

Weekly Commentary

21 August 2017



To LVR or not to LVR?

With the housing market continuing to slow, there have been calls for the Reserve Bank's loan-to-value restrictions to be rolled back. But while lending restrictions are playing a role, the more significant factor that has caused the housing market to cool is the rise in borrowing rates over the past year. In addition, the financial risks that lending restrictions aim to address haven't gone away, meaning the RBNZ won't be in any hurry.

The housing market has continued to lose steam. Sales have fallen 25% over the past year, and house price growth has slowed to just 1% on a nationwide basis. This slowdown has been the sharpest in Auckland, where prices have fallen 4% since the start of this year. However, housing market conditions have been softening across the country.

This slowdown in the housing market has raised questions about whether the Reserve Bank will now loosen the loan-to-value lending restrictions (LVRs) on home lending. We think that this suggestion is premature. LVR settings hinge on the degree of risk to the financial system. And at this stage, we're not really seeing the evidence that risks around highly leveraged borrowing and debt have materially eased.

Why has the housing market slowed?

The slowdown in the housing market began late last year, and did initially follow a tightening in lending restrictions by the Reserve Bank. Last year's changes included tighter restrictions on lending to investors, as well as some tightening in restrictions on lending to owner-occupiers outside of Auckland (where restrictions had previously been more permissive). While these changes took effect from October 2016, banks began adjusting lending from mid-2016 to ensure they complied with the policy.

But it's now been around a year since lending standards began tightening, and the housing market has continued to

slow. As we saw when the LVRs were introduced in 2013 and again when they were changed in 2015, changes in lending restrictions tend to have a relatively short-lived impact on house price growth (more like six months, rather than a year). That's because, for those borrowers who still qualify for credit, the restrictions only have a limited impact on the value of a house or what they are willing to pay.

There are also suggestions that nervousness about September's election is weighing on housing market conditions. However, in the past, pre-election uncertainty has only had a small, impact on the housing market.

The more significant factor that has dampened house price growth is the rise in mortgage rates. Increases in both domestic and offshore funding costs have seen mortgage rates creeping higher since August of last year. And while borrowing rates are still at relatively low levels, this has been a significant change in New Zealand's lending environment after several years when mortgage rates were either flat or falling.

For prospective owner-occupiers, the rise in borrowing rates is adding to challenges around housing affordability (which is already stretched in some parts of the country). Similarly, for investors and developers, increases in interest rates mean that the financial returns on housing assets are looking a lot less attractive than they have in recent years.

To LVR or not to LVR? continued

Under what conditions would the LVRs be eased?

The RBNZ has always said that the imposition of macroprudential tools, like LVRs, was meant to be a temporary measure to manage the risks to the financial system over the course of the cycle. However, the framework for macroprudential policy decisions is inevitably quite subjective. The RBNZ's publications have tended to focus more on how the various macroprudential tools would be applied. There is less guidance in relation to their removal.

The best way to determine what happens next with the LVR restrictions is to step back and look at what the RBNZ is trying to achieve with this policy. The purpose of macroprudential policy is not to protect individual borrowers from risky borrowing decisions (a misconception that's probably not helped by the choice of LVRs, which are applied at the individual loan level). And it's not a substitute for monetary policy. Instead, the aim of this policy is to ensure the efficiency and soundness of the broader financial system.

So the case for easing or removing the LVR limits rests on these three questions:

- Are LVR limits impeding the functioning of the loan market by more than is necessary?
- Are LVR limits at risk of creating stress on the financial system?
- Would there be excessive risk in the financial system if the LVRs were removed?

On the first question, LVR limits have certainly done a lot to slow the pace of house sales. But it's less clear that the restrictions are leading to dysfunction in the loan market. One symptom of this would be a rush of home buyers towards non-bank lenders; there has been some pickup in that segment of the market, but it remains a very small share of total lending.

On the second question, there would be a strong case for easing the restrictions if house prices were falling too rapidly, putting borrowers into negative equity and increasing the likelihood of loan defaults. But the fall in house prices that we've seen to date doesn't meet that description. And going forward we're expecting prices to flatline, rather than spiral downward.

On the third question, the risks for the financial system haven't really dissipated despite the slowdown in the housing market. Household debt is still at a high level relative to household incomes. In addition, house prices remain stretched relative to a range of fundamentals, such as price-to-income ratios.

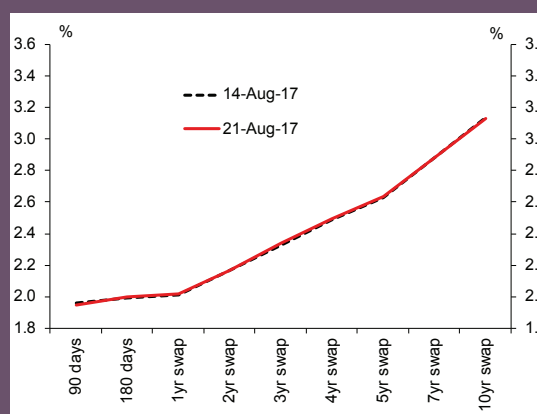
Putting it all together, the case for loosening the LVR limits is not compelling at this time, especially with the financial stability risks stemming from the housing market still a dark cloud on the economic horizon. While lending restrictions will be eased at some point, their eventual roll back is likely to be gradual and is likely to be preceded by a period of consultation.

Fixed vs Floating for mortgages

For borrowers with a deposit of 20% or more, the best value lies in the two-year rate or shorter terms. Three- to five-year rates seem high relative to where we think short-term rates are going to go over that time. That said, these rates are most likely to be pressured higher by global market trends, so borrowers who prefer the security of a longer term still have a chance to lock in at historically quite low levels.

Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates such as the six-month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

NZ interest rates



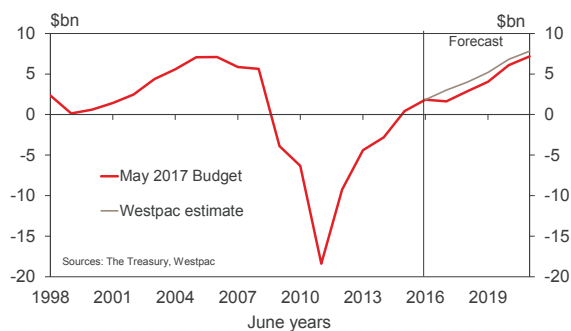
The week ahead

NZ Pre-election Economic and Fiscal Update

Aug 23, operating balance 2016/17 last: \$1.6bn, Westpac f/c: \$3.0bn

- The Treasury is due to open the books ahead of the general election on 23 September. These should show the fiscal accounts in good shape, leaving plenty of scope for election promises.
- The May Budget projected an operating surplus of \$1.6bn in the year to June 2017, rising to \$7.2bn by June 2021. However, the tax take is already tracking well ahead of the forecasts made three months ago. We expect an operating surplus of around \$3bn for the June 2017 year, with some lift in the forecasts for later years as well.
- The economic forecasts that underpin the fiscal projections are unlikely to have changed much in the last three months.

Operating balance (excluding gains and losses)



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 21					
NZ	Jul net migration	6350	-	6100	Annual net migration to remain very strong.
UK	Aug Rightmove house prices	0.1%	-	-	Political and eco. uncertainty are weighing on house prices.
	Jul public sector borrowing £bn	6.3	-	-	Soft growth and inflation lift pressuring fiscal position.
US	Jul Chicago Fed activity index	0.13	-	-	Points to growth around trend.
Tue 22					
Eur	Aug ZEW survey of expectations	35.6	-	-	Reflecting a positive outlook on the economy.
US	Jun FHFA house prices	0.4%	-	-	Gains remain robust.
	Aug Richmond Fed index	14	10	-	Still at an elevated level.
Wed 23					
NZ	Pre-election Eco. and Fiscal Update	-	-	-	Tax take already outpacing the May 2017 Budget estimates.
Eur	Aug Markit manufacturing PMI	56.6	-	-	Domestic and external demand...
	Aug Markit services PMI	55.4	-	-	... giving broad support across economy.
	Aug consumer confidence	-1.7	-	-	Elevated on stronger growth and labour market.
	ECB Draghi speaks	-	-	-	Gives keynote at Lindau Meeting on Economic Sciences.
US	Aug Markit manufacturing PMI	53.3	53.4	-	At a lower level than ISM manufacturing...
	Aug Markit service PMI	54.7	54.9	-	... as is the services measure.
	Jul new home sales	0.8%	0.0%	-	Demand reportedly still robust; but momentum slowing.
	Fedspeak	-	-	-	Kaplan speaks at a petroleum association lunch in Texas.
Thu 24					
NZ	Jul trade balance, \$m	242	-200	-200	Dairy exports to moderate but other commodities faring well.
UK	Q2 GDP (2nd estimate)	0.3%	0.3%	0.3%	Softness in household spending and manufacturing.
US	Initial jobless claims	232k	-	-	Very low.
	Jul existing home sales	-1.8%	0.6%	-	Supply continues to be cited as key issue.
	Jackson Hole policy symposium	-	-	-	24/08 to 27/08 on "Fostering a Dynamic Global Economy".
Fri 25					
US	Jul durable goods orders prelim.	6.4%	-5.8%	-4.5%	Underlying trend remains weak.
	Fed Chair Yellen speaks	-	-	-	Speaks at Jackson Hole on financial stability.

New Zealand forecasts

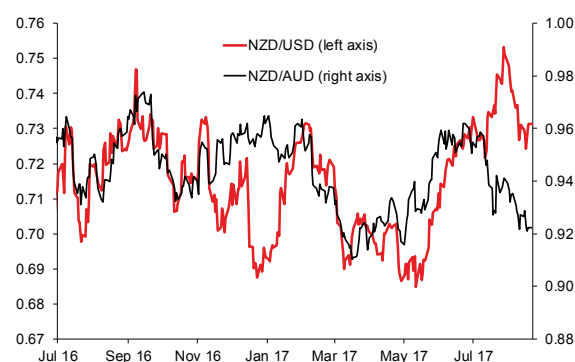
Economic Forecasts	2017				Calendar years			
	% change	Mar (a)	Jun	Sep	Dec	2015	2016	2017f
GDP (Production) ann avg	0.5	0.8	0.9	0.7	2.5	3.1	2.6	3.0
Employment	1.1	-0.1	1.3	0.5	1.4	5.8	2.8	1.8
Unemployment Rate % s.a.	4.9	4.8	4.5	4.5	4.9	5.2	4.5	4.5
CPI	1.0	0.0	0.5	0.4	0.1	1.3	1.9	1.5
Current Account Balance % of GDP	-3.1	-2.9	-2.9	-3.0	-3.4	-2.8	-3.0	-3.3

Financial Forecasts	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	1.95	1.95	1.95	1.95	1.95	1.95
2 Year Swap	2.10	2.10	2.15	2.20	2.30	2.40
5 Year Swap	2.65	2.70	2.80	2.90	3.00	3.10
10 Year Bond	2.90	2.95	3.10	3.20	3.30	3.40
NZD/USD	0.72	0.70	0.69	0.68	0.67	0.66
NZD/AUD	0.92	0.92	0.92	0.92	0.93	0.94
NZD/JPY	79.2	77.7	77.3	76.8	76.4	75.9
NZD/EUR	0.62	0.60	0.59	0.59	0.59	0.58
NZD/GBP	0.57	0.56	0.56	0.55	0.55	0.55
TWI	76.4	75.0	74.3	73.8	73.4	72.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 21 August 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.84%	1.86%	1.82%
60 Days	1.89%	1.90%	1.87%
90 Days	1.95%	1.95%	1.94%
2 Year Swap	2.17%	2.19%	2.22%
5 Year Swap	2.64%	2.69%	2.76%

NZ foreign currency mid-rates as at Monday 21 August 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7314	0.7404	0.7450
NZD/EUR	0.6220	0.6289	0.6385
NZD/GBP	0.5686	0.5677	0.5728
NZD/JPY	79.98	82.01	82.75
NZD/AUD	0.9223	0.9344	0.9421
TWI	77.29	78.27	78.85

International forecasts

Economic Forecasts (Calendar Years)	2013	2014	2015	2016	2017f	2018f
Australia						
Real GDP % yr	2.1	2.8	2.4	2.5	2.3	3.0
CPI inflation % annual	2.7	1.7	1.7	1.5	2.0	2.5
Unemployment %	5.8	6.2	5.8	5.7	5.7	6.1
Current Account % GDP	-3.4	-3.0	-4.7	-2.7	-1.2	-2.1
United States						
Real GDP %yr	1.5	2.4	2.9	1.5	2.1	2.1
Consumer Prices %yr	1.5	1.6	0.1	1.3	2.0	1.8
Unemployment Rate %	7.4	6.2	5.3	4.9	4.4	4.3
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.7	-2.8
Japan						
Real GDP %yr	1.4	0.0	0.5	0.6	1.1	1.0
Euroland						
Real GDP %yr	-0.3	0.9	1.6	1.7	1.9	1.5
United Kingdom						
Real GDP %yr	2.2	2.9	2.2	2.0	1.8	1.6
China						
Real GDP %yr	7.7	7.3	6.9	6.7	6.7	6.2
East Asia ex China						
Real GDP %yr	4.2	4.1	3.7	3.7	3.7	3.8
World						
Real GDP %yr	3.3	3.4	3.2	3.2	3.5	3.5

Forecasts finalised 11 August 2017

Interest Rate Forecasts	Latest	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.69	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.62	2.75	2.80	2.90	2.95	2.95	3.00	3.00
International								
Fed Funds	1.125	1.125	1.375	1.375	1.625	1.625	1.875	1.875
US 10 Year Bond	2.20	2.40	2.50	2.75	2.85	2.90	3.00	3.00
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.30

Exchange Rate Forecasts	Latest	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
AUD/USD	0.7897	0.78	0.76	0.75	0.74	0.72	0.70	0.70
USD/JPY	109.36	110	111	112	113	114	115	115
EUR/USD	1.1734	1.17	1.17	1.16	1.15	1.14	1.13	1.13
AUD/NZD	1.0829	1.08	1.09	1.09	1.09	1.07	1.06	1.06

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