

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 loanto-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.

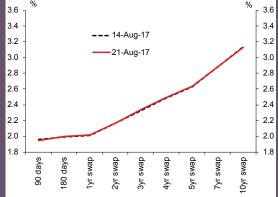
Fixed vs Floating for mortgages

For borrowers with a deposit of 20% or more, the best value lies in the two-year rate or shorter terms. Threeto 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

3.6 3.4 - 14-Aug-17

NZ interest rates



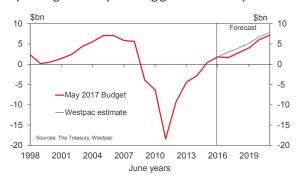
The week ahead

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 $% \left(1\right) =\left(1\right) \left(1\right) \left$ 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		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	2018f		
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		
СРІ	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



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%

NZD/USD and NZD/AUD



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

Contact the Westpac economics team

Dominick Stephens, Chief Economist +64 9 336 5671 Michael Gordon, Senior Economist +64 9 336 5670 Satish Ranchhod, Senior Economist +64 9 336 5668 **Shyamal Maharaj,** Economist +64 9 336 5669 Paul Clark, Industry Economist +64 9 336 5656 Any questions email: economics@westpac.co.nz

Past performance is not a reliable indicator of future performance. The forecasts given in this document are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Disclaimer

Things you should know

Westpac Institutional Bank is a division of Westpac Banking Corporation ABN 33 007 457 141 ('Westpac').

This material contains general commentary, and market colour. The material does not constitute investment advice. Certain types of transactions, including those involving futures, options and high vield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. This material may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts

Country disclosures

Australia: Westpac holds an Australian Financial Services Licence (No. 233714). This material is provided to you solely for your own use and in your capacity as a wholesale client of Westpac.

New Zealand: In New Zealand, Westpac Institutional Bank refers to the brand under which products and services are provided by either Westpac or Westpac New Zealand Limited ("WNZL"). Any product or service made available by WNZL does not represent an offer from Westpac or any of its subsidiaries (other than WNZL). Neither Westpac nor its other subsidiaries guarantee or otherwise support the performance of WNZL in respect of any such product. The current disclosure statements for the New Zealand branch of Westpac and WNZL can be obtained at the internet address www. westpac.co.nz. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement at www.westpac.co.nz.

China, Hong Kong, Singapore and India: This material has been prepared and issued for distribution in Singapore to institutional investors, accredited investors and expert investors (as defined in the applicable Singapore laws and regulations) only. Recipients in Singapore of this material should contact Westpac Singapore Branch in respect of any matters arising from, or in connection with, this material. Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activities. This material is intended only to "professional investors" as defined in the Securities and Futures Ordinance and any rules made under that Ordinance. Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking Regulatory Commission (CBRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

UK: The contents of this communication, which have been prepared by and are the sole responsibility of Westpac Banking Corporation London and Westpac Europe Limited. Westpac (a) has its principal place of business in the United Kingdom at Camomile Court, 23 Camomile Street, London EC3A 7LL, and is registered at Cardiff in

Disclaimer continued

the UK (as Branch No. BR00106), and (b) authorised and regulated by the Australian Prudential Regulation Authority in Australia. Westpac is authorised in the United Kingdom by the Prudential Regulation Authority. Westpac is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

This communication is being made only to and is directed at (a) persons who have professional experience in matters relating to investments who fall within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (b) high net worth entities, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(2)(a) to (d) of the Order (all such persons together being referred to as "relevant persons"). Any person who is not a relevant person should not act or rely on this communication or any of its contents. The investments to which this communication relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this communication or any of its contents. In the same way, the information contained in this communication is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Conduct Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on the information in this communication to any third party. In particular this communication and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction. This communication is made in compliance with the Market Abuse Regulation (Regulation(EU) 596/2014).

Investment Recommendations Disclosure

The material may contain investment recommendations, including information recommending an investment strategy. Reasonable steps have been taken to ensure that the material is presented in a clear, accurate and objective manner, Investment Recommendations for Financial Instruments covered by MAR are made in compliance with Article 20 MAR. Westpac does not apply MAR Investment Recommendation requirements to Spot Foreign Exchange which is out of scope for MAR

Unless otherwise indicated, there are no planned updates to this Investment Recommendation at the time of publication. Westpac has no obligation to update, modify or amend this Investment Recommendation or to notify the recipients of this Investment Recommendation should any information, including opinion, forecast or estimate set out in this Investment Recommendation change or subsequently become inaccurate.

Westpac will from time to time dispose of and acquire financial instruments of companies covered in this Investment Recommendation as principal and act as a market maker or liquidity provider in such financial instruments.

Westpac does not have any proprietary positions in equity shares of issuers that are the subject of an investment recommendation.

Westpac may have provided investment banking services to the issuer in the course of the past 12 months.

Westpac does not permit any issuer to see or comment on any investment recommendation prior to its completion and distribution. Individuals who produce investment recommendations are not permitted to undertake any transactions in any financial instruments or derivatives in relation to the issuers covered by the investment recommendations they produce.

Westpac has implemented policies and procedures, which are designed to ensure conflicts of interests are managed consistently and appropriately, and to treat clients fairly.

The following arrangements have been adopted for the avoidance and prevention of conflicts in interests associated with the provision of investment recommendations.

- (i) Chinese Wall/Cell arrangements;
- (ii) physical separation of various Business/Support Units;
- (iii) and well defined wall/cell crossing procedures;
- (iv) a "need to know" policy;
- (v) documented and well defined procedures for dealing with conflicts of interest;
- (vi) steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures $\,$ Trading Commission ("CFTC") as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC ('WCM'), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 ('the Exchange Act') and member of the Financial Industry Regulatory Authority ('FINRA'). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided $% \left(1\right) =\left(1\right) \left(1\right) \left$ by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. All disclaimers set out with respect to Westpac apply equally to WCM. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. selfregulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.