

## Housing slowdown Inflation

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### Summary

- > The monthly *Property Focus* publication is aimed at providing investors and prospective homeowners with an independent appraisal of recent developments in the property market, as well as our favoured mortgage borrowing strategy. In this issue, we present two feature articles. One is on the regions with greater exposure to the more speculative aspects of the property market – sections and apartments. The other looks at the typical anatomy of a housing market slowdown.

### The month in review (page 2)

- > The housing market and consumer spending are moving in the right direction for the Reserve Bank. But with no inflation headroom, stimulus from the Government and booming commodity prices, interest rate settings will remain restrictive until the Bank sees reduced inflation pressures.

### Property gauges (page 3)

- > The real estate market is still receiving support from liquidity and restricted supply. But affordability measures remain over-extended, and high mortgage rates are having an impact on housing market activity.

### Economic backdrop (page 5)

- > A strong first half performance from the NZ economy has increased the inflation risks facing the Reserve Bank. While growth is expected to slow over the remainder of the year, with little inflation headroom, the Reserve Bank will maintain restrictive interest rate settings until it is convinced that its job is done.

### Mortgage borrowing strategy (page 6)

- > A more persistent inflation theme leaves us more circumspect towards interest rates. Upside risks to inflation are being countered by signs the housing market is slowing and the turn in the credit cycle. The 2- to 3-year part of the curve looks to be the sweet spot.

### Feature article – Vulnerability or a sign of confidence? (page 7)

- > Sections and apartments are often talked about as the most vulnerable parts of the property market. We rank the regions according to who has the most sections and apartments for sale. Southland is tops, but is this potentially a sign of strength? A lot of New Zealand's regional "sun" and retirement spots also feature as "vulnerable".

### Feature article – Anatomy of a housing slowdown (page 9)

- > Activity in the housing market has slowed sharply in recent months. This would typically translate into an eventual reduction in pressure on non-tradable inflation (the Reserve Bank's desired end-game). We present a series of charts that illustrate how this may occur, and note some challenges to the traditional model.

### Key forecasts (page 11)



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## The month in review

**The housing market and consumer spending are moving in the right direction for the Reserve Bank. But with no inflation headroom, stimulus from the Government and booming commodity prices, interest rate settings will remain restrictive until the Bank sees reduced inflation pressures.**

**Domestic demand and pressures on the housing market continue to ease...**

- > **REINZ housing data – September.** Housing market activity softened further in September, with house sales down 6.2 percent to 6,163 in seasonally adjusted terms and days to sell up to 34 (seasonally adjusted). House prices posted a small increase to \$351,500. House prices are up 12.3 percent on a year ago, but only two percent since the Reserve Bank started hiking in March.
- > **Retail sales – July.** Another soft month for retail spending, with headline sales flat and core sales (which exclude vehicle-related industries) down 0.2 percent. Much of the weakness in July comes from spending on durable goods, which is an indication that interest rate increases are having an impact.
- > **External migration – August.** There was a seasonally adjusted net inflow of 750 people in the month. While this is up slightly on the 470 net inflow recorded in July, annual net migration flows continue to trend lower (down to 8,730 for the year to August). The slowing in net migration will take further pressure off the housing market, a development that the Reserve Bank will welcome.
- > **Building Consents – August.** Residential building consents rebounded in August (up 5.8 percent seasonally adjusted) after recording a sharp fall in July. The increase in some Local Authority fees for consent applications on 1 July has heightened volatility. Trend measures, which look through the volatility, suggest a softening, and over the past six months, the number of ex-apartment consents has been relatively flat – a better reflection of underlying residential consent activity.
- > **Mortgage lending - August.** Growth in lending to households eased to 0.9 percent for the month of August, despite there being five Fridays in the month (which would usually boost lending figures).
- > **Reserve Bank Monetary Policy Statement.** The Reserve Bank left the Official Cash Rate (OCR) unchanged at 8.25 percent, as widely expected. Inflation pressures are still a concern for the Bank, but these are offset by signs of a slowing domestic economy and uncertainty surrounding the global economic environment.
- > **Gross Domestic Product – June quarter.** GDP grew a stronger than expected 0.7 percent in the June quarter. The stronger outturn and upward historical revisions mean economic activity, and therefore pressures on the economy, are more intense than the Reserve Bank was expecting. This data, coupled with burgeoning food-related inflation and subsiding credit fears, means a further rate hike cannot be ruled out.

**...giving the Reserve Bank some comfort.**

**But resource pressures remain intense...**

## Assessment

Interest rate increases earlier this year are biting, and this is now coming through in the data relating to the housing market and consumer spending. The Reserve Bank is taking some comfort from this, but they cannot afford to relax yet. In an environment with a distinct lack of inflation headroom, the strength of demand (with the associated pressure on resources) in the first half of the year and strong near-term inflation pressure coming from food and energy related prices, will keep them very wary. The Reserve Bank needs to see the slowdown in the housing market translating through into reduced pressure on non-tradable inflation, including housing inflation and construction costs. Until they see this, interest rate settings will remain restrictive.

**...and it is too early for the Reserve Bank to relax.**

## Property gauges

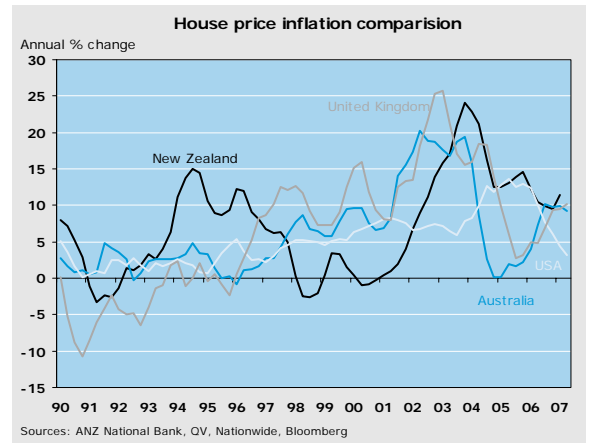
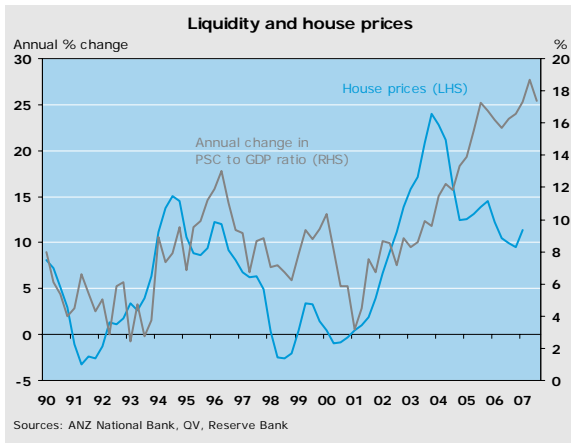
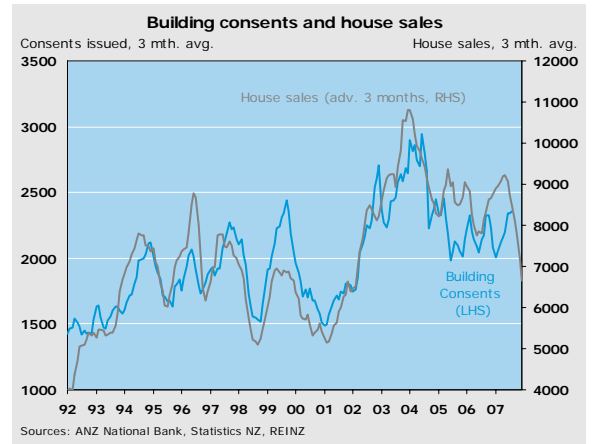
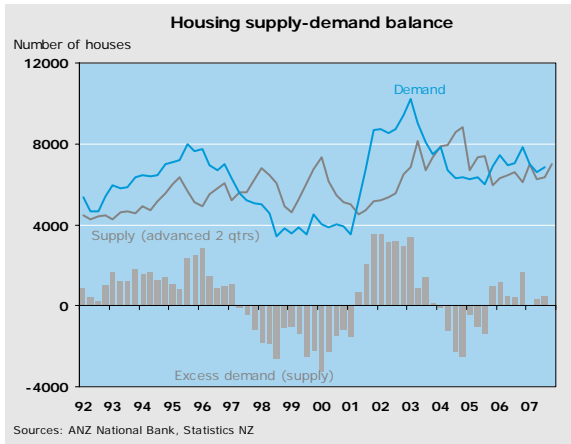
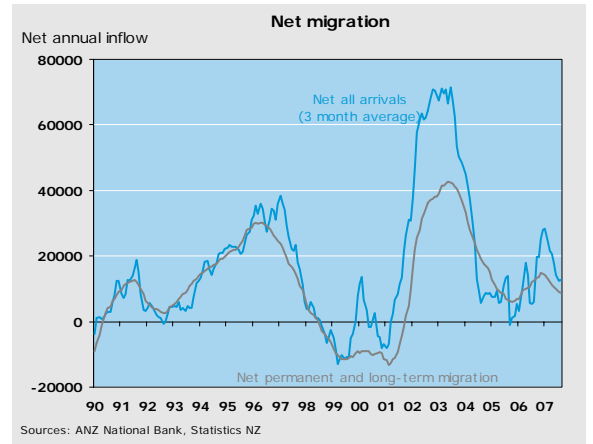
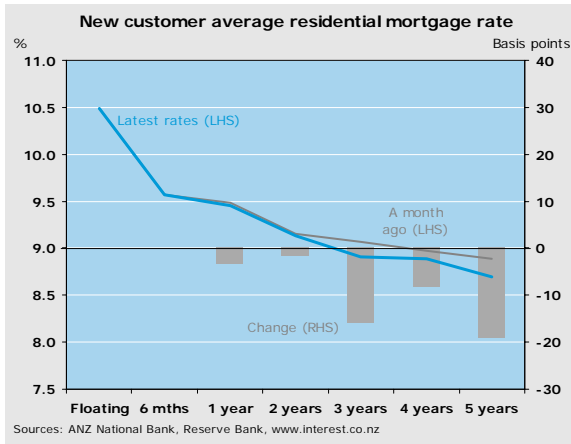
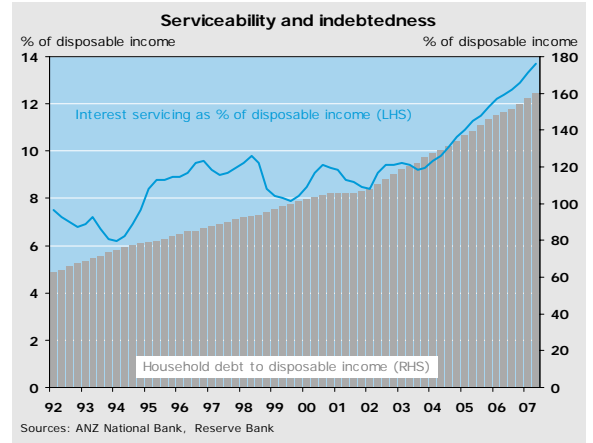
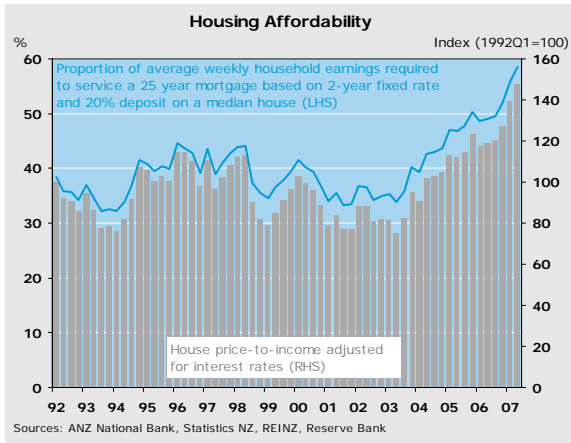
**The real estate market is still receiving support from liquidity and restricted supply. But affordability measures remain over-extended, and high mortgage rates are having an impact on housing market activity.**

We use eight gauges to assess the state of the property market, and whether warning signs are emerging.

- > **Affordability.** For new entrants into the housing market, we measure affordability using the ratio of house prices-to-income (augmented 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.

The housing market and consumer spending are slowing. The Reserve Bank will now be looking for signs that this slowdown is translating into reduced inflation pressure from the non-tradables sector. They will remain cautious until they see conclusive evidence of this.

Indicator	Level	Direction for prices	Comment
Affordability	Expensive	↓	Price increases are showing signs of slowing and mortgage rates are stabilising. But affordability remains at extremely expensive levels.
Serviceability / indebtedness	High	↓	Household indebtedness and the debt servicing burden keep hitting new highs and show no signs of consolidating yet.
Interest rates	High	↓	Some relief coming through in the form of lower longer-term fixed rates over the past month, although they remain well north of their historical averages. Rate cuts from the Reserve Bank are some way off still.
Migration	Medium	↔/↓	Migration inflows continue to slow.
Supply-demand balance	Neutral	↔	Close to balance, in line with slowing migration inflows.
Consents and house sales	Consents stable, sales softening	↔	Looking through recent volatility, ex-apartment consent issuance has been stable. Sales volumes are falling.
Liquidity	High	↑/↔	Liquidity remains abundant, and while global events have stabilised recently, changes to attitudes towards risk suggest diminished appetites to lend could be pending.
Globalisation	Cheap in world terms	↑	On a relative basis, NZ property is still cheap.
<b>On balance</b>		↓	<b>RBNZ is winning, but can't relax yet.</b>



## Economic backdrop

**A strong first half performance from the NZ economy has increased the inflation risks facing the Reserve Bank. While growth is expected to slow over the remainder of the year, with little inflation headroom, the Reserve Bank will maintain restrictive interest rate settings until it is convinced that its job is done.**

### > Our core economic view.

Two themes are dominating the outlook at present – inflation and the credit cycle. The outlook for inflation remains uncomfortably high. The Reserve Bank's September *Monetary Policy Statement* reinforced the lack of inflation headroom available to the Bank. The New Zealand economy expanded strongly over the first half of 2007, with data released in late September recording a stronger-than-expected 0.7 percent growth rate in the June quarter. This came on the heels of an upwardly revised 1.2 percent increase in March, and has raised the annual rate of growth to 3.2 percent (well up on the modest one percent annual growth recorded a year ago). The strength in economic activity over the first half of the year has increased the near-term inflationary risks facing the economy. Stronger-than-expected growth implies tighter resource pressure and raises the prospects of more cost-push inflation from an already tight labour market. In addition, food price inflation and surging global oil prices pose further upside risks at a time when the Reserve Bank already faces very limited inflation headroom.

While strong, the growth recorded in the first half of the year was not balanced, with domestic demand solid but net exports detracting from growth. More timely data and forward looking indicators suggest that economic activity will slow over coming quarters. Higher mortgage rates are still flowing through into the housing market, and have started to bite. Consumer spending has eased, the housing market has slowed, and borrowing growth is moderating. The Reserve Bank has a relatively blunt instrument at its fingertips. At present it is having success slowing housing activity. But it needs to see this diffuse through the wider economy, at a time the dairy sector is booming. If the aggregate economy does not slow through such diffusion and inflation does not subside, the housing market could feel the brunt of further interest rate adjustments.

As we have noted previously, the turn in the global credit cycle has seen risk being re-assessed and re-priced. For New Zealand, as a net borrower, this leaves us very vulnerable to changes in risk appetites and certain leveraged pockets appear very exposed to the altered credit environment. A surprise 50 basis point rate cut from the Fed last month has gone a long way towards improving sentiment, risk appetites have improved and there has been some easing in the restrictive conditions in credit markets. But while the easing in pressure has mitigated some of the risk to the New Zealand economy, global financial markets remain edgy, and we remain very wary of the impact of the credit cycle in certain leveraged pockets of the economy.

In this environment the Reserve Bank (and other central banks) faces a delicate balancing act – weighing up heightened inflation pressure, credit risks and forward looking indicators that suggest economic activity will slow over the coming quarters. The lack of inflation headroom looks like it will tie the Reserve Bank's hands and official interest rates look set to remain on hold for some time. It will be a testing time for monetary policy.

**Inflation risks are rising.**

**The slowdown needs to broaden beyond the housing market.**

**Credit worries persist, despite recent easing.**

**The Reserve Bank faces a delicate balancing act, and inflation concern is likely to dominate.**

## Mortgage borrowing strategy

**A more persistent inflation theme leaves us more circumspect towards interest rates. Upside risks to inflation are being countered by signs the housing market is slowing and the turn in the credit cycle. The 2- to 3-year part of the curve looks to be the sweet spot.**

### > Our view

We have shifted to a more neutral stance towards the Reserve Bank. While we still harbour concerns on some levels (e.g. the credit cycle), a more persistent inflation theme will have the Reserve Bank on alert. With credit markets improving (mitigating some of the downside risks facing the New Zealand economy) and inflation pressures intensifying, we have pushed out our expectations for the timing of the start of the Official Cash Rate easing cycle. We now expect the start of the Reserve Bank's easing cycle in late 2008.

As discussed on page 5, the inflation risks facing the economy have intensified over recent weeks, the "starting point" for the economy (reflected in H1 growth) is stronger, and some of the credit concerns that clouded the economic outlook have eased. On balance, these changes in the economic environment have been sufficient to move us back to a more neutral view of the outlook for the Official Cash Rate. Our interest rate forecasts still contain an easing profile, with cuts from late 2008, but the underlying spirit is one of official interest rates being high and restrictive for some time.

Borrowers need to be aware of these issues at present:

- Inflation is becoming more persistent.
- The Reserve Bank is likely to be cautious in such an environment, making sure inflation is well and truly contained before easing. It is likely to take an accident of sorts to kick-start an early easing cycle.
- Weakness in housing may not be sufficient to contain inflation in an environment where cost pressures are significant, and inflation expectations are uncomfortably high. The response of wage and price setting behaviour to cost pressures and a higher inflation rate in the near-term will be critical. The year ahead is likely to provide a fundamental test of the monetary policy framework.

### > Themes we favour in the current environment

With the Official Cash Rate unlikely to be lowered any time soon, mortgage borrowers should not expect much relief in floating or shorter-term borrowing rates. While these remain at current levels (9½ percent plus), their attractiveness will be limited to those borrowers who require the increased flexibility that they offer.

There is presently nowhere for mortgage borrowers to hide. While five year mortgage interest rates have eased over the past month, they remain well above their historical average, and there would appear to be little advantage from borrowing at this part of the curve except to pick up some (relatively short-term) cash-flow advantages. In the current environment, rates in the middle part of the fixed rate mortgage curve still appear to offer the best combination of flexibility against lower relative cost.

- **Take a balanced (diversified) approach.** A balanced approach to spread risk by having exposure to different parts of the mortgage yield curve.
- **We are more inclined to 2 to 3-year rates given recent developments.** With the OCR likely to be kept high for longer, these rates appear to offer a reasonable balance between cost and flexibility.
- **We continue to struggle to see value in the 5-year rate at present.**

**Heightened inflation risks and a stabilising credit environment now make early rate cuts unlikely.**

**There is nowhere to hide in the current interest rate environment.**

## Feature article – Vulnerability or a sign of confidence?

**Sections and apartments are often talked about as the most vulnerable parts of the property market. We rank the regions according to who has the most sections and apartments for sale. Southland is tops, but is this potentially a sign of strength? A lot of New Zealand's regional "sun" and retirement spots also feature as "vulnerable".**

The section and apartment sectors of the property market – traditionally more speculative areas – are often touted as being the pockets that are the most vulnerable at this stage in the property cycle.

Higher interest rates or changes in the credit cycle often mean that these pockets can experience large price swings, relative to other types of property, as demand wanes. But what regions have all the sections and apartments on the market?

It makes little sense to look at apartments and sections in isolation because if you don't have much land, you end up building more apartments. So we have derived a crude indicator that uses both, based on data from the Trade Me website (which provides easy access to this type of data). The table on the following page shows the number of sections and apartments for sale, relative to the total number of properties on the market, across all the regions and ranks them from highest to lowest.

### > So what does it show?

- The region at the top of the list is also the one facing some large positive stimuli. Southland, a key dairy region and potential Norway of the South Pacific, has over half of its properties for sale as either sections or apartments. Based on REINZ data, Southland is also the hottest region at the moment with median days to sell a property at just 19 days, nearly half the NZ-wide figure of 34 days. Although there are a high number of sections for sale, they don't stay unsold for long!
- A holiday or retirement destination theme is also present. Popular locations for the family bach and retirement, namely Thames/Coromandel, Taupo, Tasman, Northland, and Queenstown all have a high exposure. These regions have experienced significant expansion and price growth over this latest cycle. However, we also note that others with the same characteristics (the Bay of Plenty areas (mid-table), Kapiti Coast and Hawke's Bay (lower third)) do not rank as highly. Is this suggesting supply may have got ahead of itself in the first group?
- In terms of the Auckland region, the city ranks highly (large number of apartments), but the majority of areas within greater Auckland are in the lower quartile, potentially reinforcing the significant impact that restricted land development from respective councils may be having.
- Other features include West Coast at number 7 (a lot of sections for Pike Coal employees), and Christchurch City near the bottom.

### > The upshot

Some regions of the country are currently more heavily exposed to the section and apartment sector of the property market. As interest rates are at elevated levels, and further pipeline tightening is likely to come through the effective mortgage rate, these regions are possibly more vulnerable to a more protracted slowdown than those regions with limited exposure. However, it may not be all bad news. Regions such as Southland – which is benefiting from high dairy prices and potential oil exploration – have a high exposure. This may just mean they are more confident about the future.

## Number of sections and apartments for sale relative to total properties for sale

Rank	Region	%	Rank	Region	%	Rank	Region	%
1	Southland	50.4	15	Nelson City	29.6	29	Waimakariri	14.5
2	Queenstown Lakes	43.5	16	Marlborough	29.3	30	Waitakere	14.3
3	Tasman	43.4	17	Rodney	28.7	31	Kapiti Coast	14.3
4	Northland – Far North	40.5	18	Whakatane	27.4	32	Hawke's Bay	13.0
5	Auckland City	37.0	19	Hauraki	25.6	33	Manawatu/Wanganui	12.5
6	Thames/Coromandel	34.8	20	Western BoP	24.9	34	Franklin	12.5
7	West Coast	33.8	21	Tauranga City	22.0	35	Timaru	10.6
8	Central Otago ex Qtwn	33.1	22	Kaikoura	21.4	36	Manukau City	10.0
9	Northland – Whangarei	32.9	23	Dunedin City	19.6	37	Papakura	9.7
10	Taupo	32.3	24	North Shore City	19.4	38	Christchurch City	8.8
11	Gisborne	31.0	25	Selwyn	16.7	39	Rotorua	7.1
12	Waitaki	31.0	26	Upper Hutt	15.2	40	Lower Hutt	4.2
13	Wellington City	30.7	27	Hamilton City	15.1			
14	Hurunui, Hanmer	30.3	28	Taranaki	15.1			

## Feature article – The anatomy of a housing market slowdown

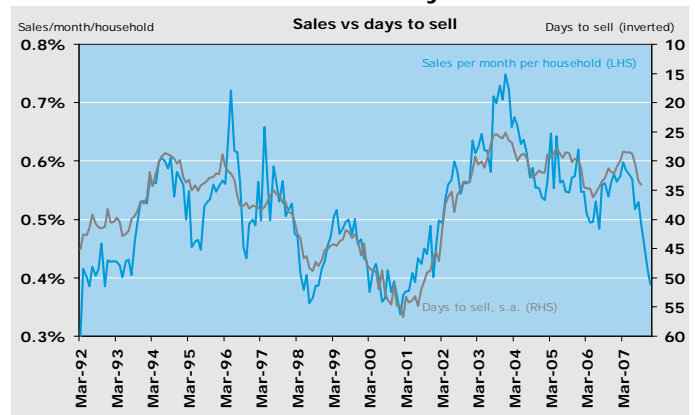
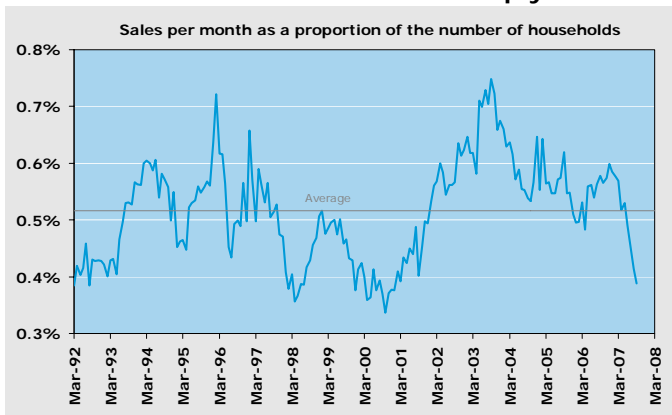
Activity in the housing market has slowed sharply in recent months. This would typically translate into an eventual reduction in pressure on non-tradable inflation (the Reserve Bank’s desired end-game). We present a series of charts that illustrate how this may occur, and note some challenges to the traditional model.

The housing cycle is a key influence on New Zealand’s economic cycle. Seldom are the two out of step. Traditionally, lower house sales has led to an increase in the number of days to sell, softer prices, and reduced construction activity. This has taken pressure off construction costs and led to a decline in non-tradable inflation. This is the Reserve Bank’s desired end-game.

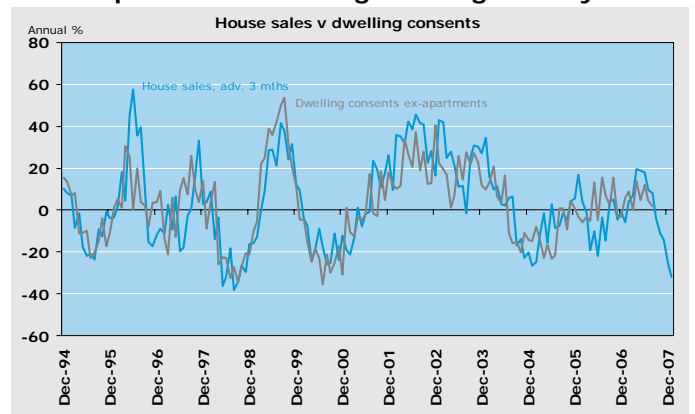
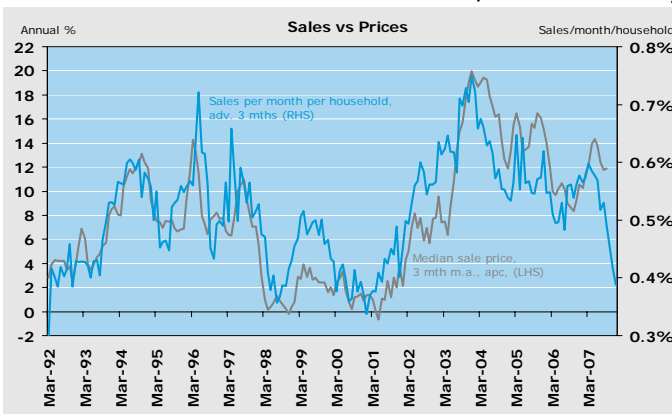
The challenge to the traditional model is coming from other economic stimulus in the form of sharp improvements in New Zealand’s terms of trade, courtesy of booming commodity (dairy) prices, and the prospect of fiscal stimulus in the 2008 (election year) *Budget*. There are also additional inflation pressures from food prices and the costs associated with meeting New Zealand’s emission targets.

The economy is in a delicate stage where weak housing activity needs to spill over into the broader economy at a time support is pending from other sectors. For the central bank and housing investor this means challenging times.

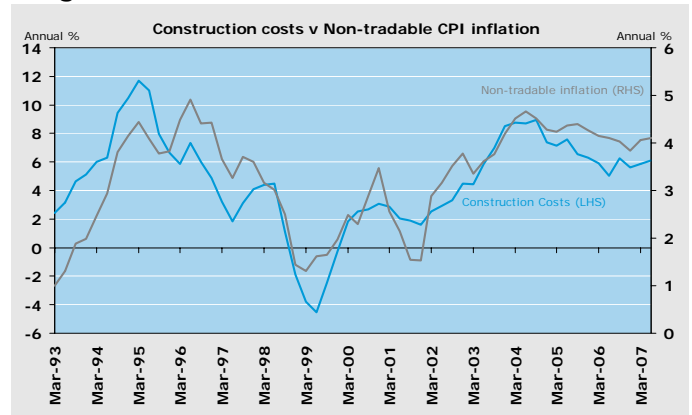
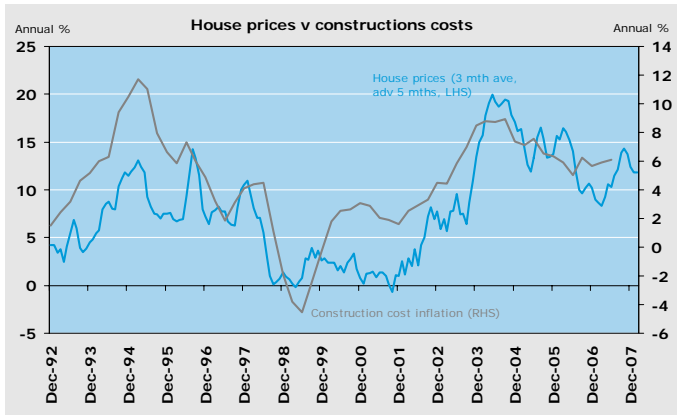
### House sales have fallen sharply...which should lead to further increases in days to sell...



### Prices tend to fall a little later, but when they do, and coupled with declining building activity...



... they point to softer construction cost inflation and reduced pressure on non-tradable inflation – the RBNZ's end-game.



## Statistical Annex

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

Mortgage Size (\$'000)	Mortgage Rate (%)														
	7.50	7.75	8.00	8.25	8.50	8.75	9.00	9.25	9.50	9.75	10.00	10.25	10.50	10.75	
100	170	174	178	182	186	190	194	197	201	205	210	214	218	222	
150	256	261	267	273	279	284	290	296	302	308	314	320	327	333	
200	341	348	356	364	371	379	387	395	403	411	419	427	435	444	
250	426	435	445	455	464	474	484	494	504	514	524	534	544	555	
300	511	522	534	545	557	569	581	592	604	616	629	641	653	666	
350	596	610	623	636	650	664	677	691	705	719	733	748	762	777	
400	682	697	712	727	743	758	774	790	806	822	838	855	871	887	
450	767	784	801	818	836	853	871	889	907	925	943	961	980	998	
500	852	871	890	909	928	948	968	987	1007	1027	1048	1068	1089	1109	
550	937	958	979	1000	1021	1043	1064	1086	1108	1130	1153	1175	1198	1220	
600	1022	1045	1068	1091	1114	1137	1161	1185	1209	1233	1257	1282	1306	1331	
650	1108	1132	1157	1182	1207	1232	1258	1284	1310	1336	1362	1389	1415	1442	
700	1193	1219	1246	1273	1300	1327	1355	1382	1410	1438	1467	1495	1524	1553	
750	1278	1306	1335	1364	1393	1422	1451	1481	1511	1541	1572	1602	1633	1664	
800	1363	1393	1424	1454	1485	1517	1548	1580	1612	1644	1676	1709	1742	1775	
850	1448	1480	1513	1545	1578	1611	1645	1679	1713	1747	1781	1816	1851	1886	
900	1534	1567	1602	1636	1671	1706	1742	1777	1813	1849	1886	1923	1960	1997	
950	1619	1655	1691	1727	1764	1801	1838	1876	1914	1952	1991	2029	2069	2108	
1,000	1704	1742	1780	1818	1857	1896	1935	1975	2015	2055	2095	2136	2177	2219	

## Housing market indicators for September 2007 (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	14.3	-1.1	147	(-20%)	53	Slowest month for sales since November 2001.
Auckland	11.1	-0.8	2,017	(-8%)	32	Largest fall in house prices (-1.9%) over the month.
Waikato/BOP/Gisborne	12.3	1.6	899	(-3%)	41	Slowest month for sales since September 2001.
Hawke's Bay	9.6	2.7	176	(-33%)	36	Largest percentage decline in sales nationwide.
Taranaki	6.0	-5.3	144	(-2%)	54	Longest days to sell in the North Island.
Manawatu-Wanganui	14.3	-2.1	313	(+4%)	37	Largest monthly percentage price increase in NZ.
Wellington	15.5	-1.5	711	(-14%)	32	Longest days to sell in three years.
Nelson-Marlborough	6.5	-0.9	247	(+15%)	35	Sales recovered from August's dip.
Canterbury/Westland	13.3	1.6	866	(-7%)	32	A new high for prices.
Otago	9.3	0.7	265	(+4%)	30	Sales up slightly on August's 6-year low.
Central Otago Lakes	8.3	5.2	114	(+12%)	57	Days to sell longest in the country.
Southland	39.3	7.1	211	(-16%)	19	Prices to new high, pushing towards \$200,000.
NEW ZEALAND	12.3	0.0	6,163	(-6%)	34	Sales down 32 percent on a year ago.

## Key forecasts

Economic indicators	Actual			Forecast						
	Dec 06	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09
GDP (ann avg % chg)	1.7	1.7	2.2	2.7	2.8	2.6	2.1	1.7	1.7	2.2
CPI inflation (%)	2.6	2.5	2.0	2.1	3.0	3.0	2.7	2.7	2.8	2.7
Unemployment rate (%)	4.0	3.7	3.6	3.7	3.8	3.9	4.0	4.0	3.7	3.6
Interest rates	Actual			Forecast (end month)						
	Aug 07	Sep 07	Current	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09
Call rate	8.25	8.25	8.25	8.25	8.25	8.25	8.00	7.5	7.00	6.75
90-day bank bill rate	8.7	8.8	8.7	8.7	8.7	8.6	8.0	7.5	7.0	7.0
Floating mortgage rate	10.4	10.5	10.5	10.5	10.5	10.5	10.2	9.7	9.2	9.0
1-yr fixed mortgage rate	9.4	9.5	9.5	9.3	9.2	9.1	8.7	8.3	7.9	7.8
2-yr fixed mortgage rate	9.2	9.2	9.1	9.1	8.9	8.8	8.6	8.3	7.9	7.9
5-yr fixed mortgage rate	8.9	8.9	8.7	8.6	8.4	8.4	8.3	8.2	8.2	8.1

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