

# NEW ZEALAND ECONOMICS ANZ PROPERTY FOCUS

JULY 2010

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## TRICKLE-DOWN ECONOMICS

### SUMMARY

Our monthly *Property Focus* publication is aimed at providing an independent appraisal of recent developments in the property market. This month we look at the impact of the leaky homes syndrome.

### THE MONTH IN REVIEW

The real estate market remains in limbo, even after uncertainties surrounding the *Budget* have been clarified. Longer-term fixed mortgage rates have eased in July – which, while good news for borrowers, is really a reflection of nervousness towards global growth prospects (which has driven wholesale interest rates lower).

### PROPERTY GAUGES

While house prices increased in June (a comforting factor for the RBNZ in terms of the required normalising of monetary policy), the general trend over 3 months is flat at best. It's hard to see this picture changing anytime soon with weekly mortgage approvals for the first week in July looking even softer than in June.

### ECONOMIC BACKDROP

There is no doubt that the economy is recovering. However, the pace of the recovery looks to have shifted back a gear. The economy still has momentum but it is patchy, soft and an aura of uncertainty remains. We continue to use the term “bathtub with waves” to describe the recovery process. A number of global developments, such as a strong Chinese economy are positive for NZ. Inc. But at the same time we are seeing growing concerns over the risk of a double-dip recession in the US, which urges caution. These sorts of dichotomies look set to continue for a while yet.

### MORTGAGE BORROWING STRATEGY

Floating rates have increased and longer fixed rates have fallen substantially in the past month. This has seen the difference between fixed and floating rates contract substantially. This raises the obvious question – is it worth fixing now that fixed rates have come down? With so much uncertainty about, especially in relation to the state of the housing market, we still favour the much lower floating rates.

### FEATURE ARTICLE – LEAKY HOMES IMPACT

“Leaky homes” relates to the lack of weather tightness for residential buildings. The potential macroeconomic impacts of leaky homes are examined by combining details from the Budget 2010 package, with other information at hand. Leaky homes are a cost to the economy. While remedial work will provide a boost to economic activity, this will be offset by weaker household spending. As leaky homes are a cost-shock, it would lead to higher inflation, with the exact magnitude depending on who picks up the bill and how they fund it.

# THE MONTH IN REVIEW

## SUMMARY

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## SNZ BUILDING CONSENTS – MAY

The seasonally adjusted number of new dwellings (ex-apartments) authorised fell by **9.5 percent in May**, partly offsetting the (downwardly revised) 13.4 percent rise in April. **The value of non-residential consent issuance fell 11.4 percent** in seasonally adjusted terms in May, with the drop being attributable to much weaker consent issuance for government related buildings, most notably hospitals and schools.

Not much singing in the rain from the building sector.

## REINZ HOUSING DATA – JUNE

House sales fell by 4.1 percent in seasonally adjusted terms. **Sales volumes remain considerably below year ago levels and are at historically low levels** as a portion of the dwelling stock. House prices rose 1.6 percent in seasonally adjusted terms in June (we prefer to use the housing price index rather than the REINZ median prices). House prices in the three months to June were down 0.3 percent on three months earlier. **The median days to sell figure continued to climb, reaching 44 days – the highest level since April 2009.** This suggests buyers are still somewhat reluctant to commit, with sellers having to leave their houses on the market for longer to achieve a sale.

Buyers remain wary of dipping their toes in the water.

## RBNZ MORTGAGE LENDING – MAY

Household credit growth (which includes housing and consumer lending) held steady at 0.2 percent for the third consecutive month. Compared to a year ago, household credit growth is 2.5 percent higher. **Mortgage lending growth increased by 0.3 percent in the month**, with the three-month annualised change lifting to 3.4 percent — its highest rate of increase in seven months.

The covers are off but a resumption in play is still some way off.

## FIXED MORTGAGE RATES - JULY

**Fixed term mortgage rates dropped in the early part of July.** This was in response to a fall in swap rates, which have eased to a 13 month low due to heightened global economic growth concerns.

Rained on and reined off.

## ASSESSMENT

The June REINZ housing report provides an opportunity to assess the impact of the *Budget* on the housing market. The low number of sales and rising days to sell suggests that **the clearing of uncertainty in relation to the tax treatment of housing has not translated into higher optimism for the housing market.** The June Official Cash Rate hike by the RBNZ may have encouraged an increasing degree of cautiousness. While house prices rose in the month of June, the trend in prices remains down, with prices in the 3 months to June 0.3 percent lower than the March quarter average. House price increases have tended to be in the more expensive suburbs, whereas house prices in the cheaper suburbs are flat to falling. This sort of picture sounds somewhat discerning if you are a housing investor but we need to remember two dynamics. Static house prices is not a bad outcome considering we are still seeing the after-effects of the global financial crisis. **Subdued domestic (housing) activity is all part of the inevitable rebalancing process for the economy.** A booming housing led recovery would be the *coup de grâce* on a double-dip recession.

After six months in a leaky boat, house prices are lucky just to keep afloat.

## PROPERTY GAUGES

While house prices increased in June (a comforting factor for the RBNZ in terms of the required normalising of monetary policy), the general trend over 3 months is flat at best. It's hard to see this picture changing anytime soon with weekly mortgage approvals for the first week in July looking even softer than in June.

We use ten gauges to assess the state of the property market, and for signs that changes are emerging.

**AFFORDABILITY.** For new entrants into the housing market, we measure affordability using the ratio of house prices-to-income (adjusted for interest rates), and mortgage payments as a proportion of income.

**SERVICEABILITY / INDEBTEDNESS.** For existing homeowners, serviceability relates interest payments to income, while indebtedness is measured as the level of debt relative to income.

**INTEREST RATES.** Interest rates affect both the affordability of new houses and the serviceability of existing mortgage payments.

**MIGRATION.** A key source of demand for new housing.

**SUPPLY-DEMAND BALANCE.** We use dwelling consents issuance to proxy supply. Demand is derived via the natural growth rate in the population, net migration, and the average household size.

**CONSENTS AND HOUSE SALES.** These are both key gauges of activity in the property market.

**LIQUIDITY.** We look at growth in Private Sector Credit relative to GDP to assess the availability of credit in supporting the property market.

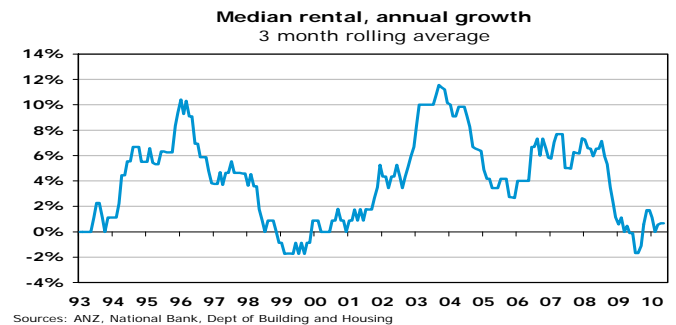
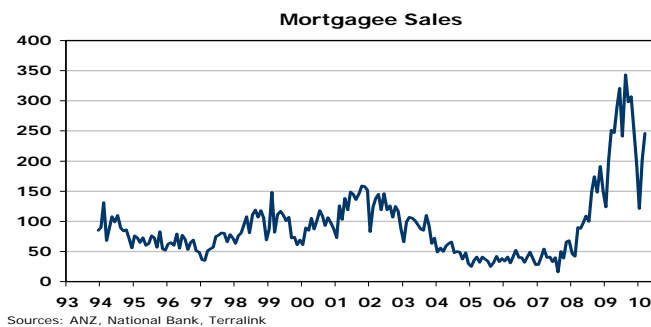
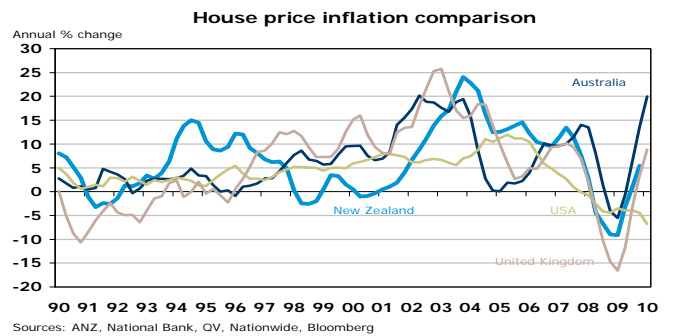
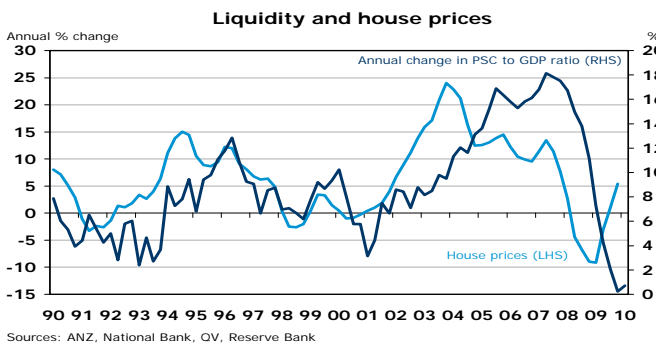
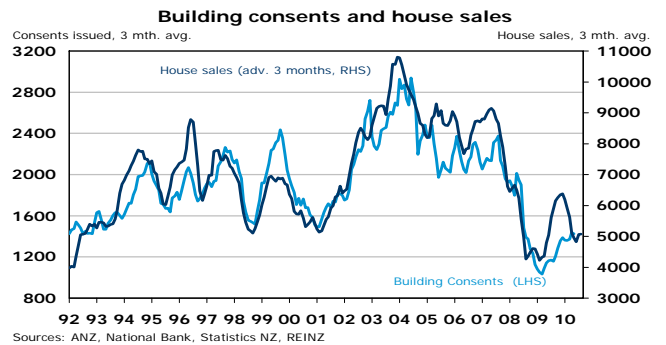
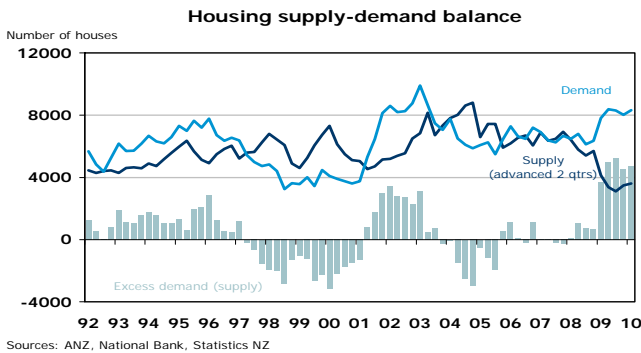
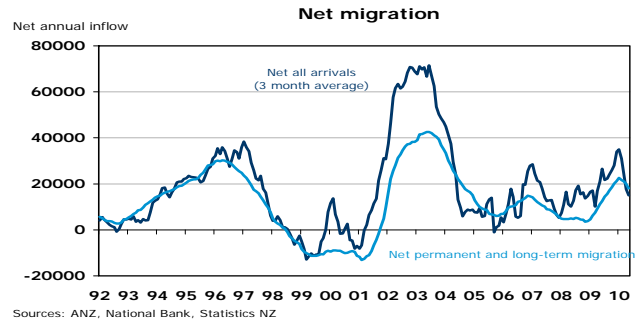
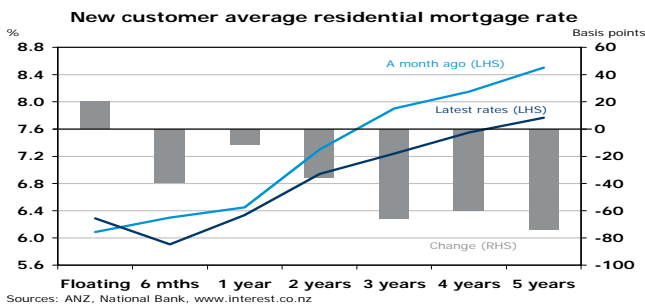
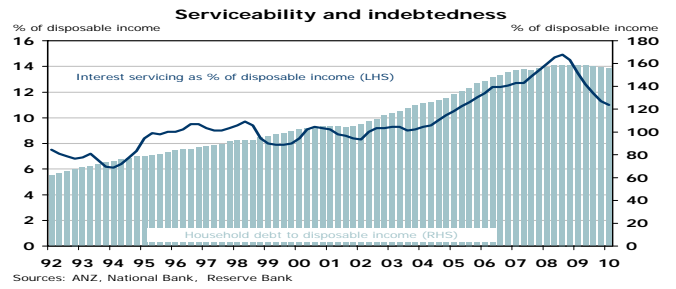
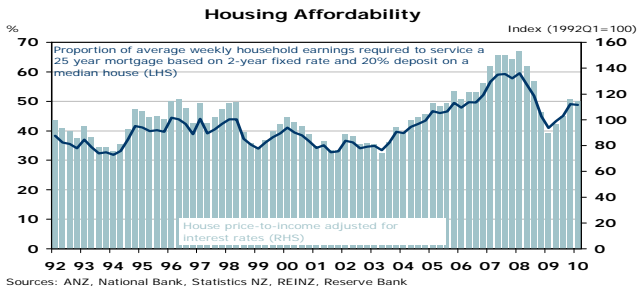
**GLOBALISATION.** We look at relative property price movements between New Zealand, the US, UK and Australia in recognition of the important role that globalisation is playing in NZ's property cycle.

**MORTGAGEE SALES.** We look at how mortgagee sales are tracking for an indication of distress in the property market.

**RENTAL GROWTH.** We look at growth in the median market rent as an indication of whether it is a better time to buy versus rent, and how rental yields are shaping up for the property investor.

Indicator	Level	Direction for prices	Comment
Affordability	Improvement likely	↔/↓	Lower interest rates will eventually aid affordability.
Serviceability / indebtedness	Easing	↓	Borrowers continue to pay down debt.
Interest rates	Flattening	↔/↓	Longer-term fixed mortgage rates have eased but floating moving up.
Migration	Easing	↔	How long before the flow dries up?
Supply-demand balance	Out of kilter	↔/↑	The jaws remain wide open – but beware the bite down.
Consents and house sales	Headwinds ahead	↔/↑	Housing indicators running out of puff.
Liquidity	Illiquid	↓	Still treading water.
Globalisation	Lagging behind	↔	Gung-ho in Australia. Gung-no in the US.
Mortgagee sales	Rebound	↔	Ticked back up.
Median rent	Still flat	↔	Renters can breathe easy, for the time being.
On balance		↔/↓	House prices increased in the month, but the general trend over the last 3 months, compared to March, is flat.

# PROPERTY GAUGES



## ECONOMIC BACKDROP

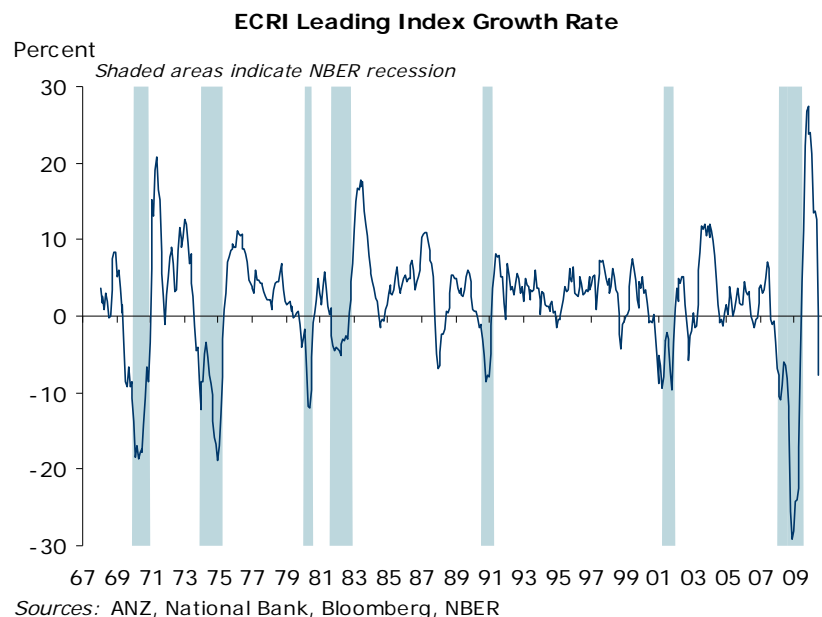
There is no doubt that the economy is recovering. However, the pace of the recovery looks to have shifted back a gear. The economy still has momentum but it is patchy, soft and an aura of uncertainty remains. We continue to use the term “bathtub with waves” to describe the recovery process. A number of global developments, such as a strong Chinese economy are positive for NZ.Inc. But at the same time we are seeing growing concerns over the risk of a double-dip recession in the US, which urges caution. These sorts of dichotomies look set to continue for a while yet.

### OUR CORE ECONOMIC VIEW

**Recent economic data has tended to undershoot expectations**, and highlights that the recovery is more gradual compared to past cycles. The latest NZIER *Quarterly Survey of Business Opinion* was the latest indicator to highlight this theme, showing a fall in business confidence. But we would characterise the survey results as the reality of a slower recovery dawning on businesses, as opposed to the recovery itself coming under threat. The former was always the endgame given the realities of working through a decade of consumer (debt driven) excesses. Or put more succinctly, you don't get out of a financial crisis in the space of 18 months.

**The economy continues to receive support** from strong commodity prices (although dairy prices have eased of late), strong demand from Asia which is benefiting the forestry sector and an upturn in manufacturing activity (albeit off lows). The labour market looks to be firming, although with the Australian unemployment rate massively below New Zealand's, the temptation to cross the ditch is seeing our net migration inflow slow to a trickle. **At the other end of the spectrum we have a very weak domestic economy.** Retailing and housing continue to face headwinds in the form of a consumer that continues to de-leverage. While in the near-term de-leveraging is a growth suppressant, it's the critical ingredient for a durable upswing to take hold. So rather ironically we take some comfort from the squeeze that continues to pervade in key sectors. Net on net the economy is moving forward, but at a subdued pace.

**The past few weeks has seen a change in global sentiment, and while NZ is far away from where global ructions are centred, it is difficult to divorce prospects for NZ.Inc from what is occurring around the globe.** In some areas, such as China, the economy remains strong. This in turn is supporting commodity prices, although they have weakened of late. But more recently ructions in some OECD nations have increased speculation about prospects for a double dip. Equity bourses remain heavy. The ECRI leading index<sup>1</sup> for the US has fallen sharply and is currently at a rate that has been consistent with recessions in the past. US housing market data slumped. Freight rates, as measured by the Baltic Dry Index, have fallen 60 percent since the recent peak in late May, and it looks to be more than simply the addition of new shipping capacity.



<sup>1</sup> The ECRI leading index is a timely high-frequency indicator of US economic growth based on financial and other data, compiled by the Economic Cycle Research Institute.

## ECONOMIC BACKDROP

**Credit markets have also been volatile**, with credit spreads tending to widen. But key barometers of liquidity remain fairly stable. For example, 5 year credit default swap spreads (or CDSs as they are known, which are analogous to bond spreads) for the "Big Four" Australian banks have widened by around 15bps over the past month. However, USD 3 month LIBOR remains steady, and while there were concerns that the expiry of one of the ECB's long-term refinancing transactions early in the month may have led to a dramatic spike higher in EURIBOR, in the event the rise was extremely muted. Markets certainly seem nervous, but have not (yet) been overcome by utter panic.

**It hasn't all been one way traffic but any "good" news has generally been ignored**, with the market focusing and reacting primarily to the negative data or newsflow. The AUD has been all over the place, which is probably a reasonable proxy for what investors' thoughts are: which is sheer and utter confusion.

**While tempting to jump on the double dip band wagon, we'll suffice with two quick observations:**

- **You don't get out of a global financial crisis in 18 months**, so we shouldn't be surprised to see some palpitations across markets from time to time.
- **There is an element of the blind leading the blind at work.** Lead (soft) indicators have been well correlated with equities for the past three years. Equity markets have come under downward pressure, which results in a softening in the lead indicators, which in turn sets off another round of equity market weakness. This doesn't mean we should slavishly ignore the equity market. But we should also be cognisant of the fact that equities have a bad track record of predicting recessions. Global lead indicators have indeed turned, but so far the easing has been mild when we overlay it on trading partner growth for NZ (although there are undoubtedly lags at play).

**In our January *Property Focus* we outlined our Key Macro Themes for 2010.** One of the themes we identified was what we thought would be the five distinct stages in the economic cycle. The first stage was the so-called "old normal" (2002 to 2007), where growth was driven by excessive leverage and risk taking, which led to asset price bubbles and artificial wealth-induced spending. Stage two saw the inevitable purging that followed such excesses over 2008 and 2009. The third stage was the recovery process courtesy of policy stimulus and an inventory fillip. Stage four was what we referred to as transition where the combination of growth payback (deleveraging), the implementation of so-called exit strategies and various other structural changes (i.e. regulation, leadership versus populism) curtailed the trend rate of growth over a number of years. Stage five was the endgame where the decision taken in the transition stage (good and bad) would determine economic performance over the coming decade.

**We suspect a fair bit of what we are seeing at present merely reflects the transition stage as the reality of change sinks in.** Markets naturally seek to push the boundaries in either direction, sometimes to extremes. So now the bears seem to have the upper paw. We'd characterise it more succinctly as people being simply too optimistic a few months back and the danger is that the reciprocal occurs. This doesn't mean we ignore the warning signs. But we have to be aware that the market tends to swing too far in either direction. The spirit of our "bathtub with waves" cycle still seems to apply when we look at the global scene and New Zealand economy.

**For New Zealand, this means we continue to look for growth over the coming year, but the recovery process is likely to be protracted relative to history.** Slowly the building blocks to a strong upswing are moving into place. It simply looks like a 2011 story, as opposed to a 2010 dynamic to us.

# MORTGAGE BORROWING STRATEGY

While floating rates have increased, fixed rates have fallen substantially in the past month, led by the long end. This has seen the difference between fixed and floating rates contract substantially. This raises the obvious question – is it worth fixing now that fixed rates have come down? With so much uncertainty about, especially in relation to the state of the housing market, we still favour the much lower floating rates.

## OUR VIEW

**Floating mortgage rates rose in June in the wake of the RBNZ's OCR increase, but most fixed rates fell, mirroring substantial falls in wholesale rates.** The spread between floating and fixed mortgage rates fell for most terms as a result, but it remains high by historical standards. Indeed, although the gap between the floating rate and the 2 year rate has contracted by over half a percent, the gap remains wide at close to 1 percent. Excluding the last 6 months, that's as wide as the gap has been in 10 years, and compares to an average gap over the past decade of minus 0.6 percent. Not surprisingly, only a small number of borrowers have been prompted to fix their rates following the recent cuts. Generally speaking we tend to agree with this behaviour. Fixing provides certainty, but when it comes at a considerable cost it is far less attractive, particularly given uncertainties elsewhere. It's one thing to pay a certainty premium when the housing market is booming, but it's another thing entirely when the housing market is in the doldrums.

Mortgage Rates		Breakevens			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.95%				
6 months	6.10%	6.80%	7.17%	7.93%	7.75%
1 year	6.45%	6.99%	7.55%	7.84%	7.90%
18 months	6.69%	7.30%	7.62%	7.91%	8.05%
2 years	7.00%	7.41%	7.73%	8.02%	8.20%
3 years	7.30%	7.68%	7.98%	8.17%	8.25%
4 years	7.60%	7.87%	8.08%		
5 years	7.75%				

**Regular readers will be familiar with our breakeven analysis.** Cashflow and affordability are crucially important considerations when it comes to choosing a term. Similarly, it is important that borrowers incorporate plans to increase or decrease borrowing into interest rate decisions. But beyond these considerations, we have not found a better way to compare rates than breakeven analysis. By comparing the choices available, breakeven analysis provides a set of figures showing where rates need to be in future to make two strategies equivalent, enabling better choices. For example, when thinking about the next 2 years, there are several choices you might consider if you wanted to fix. For example, you might consider fixing for 2 years; fixing for 1 year, and then for another year in 1 year; or fixing for 6 months, and then again in 6 monthly intervals over the remaining 18 months, and so on. Breakeven analysis allows you to compare these strategies against one another. For example, when compared to fixing for 2 years at 7.00%, if you did fix for 1 year at 6.45%, breakeven analysis shows that you would need to be able to re-fix at 7.55% in one year's time for the split strategy to be the better one. The question is, do you think the 1 year rate will rise by 1.1% in the next year? We think it's a line call. We certainly expect the OCR to move higher over the next year, but it will do so only gradually, suggesting if you do "beat the market", it may not be by much. Fixing for 2 years therefore looks a little expensive.

**While breakeven analysis is useful when comparing fixed terms, it is less helpful when choosing between fixed and floating.** Because there are so many possibilities when you go floating – you can fix at any time – it's more difficult to do scenario analysis. But pragmatism would suggest that if the RBNZ were to raise the OCR by another 25bps at the end of July, as we expect, chances are the floating rate will go up by a similar amount. And with the floating rate only 15bps below the 6 month rate, this makes the 6 month rate a fairly attractive proposition.

While remaining floating or fixing for a much shorter period (like 6 months) will leave you more exposed to rising interest rates, two things are worth bearing in mind. The first is that the term structure of interest rates already has an upcoming OCR rise "built" into it, which is why fixing for a long period costs more. Therefore,

## MORTGAGE BORROWING STRATEGY

when choosing whether or not to fix, your decision should not be made against where rates are now, but rather against where the market expects rates to be in future. If you think rates will rise more quickly than the market, paying fixed might be worthwhile. But when the market is "pricing in" hefty rate hikes as it is now (our analysis shows that the market expects 3 rate hikes by December), then fixing may be less attractive.

The second point relates to the slope of the curve, or the gap between floating and fixed rates. As we noted earlier, in the past this has tended to be reasonably small, and often negative. This meant fixing often meant paying a lower rate, at least initially. However, extreme caution on the part of global investors has seen a large rise in the term premium, and this has come at a time when regulatory changes are encouraging banks to lengthen the term of their own funding. The end result is a significantly steeper yield curve, and that favours depositors over borrowers. Instead of being "rewarded" for borrowing money (with easy access to loans at rates well below the pace of capital gains in housing), households are now being rewarded for putting money in bank term deposits. This has, and will continue to lead to fundamental changes in borrower behaviour.

# LEAKY HOMES IMPACT

## SUMMARY

“Leaky homes” relates to the lack of weather tightness for residential buildings. The potential macroeconomic impacts of leaky homes are examined by combining details from the Budget 2010 package, with other information at hand. Leaky homes are a cost to the economy. While remedial work will provide a boost to economic activity, this will be offset by weaker household spending. As leaky homes are a cost-shock, it would lead to higher inflation, with the exact magnitude depending on who picks up the bill and how they fund it.

## THE PROBLEM

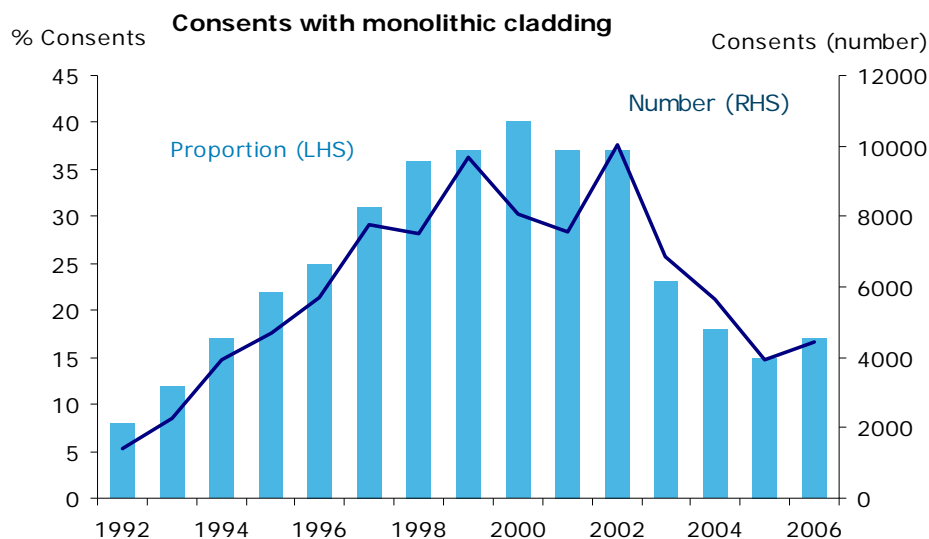
Under The Building Act 1991, which came into force in 1992, monolithic cladding (coated sheets which give the appearance of concrete, masonry or plaster) could be used as an alternative to timber or masonry. Untreated timber was also allowed for framing from 1996. These building materials were subsequently found to be more susceptible to watertightness issues, and building regulations were progressively tightened from 2005. Subsequent building inspections revealed a sharp drop-off in leaky buildings for dwellings constructed from 2007 onwards. However, the damage had already been done.

## HOW MANY DWELLINGS ARE AFFECTED?

**The scale of the problem is potentially very large.** Approximately 330,000 dwelling consents were issued from 1992 to 2006. Of this, nearly 30 percent were for monolithic clad dwellings.

As at 31 March 2010, the Weathertight Homes Resolution Service (WHRS) had received claims and completed assessments for nearly 8,000 properties. Claims were highest in the Auckland region (around 2,000 from Auckland city alone).

In making projections based on claims lodged, PricewaterhouseCoopers (PWC) estimated the number of potential failures could range between 22,000 and 89,000 dwellings. **The central estimate of 42,000 is approximately 2.5 percent of the total dwelling stock or around 10 percent of all houses built since 1992.** The wide error bands around the PWC projections illustrate considerable uncertainties involved. It can take several years before problems surface (the median lag from construction to a problem being reported has been found to be 8 years).



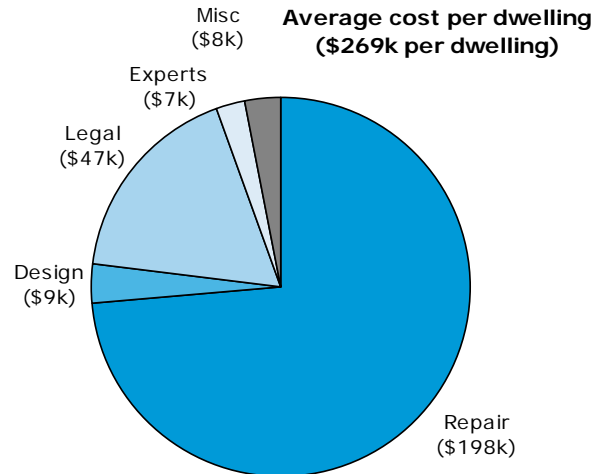
Source: WHRS, PWC, ANZ, National Bank, Statistics New Zealand

## WHAT ARE THE POTENTIAL COSTS?

**Leaky buildings are expensive to remedy as in many cases the structure and some contents are beyond salvageable repair.** WHRS estimates put the average cost per dwelling at around \$270,000 (in 2008\$). Only 70 percent of the total cost is for remedial building work, with legal fees, design and other

## LEAKY HOMES IMPACT

consultancy fees making up the balance. Even when claims are settled via mediation (i.e. for claims below \$20k), there is likely to be a legal cost involved.



Source: PWC, ANZ, National Bank

**Assuming 42,000 dwellings are affected, the PWC report estimates the total economy-wide cost of leaky buildings at \$11.3bn (6 percent of GDP).** Depending on how many homes are affected, the total cost could range from \$6bn to \$24bn. Aside from assumptions on the number of dwellings affected, the assumed costs are very sensitive to a number of other assumptions. For example, if the estimated failure rate of monolithic dwellings was 20 percent lower, PWC estimate the total cost would be \$8.5bn, rather than \$11.3bn.

### WHO CARRIES THE COST?

This is the \$64,000 (or should it be \$11.3bn) question.

**Leaky home owners have some recourse** through the WHRS Act 2006 and the Consumer Guarantees Act (1993). Legally, any party who owes a duty of care may be brought into proceedings. This can include builders, building companies, sub-contractors (i.e. plumbers, electricians, and landscapers), architects and councils.

**Nevertheless, there are hurdles to overcome:**

- **Legal costs can be significant.** To show that a party is liable under negligence, it must be proven that the party owes a duty of care to the homeowner, that duty has been breached, and damage has resulted. Even for less expensive claims (those less than \$20,000 are usually settled via mediation) legal representation is usually needed.
- **The time horizon for claims is also limited.** Under current law, homeowners must report problems to the WHRS within 10-years of construction date to be eligible for compensation. Current estimates suggest that around one-third of dwellings are likely to fall outside this window, with the cost of repair being solely borne by the owner.
- It is also common to find that when parties are brought into account for their liability, they may not be in a suitable position from which to contribute. PWC estimate less than 5 percent of the total cost will be incurred by builders/developers.
- Furthermore, even if owners successfully obtain a favourable settlement, these are well below the claimed amount meaning the owner is still considerably out of pocket.

### BUDGET 2010 PROPOSAL

One of the policy announcements occurring around the time of the 2010 *Budget* was a new package to partly compensate affected homeowners. According to the new package, government and local councils would each contribute 25 percent of the cost of repair, with homeowners coughing up the remaining 50 percent.

# LEAKY HOMES IMPACT

The details of the package are as follows:

- Compensation would not be provided to the 5,000 or so households who have already repaired their dwellings (see following section for further details).
- Councils will not contribute in cases where outside or outsourced building certifiers have approved sub-standard work.
- Homeowners would only qualify for assistance if their claim is received within ten years of construction. It is estimated that less than 24,000 dwellings would still be eligible.
- Homeowners cannot sue their council for approving faulty work, but can continue to sue other parties involved.
- Funds to homeowners will be provided through Government guaranteed bank loans.

Table 1 shows a rough breakdown of the costs under the proposed plan compared to the total costs of leaky buildings. Households are assumed to bear the full cost of repair if it falls outside the eligibility criteria for government assistance. This is likely to slightly overstate the burden on households and understate that on councils (and other parties) as some households have managed to obtain some form of compensation.<sup>2</sup>

Table 1: Distribution of costs			
	% Cost	\$bn	% Income
Latest proposal: 23,500 dwellings			
Homeowners	50	3.2	3.3
Local authorities	25	1.6	23.4
Central Government	25	1.6	2.5
Total	100	6.3	3.4
Total costs: 42,000 dwellings			
Homeowners	72	8.1	8.6
Local authorities	14	1.6	23.4
Central Government	14	1.6	2.5
Total	100	11.3	6.2
Income: Household Disposable Income, Total Local Authority Revenue, Total Crown Revenue, Nominal GDP respectively.			
Sources: PWC, Statistics NZ, ANZ, National Bank.			

**Our estimates show that nearly three-quarters of the total costs will be borne directly by affected households.**

## WHAT IS THE ECONOMIC IMPACT?

### Past impacts

**Some of the repairs have occurred already.** PWC estimates suggest up to 3,500 repairs took place up to the end of 2008, but these are approximate, as remedial work to correct leaky buildings did not require a building consent from March 2005 till March 2008. It is likely that the actual figure could be considerably higher and we assume that around 5,000 dwellings have already had remedial work done. **Assuming costs are proportionate to the PWC estimate, nearly \$1.3bn has already been spent on leaky buildings since 1992, with around \$1.0bn being spent on building work alone.**

### Future impacts

**Of the 37,000 remaining dwellings, nearly two-thirds (23,500) are covered by the new scheme.** The following assumptions are used:

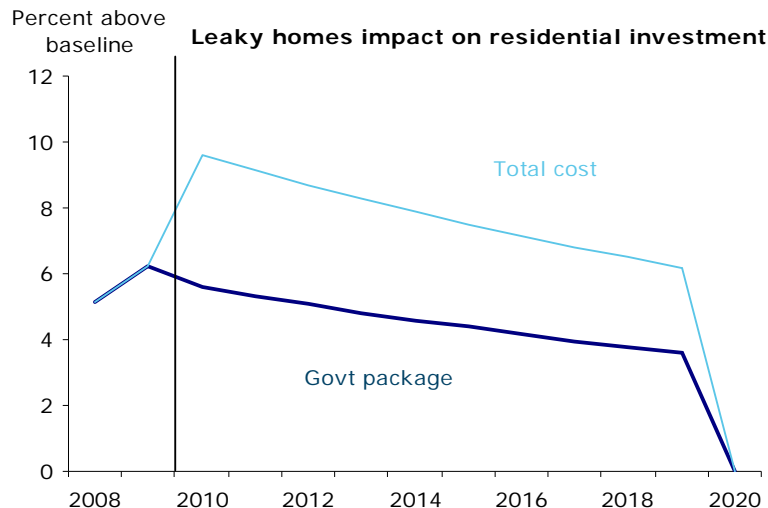
- All households covered by the scheme take part.

<sup>2</sup> In March, the Court of Appeal awarded in favour of apartment owners on a leaky home claim against the North Shore City Council.

## LEAKY HOMES IMPACT

- Repair work on these dwellings would not divert work from other areas<sup>3</sup>. Recognising that spare capacity in the construction sector is limited, we assume the repair work will be spread over the next 10-years, an average of 2,350 dwellings per annum.

The boost to construction sector activity would be in the order of \$600m in 2008 dollars, or around 0.2 percent of GDP per annum over the next decade. As some homeowners may not be able to afford the loan repayments to the government, take up of the scheme may be smaller than what we assume.



Source: PWC, Statistics NZ, ANZ, National Bank.

However, there are 13,500 buildings not covered by the new offer. If all the affected dwellings are repaired over the next 10 years (3,700 per year), the value of repairs is equivalent to 0.3 percent of GDP per annum.

While construction sector activity is bound to benefit from the remedial work, **most of the costs will be borne by the household sector. Owners affected by leaky homes will be significantly out of pocket, and this is likely to weigh down on consumer spending.**

Costs	Cost	Effect on Consumption	% GDP pa
<b>Balance sheet impact</b>	-\$8.1bn	-\$440m to -\$610m	Up to -0.1%*
<b>Debt servicing</b>			
Households in govt scheme (23,500)	-\$3.16bn	-\$245m pa	-0.1%
Non-govt scheme (18,500)	-\$4.97bn	-\$385m pa	-0.2%
<b>Total</b>	<b>-\$8.1bn</b>	<b>-\$630m pa</b>	<b>-0.3%</b>

\*Estimated short-run impact on GDP. The average impact on GDP each year is smaller.

Sources: PWC, Statistics NZ, ANZ, National Bank.

In assessing the effects on consumer spending, we examine two different approaches:

- Consumption will fall by the impact on balance sheet wealth. **Household wealth is assumed to decline by the value of repairs borne by households (\$8.1bn according to table 1). This is about 1.3 percent of total net household wealth** (roughly \$625bn according to RBNZ estimates). Recent RBNZ

<sup>3</sup> The low number of dwelling consents being issued (which currently equates to an addition of 16,000 dwellings to the housing stock each year as opposed to the 26,000 consents issued in 2007), which suggests (all else equal) some additional capacity.

## LEAKY HOMES IMPACT

research places the long-run marginal propensity to consume from housing wealth in the region of 5.4 to 7.5 percent. This implies a fall of between \$440m to \$610m, less than 0.05 percent of GDP per annum if spread over the next decade. The short-run impact will be up to a 0.1 percent hit to GDP for the first year.

- The impact on consumption for affected households will be commensurate with the costs of borrowing to fund the repair work. Of the 42,000 affected households, 23,500 are eligible for government assistance and are assumed to borrow to fund the \$134k cost each. The remainder are assumed to borrow to fund the full cost of repairs (\$269k). The aggregate debt servicing cost, assuming a borrowing duration of 25 years and a mortgage interest rate of 6 percent, would be approximately \$630m, or 0.3 percent of GDP per annum.

**These two estimates are likely to show extreme ends of the scale.** The actual impact on consumption is likely to fall somewhere in-between. Funding the cost of repairs will significantly impact on cashflow of affected households and weigh on discretionary spending, which implies a bigger consumption impact than implied by the balance sheet channel alone. Conversely, the consumption impact will be more modest than implied by debt servicing costs, given affected households may prefer to cut down on precautionary saving rather than fully absorb the hit to spending. There are also sizeable distributional effects involved, with higher spending from builders, lawyers and consultants likely to provide a partial offset.

As leaky homes are a cost to the economy, the net impact is likely to boost inflation. **However, the impact on inflation would depend on who picks up the bill and how they fund it.** If, for example, local authorities fund one quarter of the cost for repairing 23,500 homes and fund this by lifting local authority rates over a 10-year period, this would equate to a 4.0 percent increase in residential and commercial rates each year for the next 10-years (or a 6 percent annual increase if councils fund one quarter of the cost of repairing 42,000 dwellings). This would directly add 0.1 percent to annual CPI inflation (0.2 percent for a 6 percent increase in rates). Higher local authority rate charges would also flow through into higher rent charges and could conceivably add a further 0.1 percent per annum to annual inflation. The impact of the remedial work on construction sector capacity could also lead to higher CPI construction costs. Offsetting this will be the impact of a lower level of GDP from the lower consumption impact.

**Table 3: Summary of impacts**

Impact	Magnitude
Activity impact	
Residential Investment	+6.3% pa
Consumption	-0.6% to -0.1% pa
GDP	+0.2% pa to -0.3% pa
Inflation impact	
Total CPI impact	+0.2 to +0.3% pa
<i>Sources: ANZ, National Bank, Statistics NZ</i>	

### References

PricewaterhouseCoopers (2009), Weathertightness - Estimating the Cost, Report for the Department of Building and Housing (29 July).

<http://www.dbh.govt.nz/UserFiles/File/News/WHRS/pdf/PWC-weathertightness-estimating-cost-full-report.pdf>

De Veirman and Dunstan (2008), "How do Housing Wealth, Financial Wealth and Consumption Interact? Evidence from New Zealand", RBNZ Discussion Paper DP2008.

## KEY FORECASTS

Weekly mortgage repayments table (based on 25-year term)

		Mortgage Rate (%)													
		5.75	6.00	6.25	6.50	6.75	7.00	7.25	7.50	7.75	8.00	8.25	8.50	8.75	9.00
Mortgage Size (\$'000)	200	290	297	304	311	319	326	333	341	348	356	364	371	379	387
	250	363	371	380	389	398	407	417	426	435	445	455	464	474	484
	300	435	446	456	467	478	489	500	511	522	534	545	557	569	581
	350	508	520	532	545	558	570	583	596	610	623	636	650	664	677
	400	580	594	608	623	637	652	667	682	697	712	727	743	758	774
	450	653	669	684	701	717	733	750	767	784	801	818	836	853	871
	500	725	743	761	778	797	815	833	852	871	890	909	928	948	968
	550	798	817	837	856	876	896	917	937	958	979	1000	1021	1043	1064
	600	870	891	913	934	956	978	1000	1022	1045	1068	1091	1114	1137	1161
	650	943	966	989	1012	1036	1059	1083	1108	1132	1157	1182	1207	1232	1258
	700	1015	1040	1065	1090	1115	1141	1167	1193	1219	1246	1273	1300	1327	1355
	750	1088	1114	1141	1168	1195	1222	1250	1278	1306	1335	1364	1393	1422	1451
	800	1160	1188	1217	1246	1274	1304	1333	1363	1393	1424	1454	1485	1517	1548
	850	1233	1263	1293	1323	1354	1385	1417	1448	1480	1513	1545	1578	1611	1645
	900	1306	1337	1369	1401	1434	1467	1500	1534	1567	1602	1636	1671	1706	1742
950	1378	1411	1445	1479	1513	1548	1583	1619	1655	1691	1727	1764	1801	1838	
1000	1451	1486	1521	1557	1593	1630	1667	1704	1742	1780	1818	1857	1896	1935	

Housing market indicators for June 2010 (based on REINZ data)

	House prices (Ann % change)	3mth % chng	No of sales (s.a.)	Mthly % chng	Avg days to sell (s.a)	Comment
Northland	-9.7	0.6	98	(-21%)	53	Largest drop in the number of sales in June
Auckland	2.3	-3.0	1,644	(-6%)	38	The shortest time to sell a house
Waikato/BOP/Gisborne	1.0	-0.8	604	(-9%)	61	Lowest number of sales for 18 months
Hawke's Bay	1.8	1.2	175	(0%)	57	Days to sell above 50 for first time in a year
Taranaki	-1.2	-2.2	236	(+4%)	64	Sub-average annual price growth for 1 year
Manawatu-Wanganui	5.1	-3.0	144	(-5%)	62	Third strongest annual price growth
Wellington	8.1	-0.1	523	(-1%)	43	All indicators better than the national average
Nelson-Marlborough	3.6	0.1	180	(-14%)	41	Annual price growth close to national average
Canterbury/Westland	10.2	1.2	735	(+4%)	41	Annual price growth above NZ avg for 3 mths
Otago	-6.3	0.8	102	(+46%)	70	Largest percentage rise in sale numbers
Central Otago Lakes	3.9	-1.1	212	(-6%)	41	Joint second fastest region to sell a house
Southland	-10.6	-3.2	114	(-10%)	43	The weakest annual rate of growth in prices
NEW ZEALAND	3.7	-1.4	4,752	(-4%)	44	Buyers remain cautious

## Key forecasts

Economic indicators	Actual			Forecast						
	Sep 09	Dec 09	Mar 10	Jun 10	Sep 10	Dec 10	Mar 11	Jun 11	Sep 11	Dec 11
GDP (Ann Avg % Chg)	-2.4	-1.6	-0.4	0.8	2.1	2.7	3.0	3.4	3.4	3.9
CPI Inflation (%)	1.7	2.0	2.0	1.9	1.7	4.8	5.0	5.6	5.3	3.0
Unemployment Rate (%)	6.5	7.1	6.0	6.3	6.0	5.6	5.4	5.0	4.9	4.9
Interest rates	Actual			Forecast (end month)						
	May 10	Jun 10	Latest	Sep 10	Dec 10	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12
Official Cash Rate	2.50	2.75	2.75	3.25	3.25	3.50	4.00	4.50	5.00	5.50
90-Day Bank Bill Rate	2.9	3.2	3.2	3.5	3.5	3.9	4.4	4.9	5.4	5.8
Floating Mortgage Rate	6.0	6.3	6.3	6.8	6.8	7.0	7.5	8.0	8.3	8.6
1-Yr Fixed Mortgage Rate	6.3	6.4	6.4	6.5	6.5	6.9	7.3	7.8	8.2	8.4
2-Yr Fixed Mortgage Rate	7.2	7.3	7.0	7.1	7.2	7.4	7.8	8.2	8.5	8.6
5-Yr Fixed Mortgage Rate	8.5	8.5	7.8	7.9	8.0	8.2	8.3	8.8	8.9	8.9

## IMPORTANT NOTICE

### NEW ZEALAND DISCLOSURE INFORMATION

The Bank (in respect of itself and its principal officers) makes the following investment adviser disclosure to you pursuant to section 41A of the Securities Markets Act 1988.

The Bank (in respect of itself and its principal officers) makes the following investment broker disclosure to you pursuant to section 41G of the Securities Markets Act 1988.

### Qualifications, experience and professional standing Experience

The Bank is a registered bank and, through its staff, is experienced in providing investment advice about its own securities and, where applicable, the securities of other issuers. The Bank has been selling securities, and providing investment advice on those securities, to customers as a core part of its business for many years, drawing on the extensive research undertaken by the Bank and its related companies and the skills of specialised staff employed by the Bank. The Bank is represented on many bank, finance and investment related organisations and keeps abreast of relevant issues by running seminars and workshops for relevant staff and having its investment adviser staff attend external seminars where appropriate. The Bank subscribes to relevant industry publications and, where appropriate, its investment advisers will monitor the financial markets.

### Relevant professional body

The Bank is a member of the following professional bodies relevant to the provision of investment advice:

- New Zealand Bankers Association;
- Associate Member of Investment Savings & Insurance Association of NZ;
- Financial Markets Operations Association; and
- Institute of Finance Professionals.

### Professional indemnity insurance

The Bank (and its subsidiaries), through its ultimate parent company Australia and New Zealand Banking Group Limited, has professional indemnity insurance which covers its activities including those of investment advisers it employs.

This insurance covers issues (including 'prior acts') arising from staff fraud, electronic crime, documentary fraud and physical loss of property. The scope of the insurance also extends to third party civil claims, including those for negligence. The level of cover is of an amount commensurate with the size and scale of the Bank.

The insurer is ANZcover Insurance Pty Limited.

### Dispute resolution facilities

The Bank has a process in place for resolving disputes. Should a problem arise, you can contact any branch of the Bank for more information on the Bank's procedures or refer to any of the Bank's websites.

Unresolved complaints may ultimately be referred to the Banking Ombudsman, whose contact address is PO Box 10-573, Wellington.

### Criminal convictions

In the five years before the relevant investment advice is given none of the Bank (in its capacity as an investment adviser and where applicable an investment broker) or any principal officer of the Bank has been:

- Convicted of an offence under the Securities Markets Act 1988, or the Securities Act 1978 or of a crime involving dishonesty (as defined in section 2(1) of the Crimes Act 1961);
- A principal officer of a body corporate when that body corporate committed any of the offences or crimes involving dishonesty as described above;
- Adjudicated bankrupt;
- Prohibited by an Act or by a court from taking part in the management of a company or a business;

- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;
- Expelled from or has been prohibited from being a member of a professional body; or
- Placed in statutory management or receivership.

### Fees

At the time of providing this disclosure statement it is not practicable to provide accurate disclosure of the fees payable for all securities that may be advised on. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

### Other interests and relationships

When a security is sold by the Bank, the Bank may receive a commission, either from the issuer of a security or from an associated person of the Bank. Whether that commission is received and, if received, its value depends on the security sold. At the time of providing this disclosure statement it is not practicable to provide a detailed list of each security that may be advised on, the name of the issuer of that security and the rate of the commission received by the Bank. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

In addition to the interest that the Bank has in products of which it is the issuer, the Bank, or an associated person of the Bank, has the following interests or relationships that a reasonable person would find reasonably likely to influence the Bank in providing the investment advice on the securities listed below:

- ANZ Investment Services (New Zealand) Limited (ANZIS), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. ANZIS may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- UDC Finance Limited (UDC), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. UDC may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- ING (NZ) Holdings Limited (ING), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. ING and its related companies, including ING (NZ) Limited, may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- Direct Broking Limited (DBL), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. DBL may receive remuneration from a third party relating to a security sold by the Investment Adviser.

### Securities about which investment advice is given

The Bank provides investment advice on the following types of securities:

- Debt securities including term and call deposits, government stock, local authority stock, State-Owned Enterprise bonds, Kiwi bonds and corporate bonds and notes;
- Equity securities such as listed and unlisted shares;
- New Zealand and overseas unit trusts;
- Share in a limited partnership;
- Superannuation schemes and bonds;
- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
- Other forms of security, such as participatory securities.

### PROCEDURES FOR DEALING WITH INVESTMENT MONEY OR INVESTMENT PROPERTY

If you wish to pay investment money to the Bank you can do this in several ways such as by:



## IMPORTANT NOTICE

- Providing cash;
- Providing a cheque payable to the relevant product or service provider and crossed 'not transferable'; or
- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

Investment property (other than money) may be delivered to the Bank by lodging the relevant property (for example, share certificates) with any branch of the Bank offering a safe custody service, or by posting (using registered post) the documents or other property to a branch of the Bank, identifying your name, account number and investment purpose.

Any investment money lodged with the Bank for the purchase of securities offered by the Bank, its subsidiaries or any third parties will be deposited in accordance with your instructions, to your nominated account or investment. Such money will be held by the Bank according to usual banking terms and conditions applying to that account or the particular terms and conditions relating to the investment and will not be held by the Bank on trust unless explicitly accepted by the Bank on those terms. Any investment money or property accepted by the Bank on trust will be so held until disbursed in accordance with your instructions. Any investment property lodged with the Bank will be held by the Bank as bailee according to the Bank's standard terms and conditions for holding your property.

### Record Keeping

The Bank will keep adequate records of the deposit of investment moneys or property and all withdrawals and dealings with such money or property, using the account/investment number allocated to your investment. You may have access to those records upon request.

### Auditing

The Bank's systems and operations are internally audited on a regular basis. The financial statements of the Bank and its subsidiaries are audited annually by KPMG. However, this does not involve an external audit of the receipt, holding and disbursement of the money and other property.

### Use of Money and Property

Money or property held by the Bank for a specific purpose communicated to the Bank (e.g. the purchase of an interest in a security) may not be used by the Bank for its own purposes and will be applied for your stated purpose. No member of the Bank's staff may use any money or property deposited with the Bank, for their own purposes or for the benefit of any other person. In the absence of such instructions, money deposited with the Bank may be used by the Bank for its own purposes, provided it repays the money to you upon demand (or where applicable, on maturity), together with interest, where payable.

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