

WESTPAC ECONOMIC BULLETIN

Deeper insights: Residential construction

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Housing shortages are being eroded, but we're not headed towards oversupply.

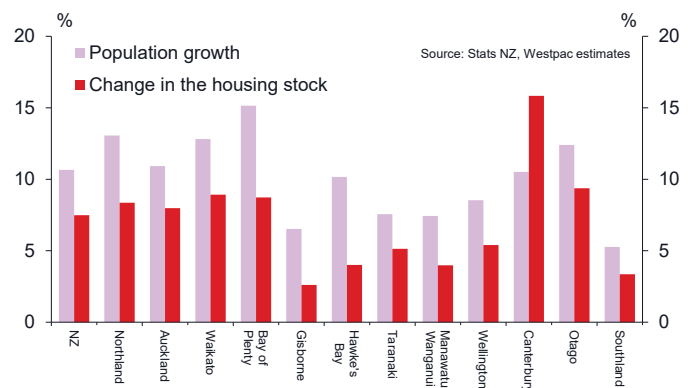
- New Zealand is still wrestling with a large shortage of houses after an extended period where population growth outpaced increases in our housing stock. However, that imbalance between population pressures and housing supply has been undergoing a rapid transformation in the wake of Covid-19.
- The closure of our borders has seen population growth plummet at the same time as home building is hitting record levels. As a result, the shortages that built up in recent years are now being rapidly eroded, and they are set to be largely eliminated by the middle of this decade.
- But even with a strong outlook for home building, this doesn't signal that a period of 'oversupply' is on the cards. Nor does it signal much relief in terms of housing affordability.

New Zealand's massive shortage of housing has started to turn.

Between 2015 and 2020 New Zealand's population grew by around 11%. Over that same period our housing stock only increased by 7%. That left us with around 75,000 too few homes.

Shortages of housing have been most intense in Auckland. However, they have become increasingly widespread across the country, with the average number of people per dwelling rising sharply in nearly every region over the past decade.

Regional housing and population changes (2015 to 2020)



That huge imbalance between population pressures and housing supply that developed over the past decade has

undergone a rapid transformation in the wake of Covid-19. We estimate that since the start of the pandemic, the shortfall of housing has fallen by around 30,000 homes. That still leaves us with a shortfall of around 45,000 houses. However, further big changes are in train in terms of both housing demand and supply.

Home building is surging...

Over the next five years, New Zealand will need to build around 130,000 new houses to address the existing shortfall and keep up with the needs of our growing population.¹ That's equivalent to building 26,000 new homes a year. Right now, consent issuance is running at nearly double that pace, with around 50,000 new dwellings consented over the past 12 months. And although shortages of materials and labour are providing a brake on how quickly housing developments are being completed, we're still looking at a period of rapid home building over the next few years.

...while population growth has plummeted.

At the same time that home building has been rocketing higher, population growth has plummeted. In the year to December, New Zealand's population grew by just 0.5% - well down on the rates of around 2% per annum that we saw in the years leading up to the Covid outbreak.

That downturn in population growth has been due to the closure of our borders and the resulting fall in net migration. Between 2015 and 2019 net migration averaged around 60,000 people per annum. But over the past year that story has gone into reverse, with the country actually recording a net outflow of 7,600 people in the year to February.

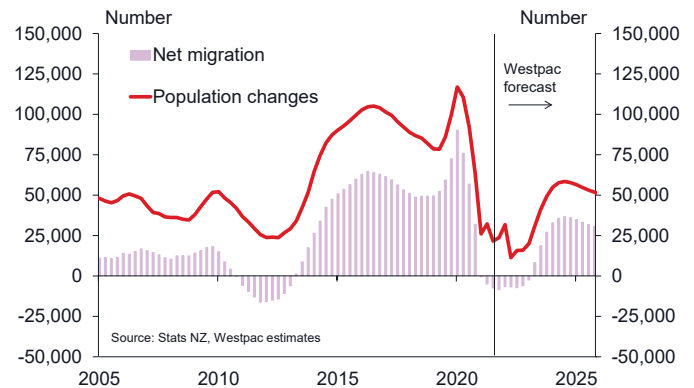
We expect that net migration will remain negative for some time yet, as many young New Zealanders who put off OEs in recent years are now looking to travel again as conditions abroad have improved.

Longer term, net migration will (eventually) turn positive again as the current pent-up demand for overseas travel by New Zealanders eases back to more normal levels. In addition, with the borders opening up again, the coming years will see a pickup in the number of new migrants landing on our shores. Even so, we don't expect a return to the sorts of migration levels that we saw over the past decade.

Prior to the pandemic, the Government had signalled its plans to tighten entry requirements for new arrivals based around skill levels. That aimed to support job opportunities and skills development among existing New Zealand residents. Now, with the borders reopening, those plans are set to be gradually rolled out. There could also be other changes affecting specific groups such as international students.

This change in migration policy could have a significant impact. As the current backlog of people waiting to enter and leave the country clears, we expect that net migration will settle at around 30,000 people per annum. That's a big step down from the annual inflows of 50,000 to 60,000 people per annum that we saw in the years leading up to the pandemic. And the impacts of that change will be felt across the economy, including in our housing market.

Population changes and net migration (annual)



Shortages of housing are now being rapidly eroded, with Auckland making faster progress than other regions.

The combination of rapid home building and slower population growth means that the housing shortages that developed in recent years are now being rapidly eroded.

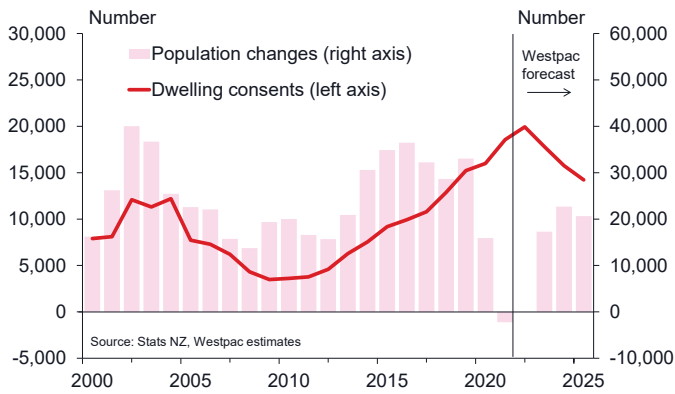
Some of the biggest changes are being seen in Auckland, where the downturn in net migration has had a larger impact on population growth. In fact, after rapid increases in previous years, Auckland's population actually fell by 1,300 people in the year to June 2021. And with population growth going backwards and home building surging, the shortage of houses in Auckland has fallen from around 35,000 homes at the start of the outbreak to around 15,000 homes now. There is still a way to go, but that is a massive turn-around after a decade when the pressures on the housing stock in our largest city had become increasingly pronounced.

With building activity continuing to ramp up, the underbuilding of homes in Auckland that developed over the past decade is on track to be largely eliminated by the end of next year.

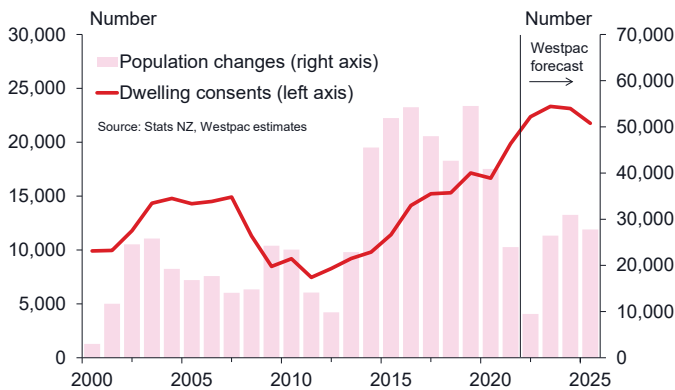
In other parts of the country, population growth has not fallen to the same extent. As a result, housing shortages in areas outside of Auckland are being eroded more gradually. Even so, building levels have lifted across the country, and the existing shortages look set to be largely eliminated in the next four to five years.

¹ This estimate includes an allowance for 'replacement' homes i.e. when one home is demolished to make way for two or more new houses. In most parts of the country, we estimate that around 10% of new builds involve the demolition of an existing dwelling. However, in Auckland, where there are a greater number of medium density homes being constructed, we estimate that around 30% of new builds involve the demolition of an existing dwelling.

Auckland home building and population changes (annual)



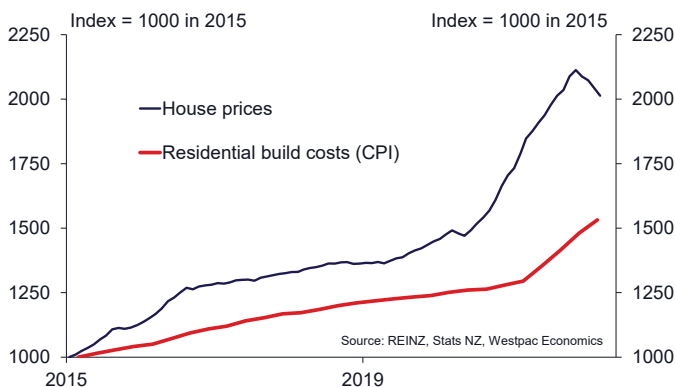
Home building and population changes (areas outside of Auckland and Canterbury, annual)



Home building is set to remain strong even as current shortages are eliminated...

We expect the level of home building will gradually ease back as we approach the middle of the decade. That's mainly due to the rise in interest rates currently in train and the related easing in house prices. Nevertheless, we expect home building activity will remain elevated for some time. That's because of the strong financial incentives for developers to bring new projects to market: while residential building costs have increased by around 50% since 2015, average house prices have more than doubled over the same period.

House prices and residential building costs



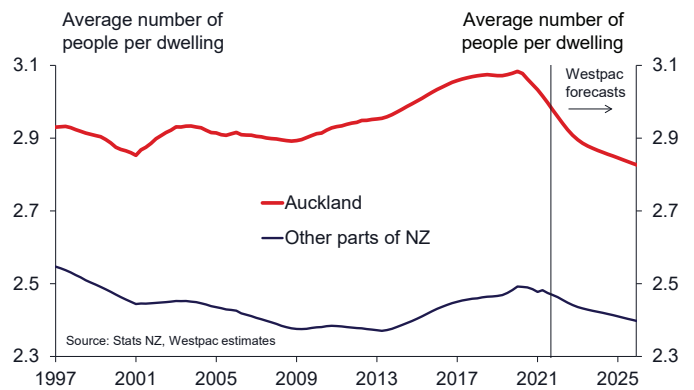
...but that doesn't mean we'll see an oversupply of homes.

Even with surging home building and a downturn in population growth, we don't expect an enduring oversupply situation will develop in the housing market. In most parts of the country, the current high levels of home building are what is needed to take the number of homes per head of population back to the sorts of levels we saw in the middle of last decade (just before the start of the recent period of very strong net migration).

It's a more nuanced picture in Auckland, however. Like other major cities around the world, population density is much higher in Auckland than in other parts of the country. And that's set to remain the case even with the current record levels of home building. However, the balance between demand and supply in the Auckland market is likely to be very different over the coming years.

Housing pressures in Auckland mean that we typically see an outflow of its residents to other parts of the country – something that's been exposed recently as the tap of incoming migrants has been turned off. With the number of completed homes set to rise sharply, that raises the risk that the city could tip into oversupply within the next few years. However, we don't think that would be the case for long: an abundant supply of housing would help to stem the exodus of Aucklanders, bringing demand and supply back towards balance. Ultimately, the risk of oversupply is more relevant at the national level, rather than regional.

Average number of people per dwelling - Auckland's housing market to remain tighter than other regions



Note: Canterbury has been excluded from the "Other parts of NZ" line due to the impacts of the 2010 and 2011 earthquakes on housing supply in the region.

House prices have started to turn, but housing affordability is set to remain stretched.

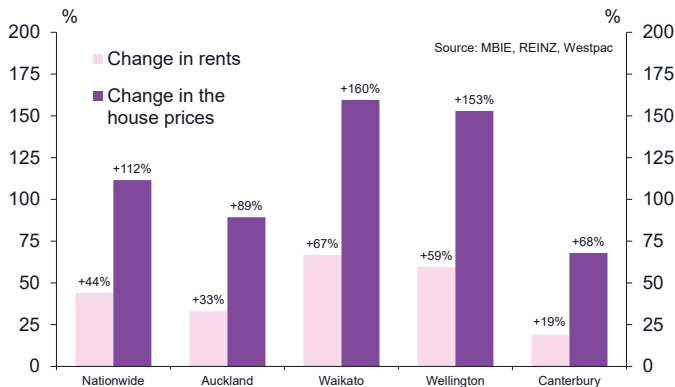
Population pressures are one factor that has contributed to the strong rise in New Zealand house prices in recent years. More specifically, rapid population growth has been a key factor that boosted the development value of land. That also pushed the prices of many existing homes higher, especially those with larger sections that could be subdivided and on-sold. That dynamic has been particularly important in Auckland, which has tended to attract a large share of new migrants.

Now, with population growth taking a step down and the previous shortages of homes being eroded, we don't expect that population pressures will provide the same boost to prices going forward that they did in previous years. Even so, we don't expect much relief for house prices as supply increases.

While there's a lot of attention paid to the physical imbalances between housing supply and population growth, on their own those factors don't explain the magnitude of the house price increases that we've seen in recent years. Indeed, if shortages of housing were the main driver of house prices, we would have expected to see house prices moving in line with changes in rents. However, bond data from MBIE shows that nationwide rents have risen by around 50% since the end of 2014, while house prices have more than doubled over the same period.

Furthermore, the regions with the largest shortages of homes, like Auckland, have not been the regions that have seen the largest increase in rents or prices. Prices in Auckland have increased by around 90% since 2014. Over that same period, prices in Wellington have risen by more than 150%, and prices in many other regions have more than doubled.

House prices and rents (December 2014 to December 2021)



As we've discussed in previous reports, financial factors like debt servicing costs and rental returns play a larger role in determining house prices than the balance between physical demand and the supply of homes. In recent years, low interest rates have made the potential capital gains on housing assets very attractive to many investors and developers. This also helps to explain why strong house price increases have not been limited to Auckland, with prices also rising rapidly in areas that do not have the same degree of housing market tightness.

However, financial conditions are also changing rapidly as New Zealand has moved into the next phase of its post-Covid economic cycle. The Reserve Bank has begun to hike the Official Cash Rate in response to the build-up of strong inflation pressures, and we expect that they will take the cash rate into 'tight' territory over the coming years.

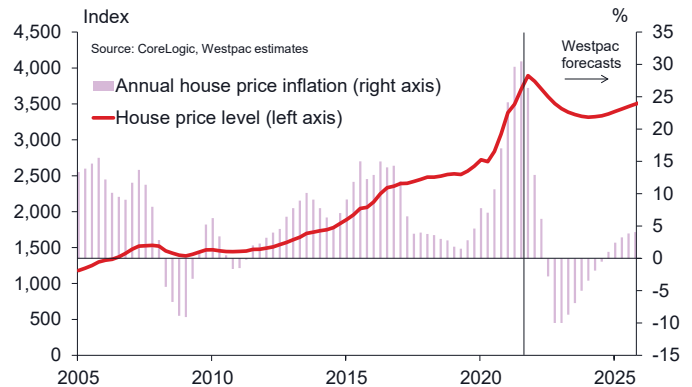
The related increases in mortgage rates have already seen the housing market turn down sharply in recent months. Nationwide prices have dropped close to 5% since November and sales numbers are now running at below pre-pandemic levels.

With mortgage rates set to continue rising over the coming year, we expect a further cooling in the housing market. We're

forecasting that nationwide house prices will drop by 10% over the course of this year and have pencilled in a further 5% decline in 2023.

But despite the expected easing in house prices, we don't expect a significant improvement in housing affordability. Average house prices have risen by around 110% since 2015, and the expected easing in prices would only offset a portion of that. In comparison, households disposable incomes have increased by around 50% since 2015. As a result, price-to-income ratios are likely to remain highly stretched across many parts of the country, and saving for a deposit will still be a significant hurdle for many families.

House prices



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