

Physical assessment

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Summary

- > Our monthly *Property Focus* publication is aimed at providing an independent appraisal of recent developments in the property market. In this issue we outline some of the key themes we see evolving over the year ahead that will have an influential role in New Zealand's economic prospects.

The month in review (page 2)

- > Housing indicators weakened in the last month of 2009. The number of houses sold eased for the third consecutive month and the median time to sell a house lengthened to a six month high (although still low). Annual price movements are lofty, but this reflects activity in H1 2009. The most recent reading of the real estate market looks as though activity has plateaued and is turning down.

Property gauges (page 3)

- > After a rebound over the middle of last year, the housing market is showing signs of flattening. Longer fixed mortgage rates are now less attractive and the flow of credit is also hampering a second wave of buyer interest.

Economic backdrop (page 5)

- > Momentum across the economy is building, albeit in an inconsistent manner. Retailing is picking up, but impetus from housing is waning. The picture still looks consistent with a "bathtub with waves" shaped economic cycle (on a slight upwards slope).

Mortgage borrowing strategy (page 6)

- > "We continue to see greater value in short-dated borrowing rates. Yes, we acknowledge rates are set to move up. But too much tightening is presently priced into the fixed lending rates and structural changes means an upward sloping yield curve is here for the foreseeable future." December *Property Focus* (and unchanged for January 2010).

Feature comment – Key Macro Themes for 2010 (page 7)

- > In this article, we outline some of the key themes we see evolving over the year ahead that will have an influential role in New Zealand's economic prospects and hence the property market. While the economy is set to expand, we are not losing sight of the bigger picture. The economy still faces challenges that will cap the magnitude of growth over the next few years, as structural changes come to the fore.

Key forecasts (page 22)



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The month in review

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Blood pressure dropping

> **REINZ housing data – December.** The number of house sales eased 3.7 percent in December (seasonally adjusted) and the median time to sell lengthened by one day, to 36 days. The median house price rose from \$355,000 to \$360,000 - up 1.4 percent in the month and 9 percent on a year ago. The REINZ House Price Index (which is a stratified measure) tells a different story, easing 0.9 percent in the month (but still up 6.4 percent on a year ago). The newly adopted stratified measure of house prices removes the bias in the median numbers (house sales are currently skewed towards the higher price brackets) and thus is more a comparison of like-versus-like property sales.

Temperature rising

> **SNZ Building Consents – November.** The number of residential building consents rose 1.2 percent in November, with the level of issuance up 21 percent on a year ago. The modest rise needs to be read in conjunction with chunky rises over the four prior months. While encouraging, we also need to be mindful of the base effect and this can only really be appreciated when you eye graphically where the rebound in building consents is coming from. So while the trend is up, there seems a way to go yet. Non-residential activity lifted for a second successive month (on our seasonally adjusted measure). But looking at the 3 month annual picture, or volumes, the level of activity is weak.

Short of breath

> **RBNZ Mortgage Lending – November.** Housing credit growth posted a 0.2 percent increase in November. The rate of lending has slowed just a tad since July, with the monthly rate of increase a constant 0.3 percent over each of the previous four months.

Irregular heart beat

> **RBNZ Weekly Housing Loan Approvals – Mid January.** The weekly housing loan approvals data for the end of 2009 was below the same level a year ago. The seasonal increase in activity has occurred over the first three observations of 2010, but lending is running behind last year's dismal level.

The sedentary lifestyle is about to change

> **VUW Tax Working Group report.** A host of changes were detailed by the working group. Without going into detail, one point seems blatantly obvious: there will be change and housing is going to get caught in the rip of it (as we detailed in our last edition of *Property Focus* in 2009).

Assessment

Doctor's report

While the number of economic indicators released over the Christmas break dries up, the ones that have been reported paint a picture of a housing market that has rebounded strongly following policy stimulus but has now done its dash. Sales volumes are down, the median days to sell is rising (but still low to be fair) and (although we are loathe to read too much into it) sale prices have plateaued after a strong surge. The annual price picture is still captivating the market and attention, whereas more timely indicators suggest a different story. The latest weekly home loan approval series suggest this easing has continued into 2010. So all up, the property market did its job helping to stabilise the economy in 2009: it responded to policy support. But it is not kicking on, and we expect more of the same as a new normal prevails.

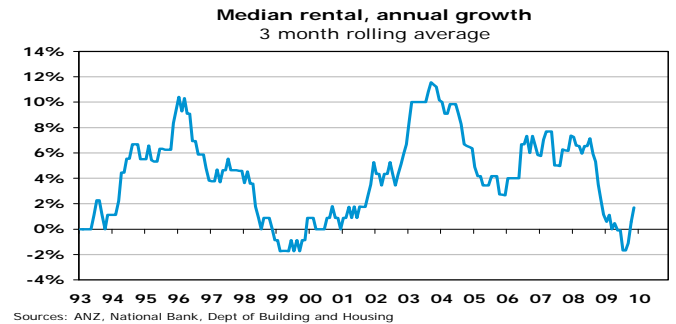
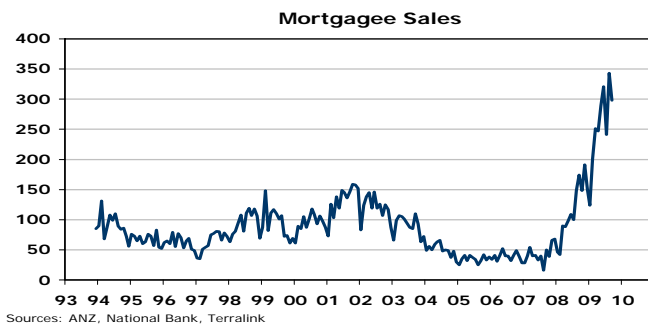
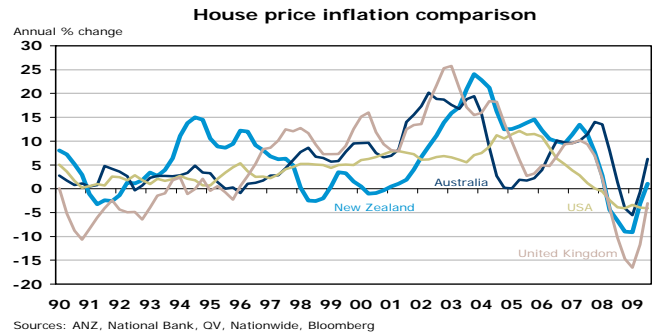
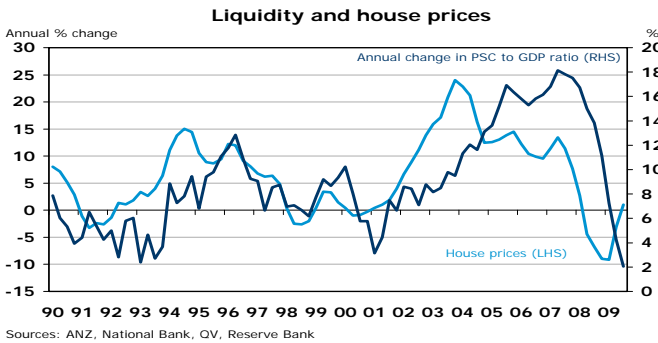
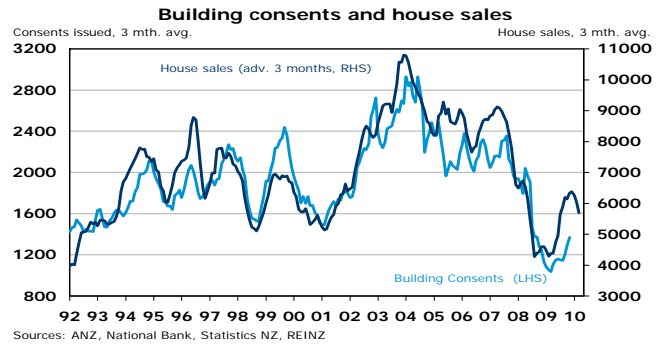
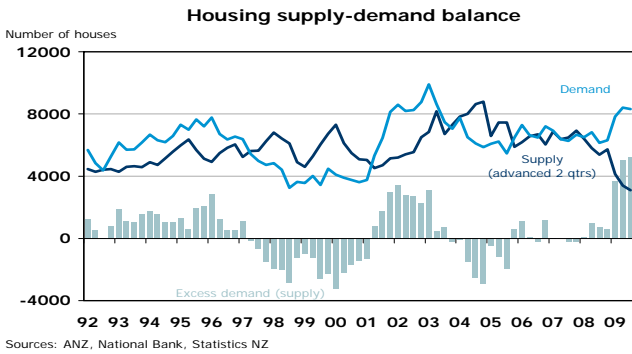
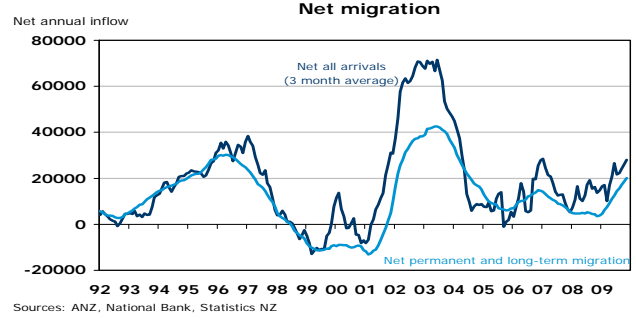
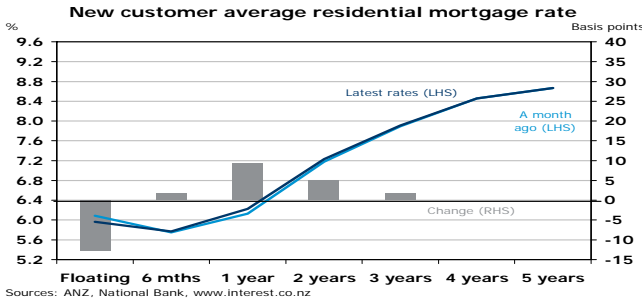
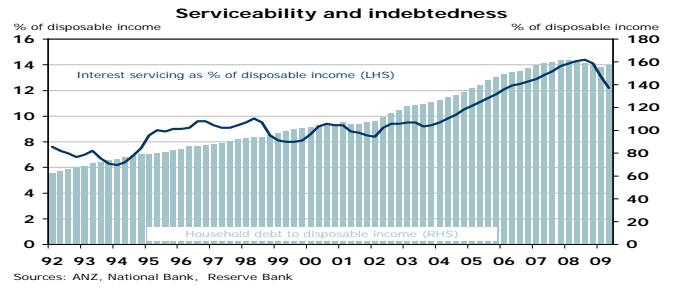
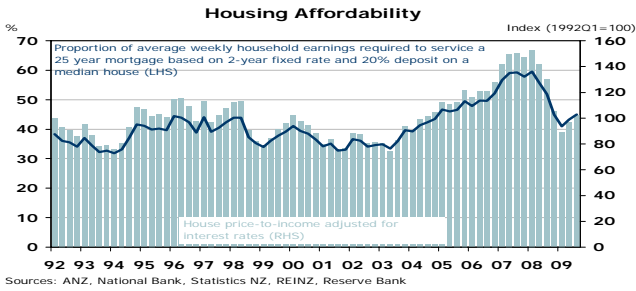
Property gauges

After a rebound over the middle of last year, the housing market is showing signs of flattening. Longer fixed mortgage rates are now less attractive and the flow of credit is also hampering a second wave of buyer interest.

We use ten 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 (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	Deteriorating	↔	Back to more normal levels but on a slippery slope.
Serviceability / indebtedness	High but easing	↓	Improving.
Interest rates	Nudging up	↔/↓	Most of the fixed lending action is around the shorter maturities.
Migration	Building	↑	A rising level and they need somewhere to live.
Supply-demand balance	One sided	↔/↑	Demand for housing remains high but supply is too low.
Consents and house sales	Glimmer of hope	↔/↑	House sales look to have turned down while consents are lifting off their low base.
Liquidity	Still a way to go	↓	Credit is a constraint.
Globalisation	A deep hole to recover from	↓	Passed the worst but still a long way to go.
Mortgagee sales	Off its high	↓	Remains at lofty levels.
Median rent	Ticked up	↓	A modest rise.
On balance		↓	The tough times may not be over, just yet.



Economic backdrop

Momentum across the economy is building, albeit in an inconsistent manner. Retailing is picking up, but impetus from housing is waning. The picture still looks consistent with a “bathtub with waves” shaped economic cycle (on a slight upwards slope).

Our core economic view

The economic recovery is underway and momentum within the economy is building. Household spending will rebound as fears of a deeper downturn recede, construction sector activity will pick-up given a looming shortage of dwellings. Commodity prices have continued to rise and the terms of trade looks good. But the recovery remains patchy over certain pockets. There is still uncertainty from firms to commit to hiring and investing. Non-residential construction is contracting and the housing market weakened into year end. So, while improvement in some sectors has been noticeable (retailing is a recent case), momentum in others, such as housing, has started to fade. There remains an element of caution in regard to hiring and investment – both preconditions to a recovery taking on a sustained look. We expect these ingredients to come into the mix as 2010 unfolds.

We think about the economic cycle as going through 5 distinct stages. The first stage was the old normal, specifically the 2002 to 2007 period, where growth was driven by excessive leverage and risk taking, which led to asset price bubbles and artificial wealth-induced spending. Stage 2 saw the inevitable purging that followed such excesses over 2008 and 2009. Stage 3 is the healing or recovery process that we are currently going through, helped by aggressive policy action. This will dominate for H1 2010.

Stage 4 is what we call transition – a stage we will enter in 2010. Transition will involve two distinct dynamics. The first is taking the patient off life support, or the so-called exit strategies. The second dynamic is introducing structural changes to prevent a repeat of the financial crisis and rebalance the economy. It is becoming increasingly clear that regulation and/or direct intervention will play a strong role in this regard, especially in preventing the build up of asset bubbles (although these are noted as being difficult to identify). Credit growth relative to GDP is set to become a key policy benchmark. Another leg of structural change will involve differentiating NZ.Inc – and positioning ourselves for the future (i.e. Asia). Various reviews have now reported back to the Government. We await the response, but it seems highly probable that changes are pending, especially in relation to the tax system. This is likely to involve some near-term indigestion issues for the property market. (Stage 5 is where the decisions in the transition stage benefit or hinder performance).

There is likely to be considerable overlap between stages 3 and 4 and we struggle to see policymakers getting the timing or execution “perfect”. Hence, we continue to see a fair degree of uncertainty over the economic outlook as we weigh up cyclical challenges (de-leveraging), policy support and structural change.

Net-on-net we see momentum building over 2010. However, we are loathe to believe it will be of a straight line variety, and the historical experience where a strong cyclical upswing follows the downturn. There are simply too many structural changes and issues that have yet to be worked through.

Mortgage borrowing strategy

“We continue to see greater value in short-dated borrowing rates. Yes, we acknowledge rates are set to move up. But too much tightening is presently priced into the fixed lending rates and structural changes means an upward sloping yield curve is here for the foreseeable future.” December Property Focus (and unchanged for January 2010).

Our view

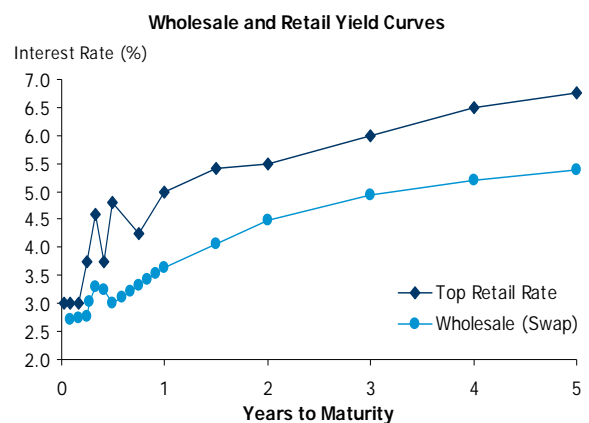
For regular readers this months’ borrowers strategy is going to ominously like the mouse on the exercise wheel... this looks familiar, this looks familiar. Interest rates will move up over 2010. The Official Cash Rate sits at an exceptional low level, and as the economic recovery broadens it is entirely appropriate for such support to be removed. To do otherwise risks inflaming another bubble or stoking inflation, which must ultimately be purged by forcing rates higher at some stage down the track.

The decision on what to do continues to be dominated by a couple of key dynamics.

Firstly, your individual circumstances. If you need borrowing certainty, don’t choke on the higher rates the steeper curve offers. This is simply a reflection of the more normal environment. Gaining certainty or peace of mind invariably involves a cost, in a similar fashion to taking out insurance. New liquidity rules now require banks to source more term funding. The longer the term, the typically higher the (deposit) price. This means an upward sloping yield curve is here to stay. If investors expect to receive a higher compensation (yield on their deposit) for “locking” in for a longer-term, then of course borrowers seeking certainty (long-term rates) end up paying the flip-side of this transaction. You can see this in the chart below which has term deposit rates and also the wholesale interest rate curve. The first simple observation is that term deposit rates move up with the length of the deposit. The second is that bank funding costs (proxied by such deposits) bear little resemblance to wholesale interest rates.

Second, the market is already pre-empting a fairly rapid rise in interest rates. The market is pricing in around a 75 percent chance of a 25 basis point hike by April and a total of 175 basis points of tightening out until December 2010. Such “expectations” are implicitly now embedded in fixed rates. Our core view continues to centre around a later start to the

tightening cycle, and one of a smaller magnitude given challenges we continue to envisage. We also expect some form of structural changes to come out of the recently announced reviews (i.e. the Tax Working Group) that will involve property in some shape or form. All else equal, this should mitigate the need for the Reserve Bank to hike as aggressively. We still see rates going up, but it’s hard to see the OCR rising any more than 250 basis points over the coming few years. We simply don’t think that borrowers could sustain more.



Feature Article – Key macro themes for 2010

In this article, we outline some of the key themes we see evolving over the year ahead that will have an influential role in New Zealand's economic prospects and hence the property market. While the economy is set to expand, we are not losing sight of the bigger picture. The economy still faces challenges that will cap the magnitude of growth over the next few years, as structural changes come to the fore.

One of our key aims in writing this article is to alert our readers to some of the wider economic forces at work, including the inherent tensions that exist within the economic system, and to start thinking about the implications for their own businesses and investing philosophy. Ultimately, it is the average rate of growth over a number of years that matter, as opposed to what GDP growth will be in a single year. The repercussions of the global financial crisis will continue to be felt for years. Therefore, we would encourage our readers to think about the macro themes we outline below within a five-year time horizon. The themes are:

- > **Rebalancing and the new normal.** The way things were pre-crisis was unsustainable. While the economy is recovering, there is still some way to go to address the imbalances that had build up in the previous decade, and it will take time.
- > **The economic cycle – a V, the Nike swish, bathtub with waves or the dreaded W?** History suggests a V, but structural forces are at play which means this time it will be different. Human behaviour, rather than pure economics, will determine the shape of the recovery path.
- > **From recovery to transition.** We are now in the recovery stage, and will enter the transition stage by mid-year, where policy support is gradually removed. But what other policy changes are introduced during the transition stage will determine the longer term growth outlook.
- > **The China factor.** A real positive medium to long-term development in NZ's favour.
- > **Looking for leadership.** The analysis has been done. Working groups and taskforces have reported back. The time has come for decisions to be made. Will the hard but necessary choices be made, or will populism and political expediency win the day?
- > **Key specifics for NZ over the year.** A list of some of the topical things to watch out for.

While the themes are by-and-large NZ centric, some of them, including the underlying principles, also apply globally. There is a degree of overlap across the themes, and we do not profess to have all the answers. Anyone who comes up with a precise prescription of how 2010 will play out is likely to be pulling your chain. There are simply too many variables – both structural and cyclical – to accurately predict. On top of that, human behaviour is going to have a huge say (economists call this 'animal spirits').

From the outset, we should outline that our key baseline assumption is that the worst of the global economic and financial crisis has passed. However, the process of financial system repair is still ongoing and will take time. Significantly, we see the global economy embarking on not only a cyclical recovery, but also a period of structural change over 2010 and subsequent years. While the former will take priority as to when policymakers decide on the timing of their exit strategies from extraordinarily stimulatory policies (in particular whether the unemployment rate has stopped rising), we must not lose sight of structural aspects to this cycle if we are to learn from lessons of

the past. We see a lot of pending tensions between the cyclical and structural forces over the year ahead, as many of our themes highlight.

Theme 1: Rebalancing and the new normal

Momentum within the NZ economy has been dominated by the spending side of the equation for the past decade. This reflects not only local specific factors (such as NZ's fixation with housing and relative insensitivity to high real interest rates), but is also symptomatic of the wider global picture. Excess savings in Asia have been channelled into savings deficit nations, mainly in the Anglo-Saxon world. For most of the first decade of this century leading up to the financial crisis, cash was not only abundant, it was also cheap. And NZ took full advantage of it.

We believe the debt-funded consumer-driven economic model that NZ ran has come to an end. While such pronouncements have proven premature in the past, we have reasonable confidence of this view this time. For one, we have the Reserve Bank Governor saying that it is untenable for NZ to go back to its borrow and spend habits of old. And he has the means to make sure we don't! In addition, policymakers globally are now taking note and the term "rebalancing" was used roughly 40 times in a 23 page communiqué from last September's G20 summit. Credit is no longer abundant or cheap despite record low official interest rates. There has been a material re-pricing of risk globally, and while short-term money markets have returned to pre-crisis levels, there is still a higher cost (premium) to raise long-term money. Policymakers require financial institutions to better match their claims and funding profile, and this has resulted in higher overall funding costs, which has been passed on to borrowers. Regulatory changes are coming thick and fast.

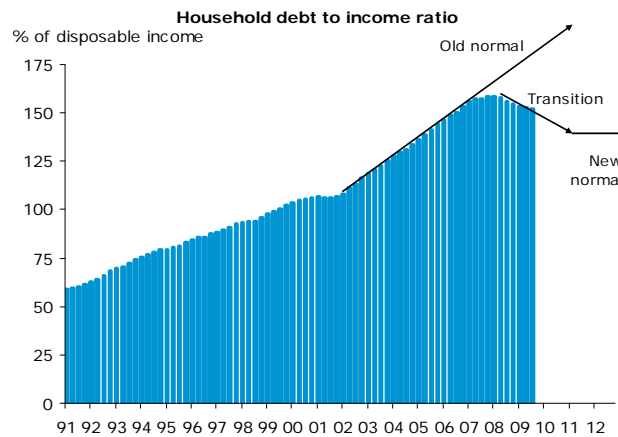
Looking at NZ's external position, it is clear that the economy has made considerable progress over the past year. The current account deficit has fallen from 8.7 percent of GDP in December 2008 to 3.1 percent in September 2009. New Zealand's net international liability position has stabilised at around 94 percent of GDP. The trade balance is back in surplus for the first time since 2003, courtesy of a sharp capitulation in imports. One-offs relating to structured tax transactions (equivalent to 1 percent of GDP) and a weak domestic economy have been the major drivers behind the improvements in the external position. But it does go some way to getting the economy on a more sustainable footing for robust growth over a number of years, as opposed to a flash-in-the-pan or bust-boom-bust style cycle.

But there is still some way to go. The household savings rate remains deeply negative (although we acknowledge the questionable quality of the statistics). Consumption as a share of GDP remains elevated. With recovery comes the inevitable temptation to go back to the ways of old. So while the current account deficit is considerably reduced, there remains the potential (or reality in most forecasts) for it to head higher again over 2010 as import demand picks up and profits by foreign owned firms recover. We, the Treasury and the Reserve Bank are expecting the current account deficit to move back above 5 percent of GDP in the next few years, which will likely mean that NZ's net external liability position will surge beyond 100 percent of GDP. While we do not know what the 'tipping point' is until we get there, it is clear that an ongoing deterioration in the net external liability position at that level is unsustainable, though like most we struggle to identify the cadaver that will stop it.

What we do know is that the whole rebalancing process will take a combination of several dynamics to occur.

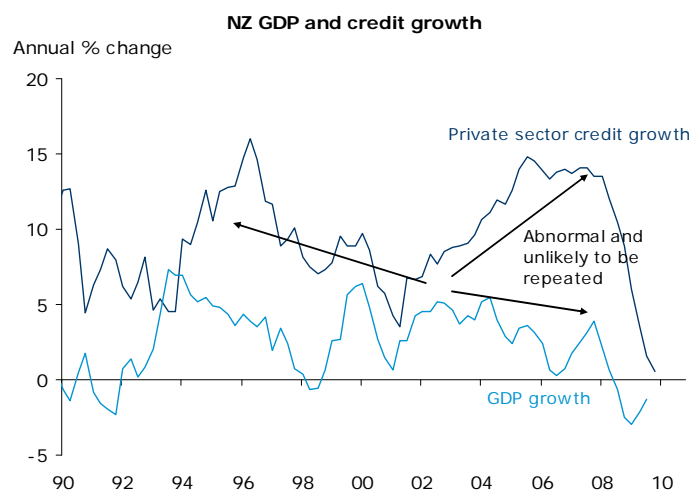
- > **NZ's rebalancing process is symptomatic of a wider rebalancing process globally.** There is a lot of talk about rebalancing, but can policymakers walk the walk? Will the US shift from being the Freddy Mercury economy (as in we want it all and we want it now)? If pockets of Asia continue to accumulate excess reserves (relative to nominal GDP), then there will surely be savings deficiencies continuing in some shape or form on the other side in the West. If so, in deficit nations, policymakers will need to set policy accordingly (read: have interest rates higher than would otherwise be the case).
- > **Relative price signals must change.** Rising deposit rates in NZ are already helping to shift the incentive away from spending towards saving. Over time, current account deficit and highly indebted nations will face downward pressure on their currencies. Conversely, the currencies of surplus nations, Asia in particular, must rise. Some of the NZD cross rates are assisting with the rebalancing (such as the NZD/AUD), while others are not (NZD/USD). However, we have already seen China raise their reserve requirements this year, which we view as a precursor to allowing their currency to appreciate. All else equal, this should take some of the pressure off the USD to remain structurally weaker against the currencies of other OECD nations, including the NZD.
- > **We need to see structural changes across the NZ economy.** The tax system is at the forefront and we will be closely watching whether the Government adopts any of the recommendations from the Tax Working Group. But in so far as creating an environment built around more savings and a better investment culture, there are a host of other necessary changes. Examples include having another look at Working for Families, improving the education system, and raising financial literacy, to name but a few. Introducing tax changes aimed at housing will do little unless matched by initiatives that give confidence in alternative investments. Making KiwiSaver compulsory would not go amiss. The bottom line is that mere tinkering will not do. Major structural changes are required to foster a fundamental change in behaviour.

Rebalancing is also about adjusting to a new normal. It is not normal to expect credit growth to expand at 2 to 3 times the rate of nominal GDP growth, nor is it normal to run excessive current account deficits indefinitely. Likewise, house prices cannot grow at double the rate of income growth. Such dynamics are ultimately explosive in terms of the pressure it places on the financial system via excessive leverage. And we should not forget what the global economy has just gone through. The Great Depression Mark 2 may have been averted courtesy of exceptional policy stimulus. But sooner or later economies will have to stand on their own two feet as they come off life support and the stimulus ceases. If the global financial crisis itself was about excessive leverage, we should not lose sight of the fact that there is still the same amount of debt in the system (perhaps even more) as before the crisis. It is just that the composition has been shifted from the private sector to the public sector in some instances.



The ramifications of a new normal are significant.

- > **There is a new benchmark for credit growth**, which in the case of NZ, would broadly equate to the nominal growth rate of the economy (as a proxy for debt serviceability). **This will be a by-product of a new regulatory environment that attempts to better manage the booms and busts in the economic cycle.** The danger with regulation of course is that one absurdity is simply replaced with another as the law of unintended consequences prevails. Nonetheless, regulation is set to play a powerful role going forward. A more subdued credit environment relative to an economy's underlying earnings growth will be the end result.
- > **Faced with more contained credit growth, this decade will be about yield and cash-flow, as opposed to being dominated by capital gains.** This is because there is less ability for that next purchaser to simply pay more because they can get the leverage. The rural sector and housing market should take note. Historical capital gains performance has been driven in part by accumulated leverage. Unless you think credit growth can continue to expand substantially in excess of nominal GDP, this game has come to an end. This does not mean there won't be any capital gains; there will be. It will merely be of a more muted variety with valuations reflecting cash-flow as opposed to anticipated capital gain realisations.



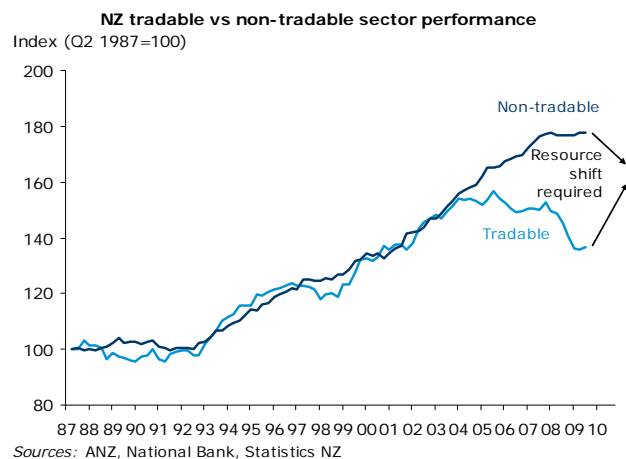
- > **Anticipated wealth, as a driver of consumer spending, will in turn be more contained.** Spending will increasingly be driven more by

income growth rather than the wealth effect. RBNZ research¹ estimates that a 1 percent increase in real per-capita housing wealth is associated with a 0.2 percent increase in real per-capita consumption in the long run. The income elasticity is estimated to be 0.5. All else equal, this implies that in the absence of any real house price gains, consumer spending can be expected to grow at only half the rate of income growth, as opposed to in excess of it, as has been the case over the past decade.

> **NZ is facing a lower trend growth rate over the next five years reflecting:**

- Some pay-back from consumption driven excesses of prior years.
- A structural resource shift as the economy rebalances away from the non-tradable sector towards the tradable sector. Capital will take time to reallocate. Bank behaviour (as allocators of capital) will take time to respond. Similarly, labour market dynamics will take time to adjust. The education system, for example, will not suddenly be spitting out fewer lawyers and more engineers.

We fully expect the rebalancing process and the transition to a new normal to be both elongated and fraught with uncertainty (and at times with self-interest dominating). Global and local excesses took decades to build up. It will take time to purge.



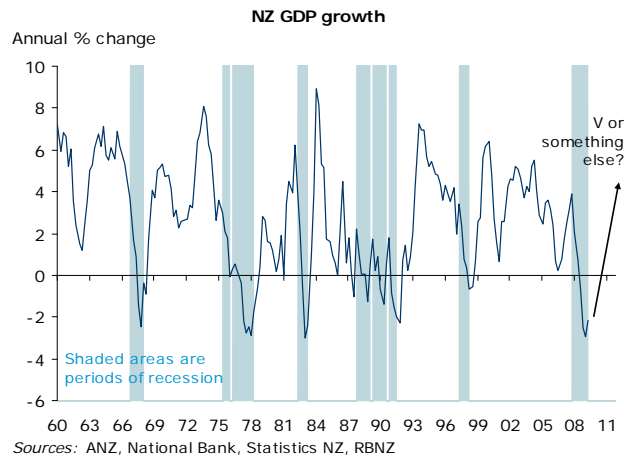
De-leveraging remains a critical aspect for a host of nations undergoing rebalancing. The first leg of this is centred on restoring health to the financial system and the private sector. This involved a transfer of debt from private sector balance sheets to the public sector. But ultimately this will be transferred back to the private sector as the process of fiscal consolidation (i.e. reducing fiscal deficits or returning to surpluses) begins in a host of nations.

Theme 2: The economic cycle – a V, the Nike swish, bathtub with waves or the dreaded W?

There are solid reasons to bank on a V. After all, this has been the traditional experience. When you fall off a cliff like the global economy (and to a lesser extent for the NZ economy) did in 2009, the first legs of recovery are, of course, always consistent with a V. Upswings tend to be inversely

¹ Veirman, E and Dunstan, A (2008) "How do housing wealth, financial wealth and consumption interact? Evidence from New Zealand", RBNZ Discussion Paper DP2008/05.

proportional to downturns. We have seen year-on-year growth reaching 6 percent following the previous two recessions in NZ. Support is being provided via extraordinarily loose monetary policy. Pent-up demand is apparent in some areas, including residential construction, where a solution to the leaky home conundrum could unleash it further. Then there is the reality of more bums on seats, with the population growing at 1.2 percent annually, courtesy of strong net migration.



However, we have to be mindful of what a V shaped recovery means.

- > **There is the base effect to be mindful of.** A 15 percent lift in house sales in 2009 bears all the hallmarks of a V, as recovery followed the downturn. But the level is still 26 percent below the average level seen over the preceding four years. So even if a lot of industries experience what looks like a V in the first instance, there is still some way to go to get back to pre-recession levels. In short, the recovery has merely moved half-way up the other side.
- > **The recession has not opened up as much spare capacity in the economy compared to previous downturns.** Capacity utilisation, as measured by the QSBO, is already back above historical average levels. The peak in the unemployment rate this time, likely at around 7 percent, will be lower than the 7.9 percent reached following the Asian Crisis (although it has increased from a far lower base, and there is more idle capacity in terms of hours worked per person). On the inflation front, it is becoming apparent that the downturn in 2008 and 2009 has merely taken the heat out of inflation as opposed to crushing it. If the economy is indeed embarking on a V shaped recovery with not as much resource slack compared to past cycles, this has important implications for how long monetary policy can remain supportive.
- > **A V implies policymakers are letting us go back to the old normal. The noises coming out of policymakers around the world suggest they will not be so inclined.** The G20 leaders have made it clear that we are not going back to *"banking as usual"*. The Reserve Bank Governor has been equally specific about NZ not returning to our borrow and spend habits of old. And it is not just the Official Cash Rate that will be used to make sure that it doesn't. New liquidity rules for banks which have been introduced are just the start. Greater regulation will be a fact of economic life, which will prevent the kinds of increases in credit growth and risk taking we saw pre-crisis. It may also slow innovation.
- > **Global forces are both assisting and derailing the V.** At the support end we have the growing importance of China (more on this in theme 4

below). Related to this, the long-run prognosis for NZ's terms of trade (broadly speaking, the relative price of soft commodities compared to manufactured goods) is good and is set to stay elevated compared to historical averages. This is because we see continued growing demand for soft commodities, where the ability to increase supply quickly is limited in the near term, while there is clear excess capacity globally for manufacturing goods. Conversely, the ongoing de-leveraging in the global financial system and the need for many governments to start addressing deteriorating fiscal positions (including in NZ) will continue to weigh on growth prospects for some time. Simply put, once the private sector has adequately de-leveraged, it will be the public sector's turn.

Human behaviour, rather than pure economics, will determine the shape of the recovery path. Economists have a notorious track record for understating both downturns and recoveries. The reason for this is simple: economists bank on the rational and most of the models they rely on assume linear relationships. In reality, the world can at times be irrational, and variables can and do interact in non-linear ways. There are tipping points at which behaviour in the form of investment and employment decisions stops and starts. Probably the most difficult task ahead of us at present is trying to predict the "behavioural aspect" within the economic cycle. Economic trends are about combinations of economics, finance and human behaviour. The difficulty in the current instance is that you have an economy undergoing deep structural change as we adjust to a new normal. Human nature however, wants to go back and grasp the "old", as in the way things were pre-crisis. The problem is that the period in the lead-up to the global financial crisis was abnormal, characterised by excesses in risk taking, credit growth and double-digit asset prices, and unlikely to be repeated again.

We see such behavioural tensions every day. One scribe notes the process of learning as similar to watching a teenager learn from a mistake: faced with two choices, the path chosen is likely to be the one that is most fun and least painful. And so it applies to the general economy in terms of how we "learn". Across the corporate world we see business leaders recognising that a step-change is required if NZ's medium-term positive potential is to be unlocked. But that requires a sacrifice up front in terms of earnings, and we all know how conditioned the market, and hence CEO behaviour, can become to hitting those near-term benchmarks. The existing level of government services is unsustainable given the income (tax) base. But where is the hurry to forge ahead with the hard decisions when you are judged in the court of public opinion? **Hence, the tendency to push against the inevitable or take the easy solution.**

We will be keeping a close eye on a number of gauges to see whether behavioural changes are taking place. Measures of lending standards (the QSBO and NBNZ Business Outlook now contain questions related to access to credit) and changes to loan-to-value ratios are one. There was a huge credit accelerator dynamic at the top of the economic cycle, and the reciprocal decelerator was at work during the crisis. The credit decelerator continues to dominate for now. But the credit accelerator/decelerator dynamic, and the consequential flow on for the credit channel of monetary policy, could quickly change. Of course, forthcoming regulatory changes will mitigate this to some extent. But at some stage the financial system will go looking for more volume driven growth. Other measures we will monitor include yields on commercial and residential property investment, and expectations of future house price gains. The adjustment from double digit rates to one closer with income growth may be difficult for some, and there are likely to be disappointments as people get used to the new reality.

The one uncertainty is whether the process of learning occurs voluntarily (orderly) or it gets forced upon us, which leads to a disorderly adjustment. The whole behavioural aspect that is inherent in every economic cycle will have a huge say.

Theme 3: From recovery to transition

We think about current events as involving 5 distinct stages. The first stage was the old normal, specifically the 2002 to 2007 period, where growth was driven by excessive leverage and risk taking, which led to asset price bubbles and artificial wealth-induced spending. Stage 2 saw the inevitable purging that followed such excesses over 2008 and 2009. **Stage 3 is the healing or recovery process that we are currently going through,** helped by aggressive policy action. Faced with the possibility of the Great Depression Mark 2, kitchen sink style economics came to the fore, and by that we mean the kitchen sink was literally thrown at it. As the G20 noted in September, *"it worked"*.

Stage 3 will continue to dominate for the first half of 2010. A mild inventory-led recovery will be the main driver in the first instance. But in the absence of a substantial pick-up in final demand, which is conditional on stabilisation/improvement in the labour market, the final conditions for a sustained recovery are not yet in place. Ensuring that conditions for a durable and sustained recovery are in place will no doubt dominate policymakers' reaction functions in the first part of this year. That means stimulus and continued support will remain in place for some time. But already, we have seen some policymakers move to reduce stimulus earlier, including the Reserve Bank of Australia and the People's Bank of China. But for those nations that suffered deep recessions, the economic priority is to ensure that the recovery is on a solid footing and can be self sustained. NZ is not in that space just yet.

At some point in 2010 (we believe the mid-year to the 2nd half) we will enter stage 4, which we refer to as the transition. The subsequent stage is the endgame, where decisions in the transition phase will determine our growth outlook.

Transition will involve two distinct dynamics. The first is taking the patient off life support, or the so-called exit strategies. There is still a lot of uncertainty over the exact timing, but H2 2010 seems reasonable at present for nations that suffered deep recessions, with the interaction between fiscal and monetary policy key to watch. The second is introducing structural changes to prevent a repeat of the financial crisis but also aimed at changing economic performance. This is where leadership (theme 5) and foresight across policymakers, in setting the scene for subsequent decades, will come to the fore as differentiators.

It is becoming increasingly clear that regulation and/or direct intervention will play a strong role, especially in preventing the build up of asset bubbles (although these are noted as being difficult to identify). Ignore the warnings from policymakers at your peril. **There is likely to be considerable overlap between the recovery and transition dynamics mentioned above, and we struggle to see policymakers getting the timing or execution "perfect"**. The past week being an example as the anti-bank feeling grows and politicians feel obliged to deliver a policy response. Each policy solution in 2009 has created an exit conundrum. There are levers to pull by different policymakers. In our view, there is a huge risk of a double-dip style recession. This is not a slur on policymakers, rather based on the

simple observation that there are simply too many variables to expect such a transition to occur in an orderly fashion.

With the movement from recovery to transition, investment attention will turn to points of differentiation as opposed to simply chasing trends. In fact, concerns over Greece's deteriorating fiscal position are already bringing traditional dynamics like sovereign risk to the fore. We

expect more of the same. During the transition stage, we see equities shifting from their cyclical bull run of late to a secular bear market.

During the transition phase, the trend rate of growth will be lower.

This is not just a reflection of growth payback, but rather due to timing lags as resources respond to different price signals. It is fine to say NZ is shifting to a more balanced growth model, but it will take time for the likes of the education system to churn out a workforce which is aligned to this, and for capital to reallocate to different sectors.

The transition stage will also see a change in expectations between cash-flow and capital gains. In the absence of leverage to drive asset prices higher, valuations will increasingly be driven by cash-flow and yield. To be fair, they have always been critical in a number of areas. But in some, they took a back seat. This will be the case no more. Residential property investors and the rural sector should take note. Your "old normal" of leverage driven capital gains will not be repeated in the "new normal". But as noted in theme 2, it will no doubt take a while for "behaviour" to adapt.

Theme 4: The China factor

One major positive medium-term development in NZ's favour is China and the outlook for the Asian region. NZ's exports to China have been growing strongly, and now account for nearly 9 percent of total merchandise exports, compared to below 3 percent a decade ago. Last year, China took over 10 percent of NZ's total dairy and fisheries exports and almost 30 percent of wood related exports. China's industrialisation still has further to run. It may now be the second largest economy after the US, but its average per capita income is still relatively low. China has the ability to grow at 8 percent per annum for many years to come.



Sources: ANZ, National Bank, Statistics NZ

NZ's economy is complimentary to China's in that it produces what China wants, and does not compete head on with it. Indeed, NZ stands to benefit from China's increasing demand for high-quality agricultural products. China is facing serious water shortage problems in its northern plains. This means it will become difficult for China to maintain the current

scale of agricultural production in the future. Meanwhile, China's affluent middle and upper class, with a per capita income of US\$7,000 and above, is emerging rapidly. Our estimates put the number at about 130 million, larger than the Japanese population. This income group will demand more proteins and high quality agricultural and fishery products, which will help keep soft commodity prices elevated.

NZ, with its free trade agreement with China, is well positioned to capitalise on this opportunity. This is one area where NZ is ahead of other countries clamouring to piggy back off China's strong growth. A flip side of the global rebalancing that needs to occur is that China needs to rely more on domestic demand to drive its future growth, rather than persevering with its export-led model. The Chinese authorities are aware of this, and steps are being taken to address it. But it will be a gradual process, and just as the household savings rate of Anglo Saxon countries have been declining for the past two decades, the same will occur for Chinese household savings rate. With a high starting point for Chinese savings (estimated at 25 percent of income), this has the potential to provide ongoing support to domestic demand for some time (and hence import demand), much to the benefit of NZ. The tourism and education sectors also stand to continue benefiting from rising income in China.

Apart from the direct demand implications for NZ's exports, a further area of benefit will be from China's foreign direct and portfolio investment outflows. There are still strict capital controls in place in China, but the authorities are gradually liberalising their capital account, though at a very slow pace. But the policy direction is clear, and more capital can be expected to flow out of China in search of opportunities around the world. We have already seen recent investments by Chinese companies in high profile NZ companies. This trend will continue.

This story is not about China alone. It is about prospects for the entire Asian region (excluding Japan). Indonesia and India are two other fast growing developing economies that will be beneficial for NZ. Growth in NZ's traditional OECD trading partners over the next decade is expected to be around 2½ percent. Asia has the capacity to grow at more than triple that rate. It does not take a genius to work out where we need to hitch our wagon. This is where progress on free trade agreements across the region and closer economic integration is critical. NZ is already ahead of the game in this respect, with free trade deals already in place with China, ASEAN, and the Gulf Cooperation Council, with progress being made to negotiating a Trans-Pacific Partnership that will include the US.



Vulnerabilities must be acknowledged and there will be bumps in the road ahead. China's investment share of GDP (at around 45 percent) portends a capacity and infrastructure overhang, and a high degree of poor performing loans. The long-term demographic picture is poor, as the effects of China's "one child policy" start to bite. At some stage, China – and the region – will have a "bad" year. The region faces inflation challenges over 2010. Policymakers have already responded by tightening monetary policy and we expect more of the same. Containing inflation expectations and

pressures across the region will be a key challenge, particularly given the tension between economic (sustainable growth) and social (jobs) objectives. However, this is more than matched over the medium-term by the basic maths behind rapidly growing per capita incomes and huge foreign reserves to absorb any near-term blips.

Theme 5: Looking for leadership

2010 is shaping up as one of the most critical years in NZ's economic history. The scene has been set with the Government talking about aspirations to catch up with Australia, and about laying the groundwork for a step-change in economic performance. The various working groups and taskforces that have been set up have largely reported back with their recommendations. The analysis has been done. The time has now come for decisions to be made and implemented.

There are four key areas to watch.

- > **The process of fiscal consolidation.** The Government's *Half-year Economic and Fiscal Update* projected underlying deficits of 2 to 4 percent of GDP over the next five years. At present we believe that around half the projected deficits are structural (i.e. permanent) and half are cyclical that will eventually correct when the economy recovers. Just as households are facing different spending choices, so too is the Government, and this includes local government as well. Thankfully NZ's fiscal position is in a far stronger state relative to peers such as the United States and United Kingdom. Nonetheless, this does not diminish the need to return the fiscal position back into surplus. Failure to curb the growth in government spending today will merely burden the next generation with more debt and potentially higher taxes. Particularly as the demographic bulge starts to hit. This will involve structural changes across the delivery of key government services (think the number of government departments, education facilities – do we need 80 plus polytechnics?). **It will also involve shifting the burden to households, which will still be de-leveraging themselves.** Someone asked us the other day about who would pay for the leaky building problems. Our answer: ultimately we will, for we fund the coffers of central and local government.
- > **The balance between monetary policy and fiscal policy.** Monetary policy has become inherently more complicated as the world becomes increasingly integrated and labour becomes even more mobile. The OCR will no doubt remain the primary policy instrument at the RBNZ, with new initiatives on the regulatory front also assisting. But it is at this juncture, monetary policy needs mates. We fully expect some of the recommendations that came out of the Tax Working Group to be acted upon, particularly in the areas related to residential investment property. This should greatly assist the RBNZ in terms of both the timing and magnitude of the tightening cycle. On the global stage, we see deficit governments that are prepared to embark on the process of fiscal consolidation earlier as assisting monetary policy, allowing interest rates to

remain lower than would otherwise be the case. This looks to be the case in NZ.

- > **Look for further progress in unlocking NZ's mineral wealth (reputedly worth \$170 billion) and other growth-wins such as oil exploration.** Strong growth over the past decade led to touchy-feely style initiatives supplanting economic priorities. This has changed given the growth outlook. The economic imperative for any government at present is growth and jobs: these are the benchmarks they will be judged in the court of public opinion. Hence, we expect substantial progress in some key areas, despite obvious concerns from some pockets.
- > **Foresight versus populism.** The Government is committed to delivering a step-change in NZ's economic performance. Yet radical change has all but been ruled out. The two appear incompatible. On the global stage, we have the group of 20 industrialised nations committing to the principles of competitiveness, anti-protectionism etc. Yet as events of the past week testify (especially in the US), there is growing populist demand for politicians to act, particularly against the banking system. Some change is inevitable, and indeed needed. But the risk is that in responding to populism, the goose that lays the golden egg gets cooked. The process of credit facilitation and creation is a critical part of the modern economy. Common-sense and analytics need to determine policy responses as opposed to populism. The latter is now emerging as a significant risk, particularly if it leads to a bout of protectionism.

How we get a step change improvement in economic performance and reduce the fiscal deficit is where there are a lot of disagreements.

Typically, the debate turns into one about who loses or pays, such as the impact of additional ACC levies for motorcyclists. There is a failure to appreciate that someone else is also impacted, and in the case of motorcyclists, the motor vehicle owners and others who are subsidising them. In the end, not everyone can be winners, and policy cannot be designed to ensure that no one loses. But it is typically small self-interest groups that grab the emotive headlines. The Government should also not be afraid to leverage off its balance sheet further in order to address national infrastructure deficits. But this is on the proviso that there are clear corresponding proactive savings initiatives in other areas and less core government spending.

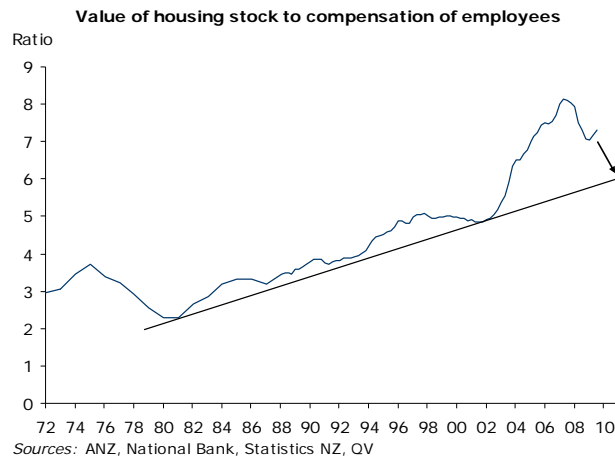
2010 is not going to be a year across political circles for making easy choices. You can't talk about a step-change in growth and then rule out the recommendations of the Productivity Taskforce as being too radical. If we see "popular" decisions being made, then we cannot expect to see meaningful improvements. But if we see the tough decisions being made, then we will have more confidence about NZ's future prospects.

Theme 6: Key specifics for NZ in 2010

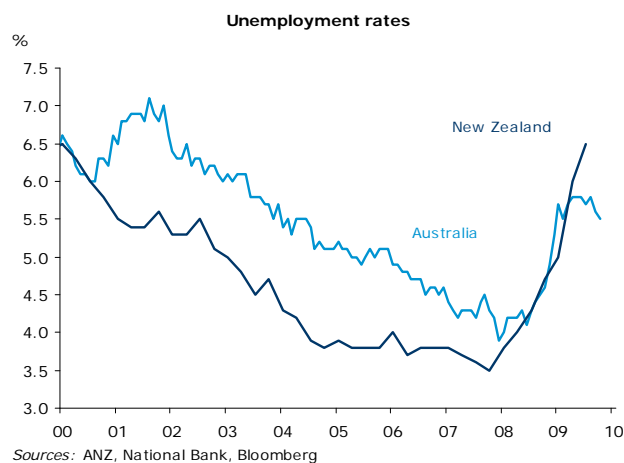
There are a host of issues everyone will be eyeing in 2010. The following list is intended to be a non-exhaustive list in relation to some of the more topical ones we see.

- > **The global surprise in 2010 is Japan or Europe and not the US.** The US has clear economic challenges, but it has flexibility across product and goods markets that allow resources to reallocate. Japan and Europe have structural rigidities that have us more concerned. In addition, Japan faces a huge demographic and government debt challenge. Greece's fiscal difficulties are only the start for Europe. Watch Spain and the others. **With this, the other surprise of 2010 may well be a rally in the USD.**

- > **Falling land prices.** NZ continues to face a house price adjustment given the multiple to income (a factor of 7). We are now leaning towards a W shaped cycle for housing. But ultimately it must be a land price adjustment. For sure, there are shortages of land in key pockets such as Auckland. But across the nation there is no shortage of land and the ripple effects of the credit decelerator are only now unfolding. The rural sector will not be immune either, despite stronger NZD commodity prices. They still do not provide anywhere near a decent return on equity.



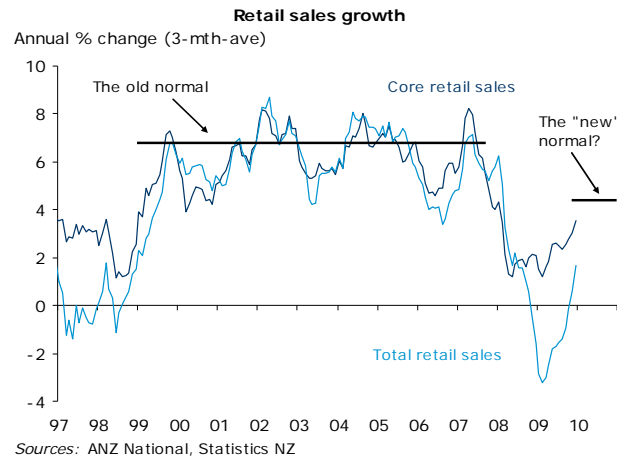
- > **Stemming the tide.** The Australian unemployment rate is currently 5.5 percent and falling. NZ's is 6.5 percent and rising. Enough said. Net migration will weaken in 2010 as more NZ'ers go to the "lucky country". Unless we see concrete steps on the policy front (leadership on the tax front), this will only get worse.



- > **Labour market divergences.** We expect the labour market to remain weak into early 2010. But already divergences are opening up and if there is one issue that is likely to confuse all and sundry, it will be the outlook for jobs. Employment intentions have picked up, yet with hours worked per person at record lows, there is the potential to meet increased labour demand simply by working the existing workforce harder. But we are also noting anecdotes of skill shortages, and worry about this being exacerbated by a pending uplift in migration to Australia. The capacity "losses" in key trades and infrastructure (e.g. medical profession) could take years to rebuild. There needs to be a policy response.
- > **The household behavioural response.** After a period of excess, household spending took a breather in 2009. With emerging signs of

recovery in consumer confidence and consumer spending evident, we hope that NZ households have learnt the lessons of the 2003-2007 period.

- > There are some positive signs out there, but discipline will need to be exercised. A key component to this will be to the extent to which the housing market (the RBNZ's perennial bugbear) remains under control, in an environment when net immigration is high and borrowing rates are relatively low.



- > **The exit strategy for the RBNZ. There are three issues.**
 - o **In regards to timing, we continue to favour a mid-year start.** There appears to be a reasonable balancing act between side-ranging nuances from demand and supply-sides of the economy. Clearly the economy has less spare capacity than initially thought. However, the recovery to date remains patchy and narrow. It is at this juncture that stimulatory monetary policy must look for its exit strategy as synonymous with the path of least potential regret.
 - o **Be assertive when you need to move.** For credibility as much as for other reasons, we believe the RBNZ needs to deliver at least one 50 basis points move early in the tightening cycle. To do otherwise would appear to go against the lessons of 2 of the preceding 3 upswings when monetary policy ended up behind the curve (the early 1990's and 2004, with 2000 the exception).
 - o **The neutral OCR is lower,** reflecting a structural shift in the pricing of risk around the globe which increases the cost of funds and keeps the yield curve steep. Structural changes that will keep the spread between the OCR and lending rates wide include the RBNZ's new liquidity rules, as well as a reversal of the downward trend in lending margins to offset slower volume growth. At present we see the neutral OCR being closer to 5 percent as opposed to the commonly perceived or talked about 6 percent.
- > **The NZD/AUD eventually gives way and hits 0.75.** This has been on the cards for some time given fundamental economic differences, notably the terms of trade. But a widening NZ-Australia interest rate differential and the reality of a stubborn USD means NZ's rebalancing process must ultimately be borne more against our largest trading partner.

The bottom line

We've turned the corner but more work still needs to be done.

Armageddon has been averted, but de-leveraging will remain a key dynamic

influencing performance over 2010. There will be much to confuse everyone as we eye improvements, but off a low base in some instances. There is a new normal. The economy still needs to rebalance. At some stage in 2010 we will enter the transition stage, which will involve the odd pocket of turbulence. Early indications for this year suggest we may be hitting that stage already. 2010 will progressively be about points of differentiation, and leadership will come to the fore. Do we take the hard or populist decisions?

If 2010 is a tough year, then we'll be euphoric over prospects for the subsequent five. A tough year will tell us the message is sinking in. Balance sheets are being repaired. Savings rates are lifting. Resources are shifting from housing to more productive investment. We are making the hard decisions. However, if we set the world on fire in the coming twelve months – with domestic consumption and property at the forefront – and momentum associated with the Rugby World Cup carries us through 2011 (provided we do not exit in the quarter finals or earlier!), then we'd put strong odds on a double-dip in 2012.

The years ahead provide opportunities for NZ to make progress towards achieving better economic performance. Everybody will need to do their part. Governments alone cannot do this, but their direction will be crucial. More focus will need to be directed towards improving skills, directing saving towards productive investment, and living within our means so that future generations are not burdened. There are no easy choices. Banks, businesses and households are all facing behavioural changes as we adjust from the abnormal to the new normal. The only uncertainty is whether we embrace it voluntarily or not.

Statistical Annex

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

Mortgage Size (\$'000)	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
100	145	149	152	156	159	163	167	170	174	178	182	186	190	194
150	218	223	228	234	239	244	250	256	261	267	273	279	284	290
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 December 2009 (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	-2.1	6.9	120	(-9%)	52	The only area to register a decline in annual sale prices
Auckland	6.8	3.7	1,936	(-5%)	34	Auckland's record high sale price unchanged at \$470k
Waikato/BOP/Gisborne	5.7	1.6	751	(+1%)	48	A large lift (4 days) in the median days to sell was noted
Hawke's Bay	9.4	6.0	189	(-11%)	44	The Bay recorded the joint largest fall in sale numbers
Taranaki	7.7	-2.2	158	(+1%)	45	A weaker patch for selling prices over past 3 months
Manawatu-Wanganui	2.9	3.9	228	(-8%)	41	The median time to sell is back above the 40-day mark
Wellington	8.1	5.5	597	(-3%)	30	Wellington was the fastest selling region in December
Nelson-Marlborough	14.5	-0.1	196	(+7%)	35	The strongest rises in monthly sales and annual prices
Canterbury/Westland	7.0	4.0	804	(+1%)	32	Median sale prices lifts to a new record high of \$320k
Otago	0.0	1.3	238	(+4%)	31	The median days to sell drops to a 2½-year low
Central Otago Lakes	1.2	8.4	84	(-11%)	58	A strong rise in selling prices over the past 3 months
Southland	10.8	-5.7	152	(-6%)	37	Selling prices softened recently but still up on a year ago
NEW ZEALAND	9.6	3.2	5,433	(-4%)	36	Third straight drop in sale numbers a sign of the times

Key forecasts

Economic indicators	Actual			Forecast						
	Mar 09	Jun 09	Sep 09	Dec 09	Mar 10	Jun 10	Sep 10	Dec 10	Mar 11	Jun 11
GDP (Ann Avg % Chg)	-1.4	-2.1	-2.2	-1.5	-0.3	0.8	1.8	2.2	2.4	2.5
CPI Inflation (%)	3.0	1.9	1.7	2.0	1.9	2.0	1.6	2.7	3.0	3.3
Unemployment Rate (%)	5.0	6.0	6.5	6.8	7.0	7.1	7.1	7.0	6.9	6.8
Interest rates	Actual			Forecast (end month)						
	Nov 09	Dec 09	Latest	Mar 10	Jun 10	Sep 10	Dec 10	Mar 11	Jun 11	Sep 11
Official Cash Rate	2.5	2.5	2.5	2.50	3.00	3.75	4.25	4.75	5.25	5.50
90-Day Bank Bill Rate	2.8	2.8	2.8	2.8	3.6	4.2	4.7	5.2	5.7	5.8
Floating Mortgage Rate	6.9	6.9	5.8	6.0	6.5	7.3	7.8	8.3	8.8	9.0
1-Yr Fixed Mortgage Rate	5.6	6.1	6.1	6.2	6.8	7.2	7.6	8.0	8.4	8.4
2-Yr Fixed Mortgage Rate	6.6	7.1	7.2	7.3	7.6	7.9	8.3	8.7	9.0	9.0
5-Yr Fixed Mortgage Rate	8.4	8.7	8.7	8.7	8.8	8.8	8.9	9.2	9.4	9.4

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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.
- The Bank has a joint venture relationship with ING (NZ) Holdings Limited (ING). ING and its related companies 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:

- 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.

NEW ZEALAND DISCLAIMER

The Bank does not provide investment advice tailored to an investor's personal circumstances. It is the investor's responsibility to understand the nature of the security subscribed for, and the risks associated with that security. To the maximum extent permitted by law, the Bank excludes liability for, and shall not be responsible for, any loss suffered by the investor resulting from the Bank's investment advice.

Each security (including the principal, interest or other returns of any security) the subject of investment advice given to the investor by the Bank or otherwise, is not guaranteed, secured or underwritten in any way by the Bank or any associated or related party except to the extent expressly agreed in the terms of the relevant security.

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