New lockdown temporarily delays interest rate rises

	Latest	Dec 2021	Dec 2022
Gross domestic product (1)	-2.3%	5.2%	1.3%
Residential consents (1)	17.8%	19.3%	1.8%
Non-residential consents (1)	13.1%	12.7%	0.0%
House prices (2)	30.0%	12.4%	1.0%
Unemployment rate (3)	4.0%	4.2%	4.0%
Net migration (4)	4,707	10,731	11,020

(1) Year-end % change (2) Three-month annual % change

(3) Quarterly level, seasonally adjusted (4) Annual total

Data source: Statistics NZ, Infometrics forecasts

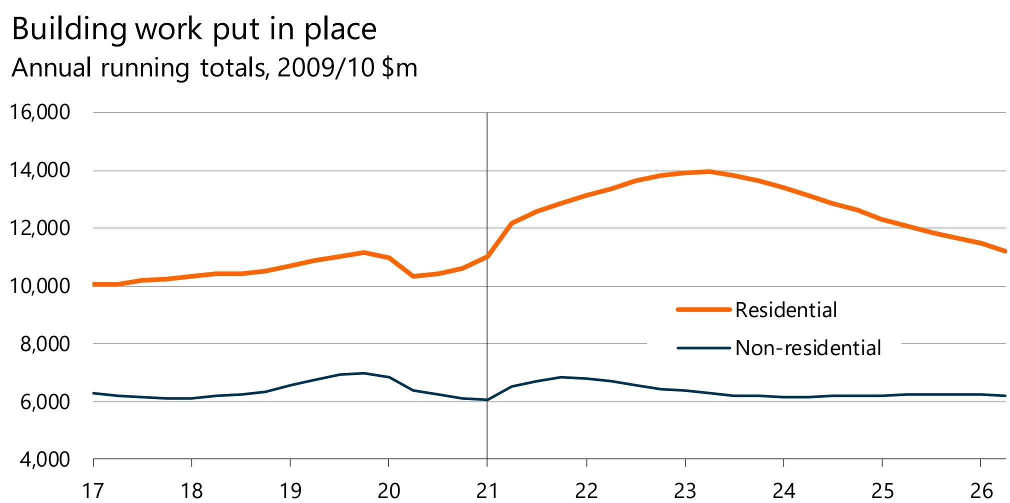
The latest Level 4 lockdown has reinforced the uncertainty and potential disruption that COVID-19 still poses for the economy. The sudden shift has seen the Reserve Bank hold off increasing the official cash rate (OCR), which was all but certain to rise in response to mounting inflationary pressures and a labour market that is operating "at or above its maximum sustainable level." The effects of the fiscal and monetary stimulus of the last 17 months are most obvious in terms of household spending outcomes, house price growth, and demand for workers. Although the current lockdown will put a temporary dampener on some of these indicators, the New Zealand economy will still face a substantial imbalance between strong demand and constrained supply when the country re-emerges from Level 4. So even though the OCR remains at 0.25% for now, it is still likely to rise by up to 1.50 percentage points by the end of 2022.

Construction demand keeps on increasing

Residential consent numbers have pushed to a new all-time high of 44,299 in the year to June. At a regional level, consents have reached record highs this year in Auckland, Waikato, Hawke's Bay, Taranaki, Manawatū-Whanganui, and Tasman. Having been fairly stable since 2016, annual house consent numbers have risen 11% over the last year to surpass their 2004 peak, while townhouse numbers have risen an incredible 44% over the same period.

Rapid house price growth, low interest rates, and strong investor demand are fuelling the residential construction boom. The supply of new housing is now running ahead of underlying demand and starting to make up for underbuilding throughout much of the last decade. However, materials and skills shortages and other capacity constraints are pushing up building costs and also mean that work is taking longer to be completed. These factors suggest that it could be late 2022 or early 2023 before residential construction activity peaks.

Non-residential consents have also performed strongly in the first half of this year, up 20% from the first half of 2020. This growth has been driven primarily by the public sector, with sizable increases in education, hospital, and social building consents. Improved investment intentions have also boosted private sector consents, most notably for factories. We expect a 12% rebound in non-residential work put in place by March 2022, and this demand indicates that non-residential activity will struggle with many of the same capacity pressures that are critically affecting the residential subindustry.



Worker shortages suggest labour cost pressures are here to stay

Construction cost inflation is showing through more strongly and rapidly in official data than we had expected. Residential costs spiked 4.6% between March and June, the largest quarterly increase since 1986. Non-residential costs lifted 3.1% (a 17-year high), while civil construction costs rose 1.9%.

Stats NZ doesn't provide any detail on the drivers of these cost increases, but the acceleration in cost inflation aligns with the pressures we have seen mounting throughout the last nine months. Materials costs have been pushed up by surging shipping costs, disrupted supply chains, and shortages of product. Labour costs have become an increasingly critical factor amid rampant demand conditions and a rapidly shrinking pool of spare labour across the economy.

International shipping costs have continued worsening over recent weeks, and other anecdotal evidence suggests that the significant upward pressure on prices for materials and componentry is not over yet. Current expectations are that the disruption behind the spike in shipping costs is unlikely to be resolved for another 12-18 months.

Nevertheless, the materials aspect of current cost pressures still looks relatively transitory when compared with the issue of the rapidly tightening labour market. The unemployment rate plunged from 4.6% to 4.0% in the June quarter and has not been lower since 2008. The NZIER's latest Quarterly Survey of Business Opinion shows that it is now the most difficult to find both skilled and unskilled workers since the question was first asked of businesses in 1975 (see our graph below), and firms are also reporting that staff turnover is at its highest since 1973. Construction has been one of the strongest industries in terms of employment growth over the last year so has clearly been drawing more workers in, but these pressures are now being felt economy-wide as spare capacity in the labour market has quickly disappeared.

The biggest concern for employers is that they have almost no ability to source workers from overseas, an approach that was a key enabler of the economy's strong growth throughout much of the last decade. The government has recently made some allowances for Recognised Seasonal Employer workers to come in for the coming summer to assist the horticulture and viticulture industries. However, the closed borders mean that other industries are effectively being forced to employ only New Zealanders (who might lack suitable skills or might not be work-ready) or achieve productivity improvements with their current workforce, possibly through investment in labour-saving technologies. Neither option appears to be viable for businesses trying to deal with immediate demand pressures.

Even when the borders reopen, growth in the working-age population will remain below pre-pandemic levels. Although the government's immigration "reset" lacks specific policy details, Infometrics expects net migration by 2024-2026 to be closer to 30,000pa than the 50,000-60,000pa that prevailed in the second half of the 2010s. Most projections see the unemployment rate holding at or below 4% over the medium term, indicating persistent tightness in the labour market.

During 2022 and 2023, there are additional downside risks to net migration and the availability of workers. A return towards more "normal" travel and living conditions internationally could lead to a jump in the number of young New Zealanders heading offshore, having previously had to put their OEs on hold for the last two years. An MBIE survey of returnees coming through quarantine also showed that 24% of people are likely to leave again once the international COVID-19 situation improves. And the lack of certainty and poor treatment given to foreigners in New Zealand on temporary visas could undermine New Zealand's ability to attract workers from overseas as the pandemic recedes, particularly if travel to New Zealand remains restricted for a significantly longer period than in other countries.

In some senses, construction is in a better space to meet future demand than other industries given the big lift in training numbers over the last year. However, the rapidly tightening labour market means that competition for workers will be intense across the economy, and labour costs are likely to continue rising as firms pay more to attract and retain staff.