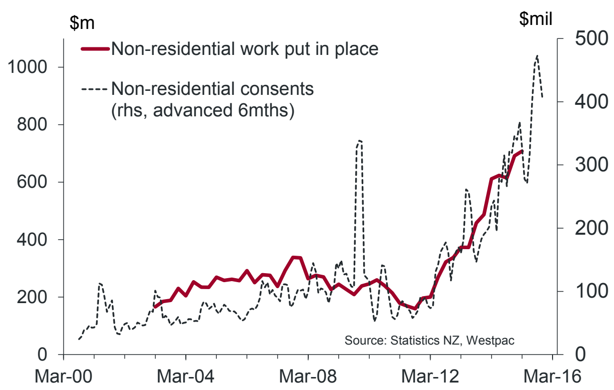
- Around $2.5b of spending on horizontal infrastructure by SCIRT. In mid-2015 around 75% of this work was complete, with the program expected to be largely complete by the end of 2016.[3]
- Around $8bn of spending on public and social assets, such as education and health care facilities.[4]

- Finally, there will be a large amount of privately funded spending on commercial construction. This includes the replacement of damaged assets (many of which will be rebuilt to a higher standard than pre-earthquake levels), and the construction of new assets.

Many of these projects are large and complex, and there have been delays. However, we are now seeing signs that work on these projects is ramping up, with a 20% increase in non-residential building activity and a 45% increase in building consent issuance over the past year (figure 4).

We expect that non-residential construction activity will continue to increase for some time, and that work will have a long tail. However, we also expect that the amount of commercial reconstruction work will ultimately be at the lower end of announced estimates. This is because the economic incentives for new commercial construction have moderated over time. There has already been a large amount of commercial office space built in recent years, and many tenants are now locked into long-term leases. At the same time as supply has been increasing, construction costs have risen sharply, pushing up the nominal returns that new projects need to generate in order to deliver an adequate yield to investors. In light of these conditions, it is likely that some projects will not be economically viable at the current time. As a result, some projects will be delayed until economic conditions are more conducive, while some other projects are likely to be cancelled.

Figure 4: Canterbury non-residential work put in place and building consents issued



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1 EQR - http://www.eqr.co.nz/repairs/repair-progress
2 Insurance Council of New Zealand - http://www.icnz.org.nz/natural-disaster/canterbury/rebuild-statistics/
3 SCIRT- http://strongerchristchurch.govt.nz/more-progress
4 Public Sector Rebuild Programme Of Work - http://cera.govt.nz/recovery-strategy/leadership-and-integration/public-sector-rebuild

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