

building forecasts

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Unless otherwise stated, the source for all data is Statistics NZ.

This forecast is based on data available up until 28 February 2005.

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1. ECONOMIC OUTLOOK

Crazy growth

If, in 2000, we had predicted economic growth would average 4%pa for the next five years, we would have been regarded as mad. Forecasting growth of 3%pa for the next two years makes us merely wacky.

Such sustained growth is at odds with New Zealand's standard economic syndrome: manic growth for a couple of years followed by a period in the doldrums. To be fair, signs of a relapse are now evident: a latent inflationary tendency, a worrying addiction to imports, and an obsession with housing.

Treatment of these imbalances will calm the economy. The first step is to resolve the capacity problem that threatens to push inflation above 3%. Dr Bollard stands ready to administer an appropriate remedy – we think the Bank will use interest rates as a sedative, rather than a shock treatment. Nevertheless, compulsive housing investors may get the shakes as higher interest rates take hold.

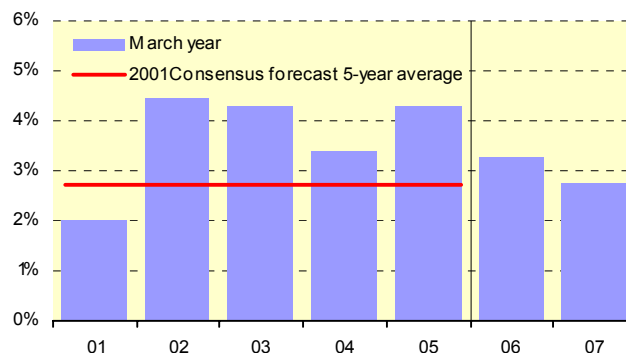
A side-effect of Dr Bollard's remedy for inflation will be an ongoing currency high: while exporters are learning to cope, the ongoing current account deficit will be a reoccurring nightmare for currency speculators.

In the labour market, delusions of grandeur are becoming common, with workers seeking wage rises of 7%. Virtually full employment means such demands are not entirely fanciful – we expect wage inflation to average between 4% and 5%pa. There is method to this madness: the strong labour market will soften any slowdown in domestic demand, and force businesses out of their dependency on labour for growth.

The Bank may be trying to lock-down economic growth, but the government will be padding the cell walls with yet more spending. Economic euphoria should see it through to another 3 years in power, but it may finally come unhinged trying to deal with junior coalition lunatics.

Surprise!

GDP, annual average % change



Graph 1.1



Summary of March 2005 forecasts

Annual average percentage changes

March years	Average 1995-2004	2002/03	2003/04	2004/05 Forecast	2005/06 Forecast	2006/07 Forecast	Forecast Average
Private consumption	3.8%	4.6%	5.6%	5.2%	3.3%	3.3%	3.9%
Private commercial investment	6.3%	10.4%	15.2%	9.9%	4.2%	2.8%	5.6%
Exports of goods and services	4.6%	7.6%	1.0%	5.6%	5.2%	5.4%	5.4%
Imports of goods and services	6.6%	7.4%	11.9%	13.4%	7.5%	6.1%	8.9%
Gross domestic product*	3.5%	4.3%	3.4%	4.3%	3.3%	2.8%	3.4%
Employment	2.3%	2.4%	2.7%	3.5%	2.1%	1.3%	2.3%
Unemployment rate (1)	6.4%	5.1%	4.5%	3.6%	3.1%	3.5%	3.4%
Hourly wage	2.8%	2.8%	3.4%	3.3%	4.0%	4.6%	4.0%
CPI (ex-credit) (2)	2.0%	2.5%	1.5%	3.1%	3.0%	3.1%	3.1%
Budget balance, \$m (3)	2,680	1,966	7,424	6,411	6,711	6,261	6,461
Current a/c balance (\$bn)	-4,870	-4,330	-6,328	-9,352	-8,671	-9,765	-9,263
Exchange rate - TWI; level	58.5	56.4	63.6	66.9	66.4	67.2	66.8
NZ interest rates - bonds	6.9%	6.4%	5.8%	6.1%	6.3%	6.3%	6.2%
- bills	6.8%	5.9%	5.3%	6.5%	6.6%	6.1%	6.4%

(1) Annual average (2) March on March (3) Year ended June *Expenditure base

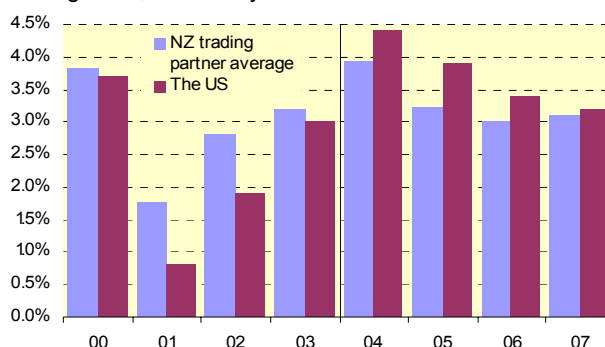
Table 1.1

A more robust world, on the whole

The performance of the US economy is still being overshadowed by its fiscal and current account deficits. Nevertheless, American GDP growth has been upbeat over the last 1-2 years, and is now more well-balanced, with a pick-up in business investment to join consumer spending. Elsewhere, the UK and Australian economies appear to have sidestepped potential problems with their overheated housing markets, while the threat from oil prices has diminished. Among the positives, there are still problems as well – the European economy remains uninspiring, while Japan has inexplicably dipped back into recession.

Hold your head high

GDP growth, calendar years



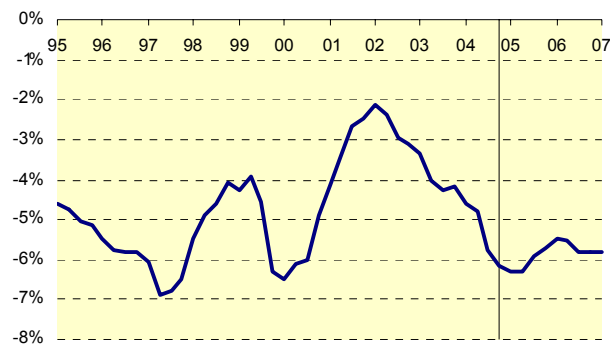
Graph 1.2

Current account let down

The threat of rampant domestic growth to the current account deficit has been realised. The deficit expanded sharply late last year and we predict it will bottom out at close to 6.5% of GDP sometime this year. The extent of the external blow-out is not surprising given booming domestic spending and the high currency. However, solid world growth and a sustained lift in New Zealand's terms of trade have helped limit the damage. These factors, plus some prospect of slowing domestic demand growth will persuade currency dealers to stick with the dollar – we anticipate no significant fall in its value over the next two years.

Deficit in danger territory

Current account deficit as % GDP



Graph 1.3

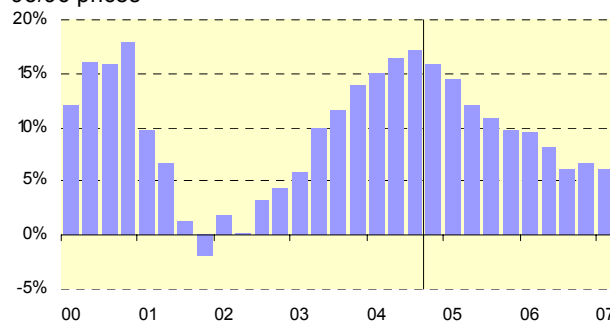
Investing in productivity

Rising wage demands will increase the pressure on business to invest in productivity-enhancing capital. Double digit growth in capital investment spending over the past year is a sign that businesses are heeding the message. But it also reflects greater confidence in the economy, sumptuous profit growth, and the low cost of imported capital equipment. We predict further growth in capital spending, although the pace of growth will slow as businesses look for a return on the investing they have been doing.

Investing productively?

Private capital spending ex residential \$m

95/96 prices



Graph 1.4

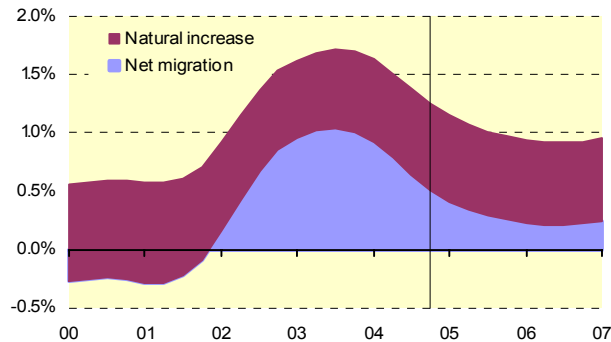


Mind the brain drain

Net migration is still shrinking, and the annual balance will fall under 9,000 by March 2006. Nevertheless, this rate of net inflow is not far removed from the long-run average, and provides a foundation for sustained population growth of around 0.9%pa. The composition of net migration is shifting, with New Zealand emigration continuing to rise over the forecast period, although departures will be restrained by tight labour market conditions. Increasing numbers of work-permits and approvals through the Skilled Migrant Category mean that the new arrivals are able to make an immediate contribution to the labour force.

Old-fashioned population growth

Annual average % change



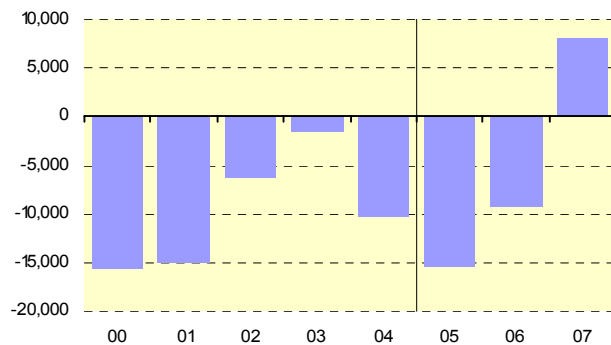
Graph 1.5

No labour left behind

The past year has seen a substantial fall in unemployment, and a large rise in the participation rate. However, there is a limit to how much more labour can be wrung from those two sources. Although we think unemployment might reach 3% in the short-term, ultimately 3.5% will prove to be the lowest sustainable level. With working-age population growth also slowing, businesses will not be able to continue expanding their employment at the current pace. Employment growth will ease from 3.5%pa over March 2005 to 1.3% in 2007, as the cost of finding, employing, and retaining labour forces businesses to seek alternative ways of expanding their output.

The well runs dry

Annual average change in unemployed



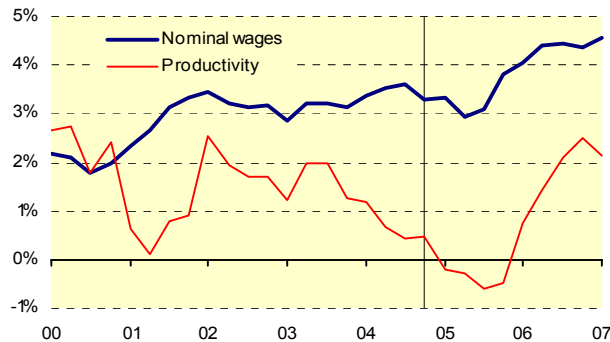
Graph 1.6

Wages are on the up and up

The inevitable consequence of severe and permanent labour shortages is a growing willingness for labour to seek higher wage claims. We expect rising nominal wage growth over the forecast period in the 4-5% range. Although inflation will remain strong, real wage gains will average 0.9% as businesses are forced to absorb some of the increased wage costs. Higher labour costs will force employers to improve productivity, which will in turn help sustain wage increases. From April 2005, the first of the staggered increases to family support is phased in, giving households another source of income growth.

A signal for change

Annual average % change



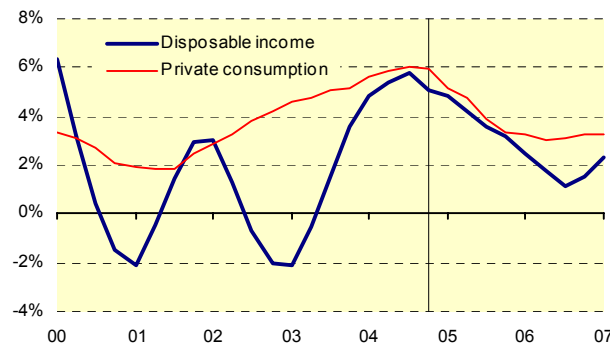
Graph 1.7

Consumption drops down a gear

Slower population and employment growth will undermine disposable income growth and eventually consumption spending. A short period of falling house prices later this year and the lagged effects of higher interest rates, will dent exuberant spending growth. However, a tight labour market and bigger pay packets will keep households confident and consumer humming along – just not as fast as it has been. We predict private consumption spending will grow at around 3.3%pa over the forecast period, somewhat faster than disposable income.

Spending splutters slightly

Annual average % change, real



Graph 1.8

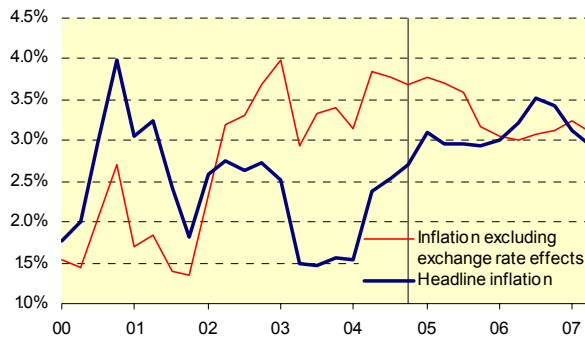


Inflated by growth steroids

Capacity constraints are putting upward pressure on inflation. The tight labour market will translate into higher wage demands, which some businesses will be able to hand straight through to consumers in the form of higher prices. The surge in prices and costs in the building industry as a result of strong demand has the potential to be repeated in other sectors. Falling prices for tradable goods have assisted the Reserve Bank in keeping headline inflation down, but the deflationary effects of the currency are waning. Inflation is set to hold up at around 3%pa over the forecast period.

Dollar not such a drag on inflation

Annual inflation rate, Infometrics estimates



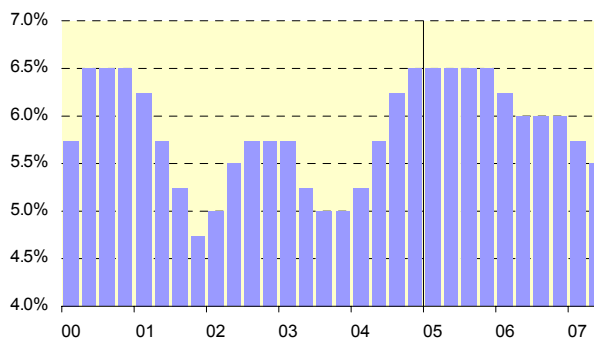
Graph 1.9

Keeping the brakes on

It goes without saying that such a buoyant inflation outlook leaves the Reserve Bank little room to cut interest rates in the near future. Although there is now a significant risk that the Bank will raise rates again to keep inflation down, our forecast is that it will hold fast to its “pipeline” argument and wait for the full effect of last year’s rate hikes to hit households. The Bank will be aware that key areas of the economy (such as housing) are starting to slow, and will be wary of pushing the currency any higher and squeezing exporters further. Interest rate cuts may be possible by 2006, but the OCR will remain at or above neutral over the forecast period.

Prolonging the squeeze

Official cash rate, end of quarter



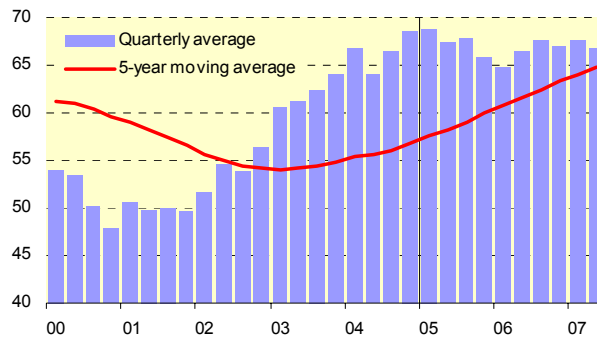
Graph 1.10

A tick from international investors

Despite being widely recognised as overvalued, the New Zealand dollar is likely to hold up over the next two years. Why? Partly because of America's ugly deficits keeping downward pressure on the \$US, and partly because of New Zealand's solid economic credentials. New Zealand's current account deficit will be over 6% of GDP, but concerns about the balance of payments will be offset by sustained economic growth and relatively high interest rates for international investors.

Living with a strong dollar

Trade weighted index



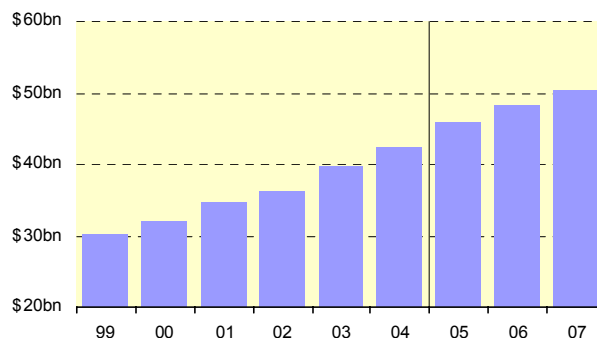
Graph 1.11

No surplus? Yeah, right

It may be trying to redefine the surplus out of existence, but the government is not fooling anyone – and tax revenues will continue to swell in the booming economy. So far, every time that economic growth surprises on the upside, the government finds a way to spend the extra revenue. The next three years will be no different, but the surplus looks likely to remain entrenched above \$6bn. The planned expansion of government spending is unprecedented, and with wide-spread capacity constraints throughout the economy, the government might start practicing what it preaches with regard to productivity.

Labour's creepy secret

Tax revenue, June year





2. POPULATION AND DEMOGRAPHICS

Population growth slides, and vacancies rise

The downturn in net migration has led to a slowdown in population growth since mid-2003 across most of the country. Those areas with the fastest lift in population over the last three years have generally experienced the most pressure on their existing dwelling stock, and thus the fastest house price inflation. In this chapter, we look at the numbers and pick which regions have got most out of balance.

The latest regional population estimates produced by Statistics NZ show that population growth over the year to June 2004 slowed across 88% of the country. The largest local authorities to record a pick-up in population growth were Lower Hutt, Whangarei, Hastings, Kapiti Coast, and Timaru.

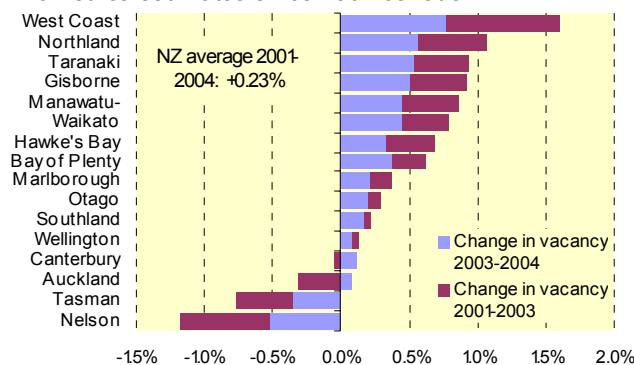
Nationally, population growth dipped from 1.8% to 1.3%pa – a result caused by a 13% decrease in long-term arrivals, and a 14% increase in long-term departures. The dip in arrivals was due to fewer foreigners immigrating to New Zealand, while the increase in departures was evenly split between foreign nationals returning home and more New Zealanders heading overseas.

The marked dip in foreign arrivals has significantly undermined population growth in Auckland City, which slowed from 3.4% over the year to June 2003 to just 1.4% the following year.

Graph 2.1 shows our estimates of changes in the regional vacancy rates since the 2001 census, split into the 2001-2003 period and the most recent year. There are three regions that have experienced a decline in the vacancy rate over the last three years as a result of pressure on their dwelling stock: Nelson, Tasman, and Auckland.

Regional changes in vacancy rates

Infometrics estimates since 2001 census



Graph 2.1

There is a reasonable correlation between regional vacancy rate changes and house price inflation over the last three years. For example, the housing boom in Nelson and Tasman has been well documented, and the lift in property values is at least partly justifiable given the population pressures experienced in these regions. But prices in other areas such

as the West Coast and Auckland don't seem to have performed as might have been expected.

Regional round-up

- Northland's vacancy rate has been rising more rapidly over the last decade as it becomes an increasingly popular holiday spot, and there is no serious oversupply in the property market. Price rises over the last three years have been modest.
- Auckland is currently suffering from the migration downturn and an oversupply of property in the central city. Nevertheless, the region consistently maintains faster population growth than the rest of the country, implying an ability for any excess in the dwelling stock to be absorbed relatively quickly.
- Changes in the occupancy and vacancy rates in Waikato remain close to their long-term trend. Hamilton has been one of the faster growing areas in terms of population over the last year, and price rises in the region are not out of line with nationwide movements.
- Population growth in the Bay of Plenty has improved over the last 2-3 years, following a period of slower growth between 1998 and 2001 that suggested the region's attractiveness might be waning. Coastal property has recorded strong price rises, but the area's real estate market generally remains well balanced.
- Gisborne's vacancy rate has risen rapidly over the last three years, but the region hardly seems to warrant its position as the worst performer in terms of house prices over that period. The region's distance from any of the major centres may be inhibiting growth in property values, but the area's coastline and climate is one of the country's most attractive.
- Hawke's Bay continues to grow as a holiday destination, but population growth of around 0.4%pa suggests it is not generally chosen as a place to live permanently. Property price rises in the region appear to be in excess of what fundamentals would justify.
- Movements in Taranaki's occupancy and vacancy rates remain in line with the region's long-term trend. Price rises have also been on par with nationwide movements, although the region's population continues to shrink.
- Manawatu-Wanganui experienced a rare lift in population over 2002/03, placing some pressure on the dwelling stock. Prices responded by rising 20% over 2004, but property values in the region have not performed as well as in Waikato or Taranaki.
- Wellington's vacancy rate has been pretty stable over the last three years. Price movements have been in line with nationwide trends, suggesting the region's property market remains well balanced.
- Tasman recorded the fastest regional population growth over 2003/04, taking the top spot from Auckland for the first time since 2001. But even with a falling vacancy rate, house price rises over the last three years have been excessive, leading to the price falls that are currently occurring.



- The situation in Nelson is less critical than in Tasman, with more pressure on the housing stock and less house price inflation over the last three years. Price falls are happening at the moment but are likely to be less severe in the city than around the coast in Golden Bay.
- House prices in Marlborough have piggybacked on the surge in Nelson and Tasman. Population growth in Marlborough almost trebled between 2001 and 2003, but the rising vacancy rate suggests the lift in property values is based on holiday homes more than anything else.
- Housing on the West Coast is still among the cheapest in the country. The surge in prices over the last couple of years appears to be a catch-up with the rest of the country, but the region's population is still shrinking and the vacancy rate is the highest in the country.
- After a sizeable lift in Canterbury's vacancy rate between 1996 and 2001, it has stabilised over the last three years. Waimakariri and Selwyn are among the fastest growing areas (in terms of population) in the country, and house price rises reflect that.
- Population growth of more than 1%pa over the last three years has placed some pressure on the dwelling stock in Otago, leading to a more stable occupancy rate. The population growth has been largely concentrated in the Queenstown-Lakes District (with a 7.2% increase over 2003/04). Although strong price rises are easily explainable in Queenstown, the rapid house price inflation in other areas of Otago is harder to justify.
- Positive population growth in Southland has underpinned a strong rise in house prices over the last 1-2 years. Fading population growth suggests further price rises will be limited, but the recent house price inflation is in line with a relatively stable vacancy rate.

Long-term trends in regional occupancy and vacancy rates (from 1976 onwards) can be viewed with this article on our website.

3. RESIDENTIAL PROPERTY MARKET

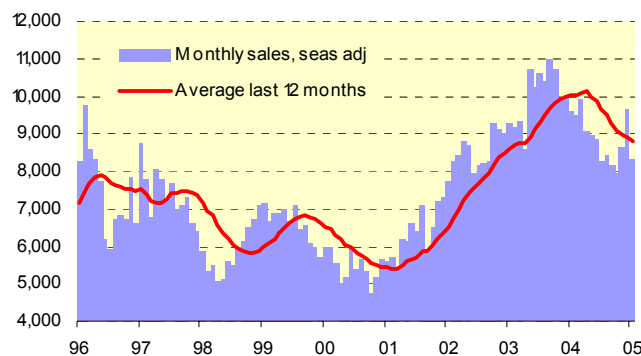
House prices still defying gravity

The latest data shows that house price inflation is still running at 14%pa, despite the annual sales total having dropped 13% since peaking in April last year. The fundamental drivers of weaker population growth and higher interest rates are still in place to send sales activity lower over 2005 and 2006. But a tight labour market and buoyant household confidence are likely to prevent a significant reversal in property prices – we remain comfortable with our forecast of a 4% real decline over 2005.

A steady downward trend in house sales activity throughout 2004 was interrupted in November and December as the banks waged a fixed-rate mortgage war. Sales volumes surged a total of 21% (seasonally adjusted) over the two months to their highest level since April.

On the way down

REINZ number of house sales



Graph 3.1

We have examined the cost of servicing a mortgage for first home buyers and concluded that the lower mortgage rates on offer had little impact, in the greater scheme of things, on the affordability of housing (see *Effects of the mortgage rate war – p44* for more). The 45% lift in house prices over the last three years heavily outweighs the effects of a 60 basis point drop in interest rates. It appears that the lift in activity was a psychological response to a perceived temporary drop in interest rates – homebuyers saw an opportunity to finance at rates that might not be seen again for some time.

With mortgage rates rebounding in late December, it is unsurprising that sales activity slipped 14% over January. On a regional basis, the worst annual growth for the three months to January was in Auckland (-17%) and Nelson/Marlborough (-16%). According to Quotable Value's new monthly house price indices, these two regions are also experiencing price falls in some areas on an annual basis.

There are two different drivers behind the drop in house prices in these regions. Rapid price growth in Nelson has led to property becoming significantly overvalued, and the lack of affordability has squeezed buyers out of the market. In Auckland, population growth has weakened as net migration has dried up, leading to an oversupply of property in the central



city. In both cases, vendors that are desperate to sell have been forced to lower their price expectations.

Nationally, however, house price inflation has been slow to come off. This reflects the buoyant economy and tight labour market boosting consumer confidence, and making households less cautious about taking on high levels of debt. We discuss the impact of these factors on the outlook for house prices at the end of this chapter.

Rental market turning in favour of tenants

Rental inflation has continued to ease since our last forecasts, and has now eased to its slowest rate in three years (3.6%pa). The rate of increase has been dragged down by falling rents across much of the Auckland metropolitan area, which makes up around 38% of the nationwide rental market. Nelson and Southland have also experienced rent declines over the last year.

Rents stop rising

Infometrics index, annual % change

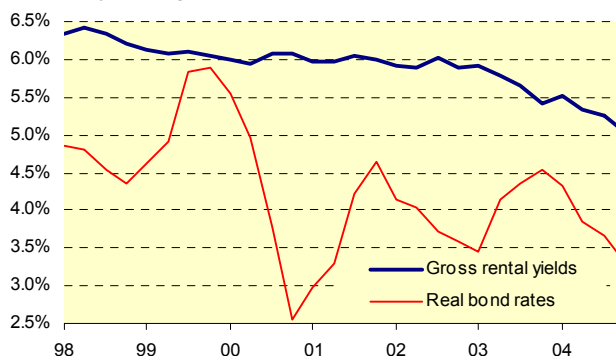


Graph 3.2

Rental yields have hit record lows across most of the country over the last couple of months. But real bond rates fell 1.2 percentage points over 2004, and so the gap between this benchmark yield and gross returns on rental property has widened to end the year in line with the average of the previous seven years.

Yields fall, but the gap widens

Quarterly averages



Graph 3.3

Rental yields are likely to deteriorate further over the next 3-6 months. Although we have factored in a modest fall in house prices over 2005, it is evident that the softer property market is also limiting the rent-setting ability of landlords. Thus it is possible that average rents may decline on a national basis over the next year. An improvement in yields is only likely to occur once the housing market begins to enter a period of significant undersupply. Given the ongoing strength of building activity, we do not anticipate that to occur within the forecast period.

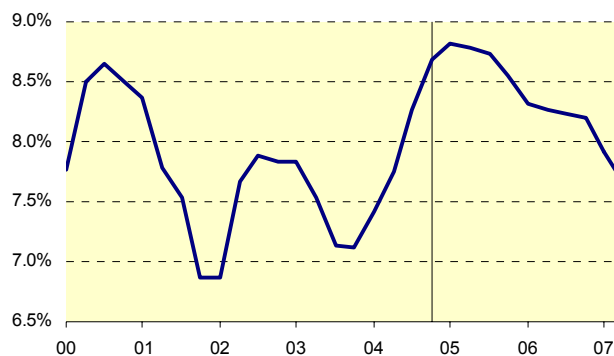
Little interest rate relief

Our general economic forecasts show that the economy has continued to grow faster than its long-term sustainable potential over recent quarters, stretching capacity and generating considerable inflationary pressures. Just as importantly, the outlook for economic growth over the next year has also improved, implying that there will continue to be upward pressure on business costs and prices.

Our higher inflation forecast leaves no room for any cut in interest rates this year. Although the housing market is slowing, the Reserve Bank has more widespread concerns to address when setting monetary policy. Even by the end of 2006, we do not anticipate the official cash rate dropping below 6%.

Mortgage rates stay high

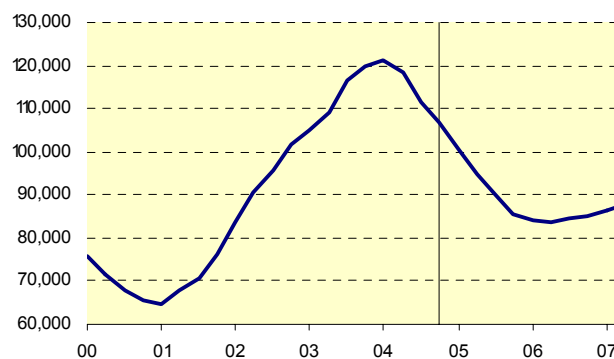
Floating rate, quarterly average



Graph 3.4

Sales slide for longer

Annual sales total



Graph 3.5



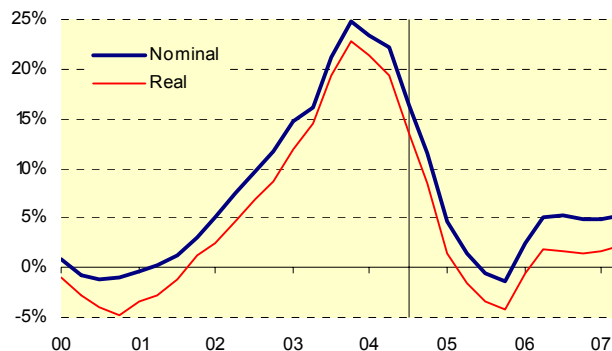
The more protracted than expected period of higher interest rates will not hasten the housing market's decline over 2005. However, it is likely to mean that the slide in sales volumes is more sustained – we do not expect the annual sales total to bottom out until the September 2006 quarter.

Our house price forecasts are slightly more positive than our prediction in November, with annual house price inflation getting no lower than -1.3% over the next year. This is partly due to a higher outlook for general inflation – we still expect real house prices to fall by more than 4% over 2005.

But the tight labour market is the key factor giving us confidence that the cooling in the real estate market will continue to be “orderly”. With good job security and strong prospects of healthy increases in income, we believe a large proportion of the population will remain comfortable with managing high debt levels. Although there is a risk that some property is overpriced, many buyers will continue to purchase housing as long as they are able to service the initial debt. This is particularly relevant for those buyers who see themselves as being “in for the long haul”, and those not purchasing property solely as an investment. These people are likely to be relaxed about the possibility of minimal capital gains over the next three years or so.

Heading down the mountain

QVNZ house price index, annual % changes



Graph 3.6

The effect of government policy

“Ownership society” is the latest political catchphrase, and the government is keen to enhance the abilities of lower socioeconomic groups to lift their home ownership rates. The proposal comes at a time when housing is particularly unaffordable by historical standards.

Statements by members of the government suggest that any financial assistance will be relatively limited in the first instance – Dr Cullen recently said that “the level of assistance required to assist many modest-income people into home ownership, especially in the Auckland area, would be high indeed and probably beyond what was affordable or wise.” In a rare moment of economic insight, the government is clearly wary of offering wholesale housing assistance to first home buyers, for fear of that assistance simply being capitalised into existing house prices. We

are clearly not going to see a blanket grant scheme similar to the one Australia has been running for the last 4½ years.

It is unclear exactly what form of assistance the government will adopt at this stage. Currently Kiwibank, which is government-owned, offers no-deposit mortgages up to \$150,000 aimed at low income households.¹ Three possible buyer assistance schemes being considered by the government are:

- lump-sum deposit assistance, which may include capitalisation of the family support benefit.
- a scheme where the government covers the interest payments, or offers low-interest loans, for a set period of time;
- making mortgage interest payments tax deductible up to a specified income limit.

Whatever the case, the government has signalled its intention to keep the size of the scheme relatively small. As such, we do not expect any policy initiatives to have a significant effect on either house prices or sales volumes.

¹ There are some conditions and variations around these figures, but this is the basic thrust of Kiwibank's scheme.



4. NEW HOUSE CONSTRUCTION

Buoyant economy to cushion residential downturn

Continued economic growth has helped sustain activity in both the housing market and residential construction industry. However, builders and developers are now complaining about the rapid increases in land and material costs over the last two years, and consent numbers are now falling. Nevertheless, the strength of the broader economy is likely to prevent construction activity dropping as far as we had previously predicted – we now expect consent numbers to hover in the 24,000-25,000pa range over the 2006 calendar year.

Residential construction activity is cooling, but only slowly. Consent numbers over the last 6-9 months have been distorted by regulatory changes and other one-off factors:

- There was a rush of new consents in June prior to the introduction of a development levy by a number of local councils. We estimate that there were as many as 570 additional consents in June in North Shore, Tauranga, and Manukau, that would otherwise have been spread over subsequent months. The 14% drop in non-apartment consents between the June and September quarters clearly amplified the turning point in residential building activity.
- Low interest rates in November and December may have added to new consent numbers. Even if the mortgage rate war did not directly boost the number of building projects, the positive impact on existing house prices has given developers more leeway in terms of being able to build and sell new property for a profit.

To gain a clearer picture of the trend in residential construction, it is worthwhile looking at the average quarterly change in non-apartment consent numbers between March and December. On average, there was a 4.9% fall in the three-month consent total over each of these quarters.

But the regulatory shenanigans are not over. With the new Building Act set to come into force on April 1, there is the potential for another rush of consents as people look to beat the more stringent standards. Although the higher standards will add some costs in terms of building materials, the real hike in costs will come through more rigorous inspection procedures and other compliance issues. It is unclear how quickly local councils will move to pass these costs on, but the cost of obtaining a resource or building consent is likely to rise sharply later this year.

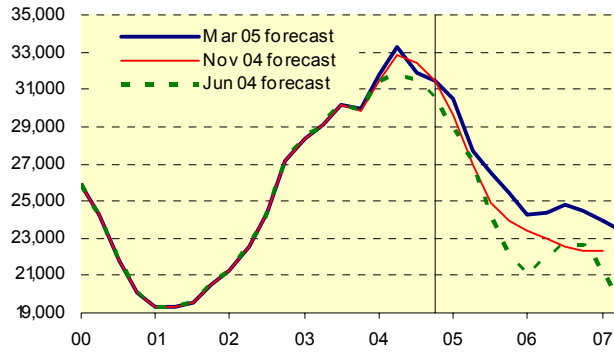
Ahead of these cost hikes, we anticipate that consent levels could hold up – we have allowed for a 4% lift in the quarterly consent total between December and March, before a sharp drop in June. If councils delay increasing their charges until July 1, the June quarter is likely to be relatively strong as well.

The new building regulation will also have the effect of reducing the number of builders able to undertake building projects. From April 1, all building work must be carried out under the supervision and responsibility of certified builders. A significant proportion of all residential building work to date has been carried out by uncertified builders. Not all “Master

Builders”, for instance, are certified. For an industry already critically short of skilled labour, the new regulations are going to further shrink capacity and raise costs.

Forecast comparison

Year ended dwelling consent total



Graph 4.1

New dwelling consents

Forecast summary

		Number		Annual % change	
		Quarterly	Annual	Quarterly	Annual
2004	Mar	8,238	31,823	30.2%	12.4%
	Jun	8,534	33,251	20.1%	14.4%
	Sep	6,941	31,864	-16.7%	5.7%
	Dec	7,710	31,423	-5.4%	5.0%
2005	Mar*	7,291	30,476	-11.5%	-4.2%
	Jun*	5,729	27,670	-32.9%	-16.8%
	Sep*	5,761	26,491	-17.0%	-16.9%
	Dec*	6,644	25,425	-13.8%	-19.1%
2006	Mar*	6,095	24,229	-16.4%	-20.5%
	Jun*	5,840	24,340	1.9%	-12.0%
	Sep*	6,267	24,846	8.8%	-6.2%
	Dec*	6,313	24,515	-5.0%	-3.6%
2007	Mar*	5,525	23,944	-9.4%	-1.2%
	Jun*	5,330	23,434	-8.7%	-3.7%

* Infometrics forecasts

Table 4.1

Costs encourage building – for now

If we look at the relative cost of buying an existing house compared with building a new house, it is not surprising that building activity has been slow to come off its peak. Although annual growth in the Tobin’s Q ratio peaked in the final quarter of 2003 (see Graph 4.2), the ratio has continued to inch higher over the last year.

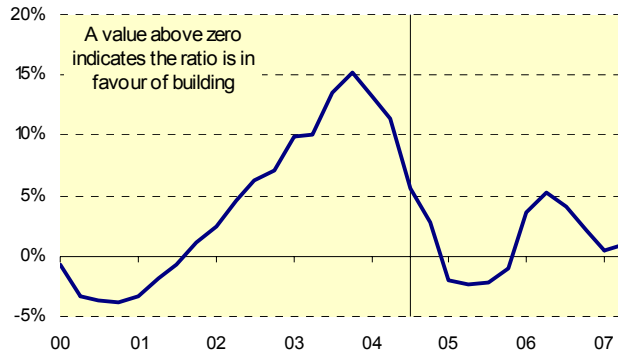
Changes in the Tobin’s Q ratio are important to predicting changes in building activity. The sustained pace of house price inflation has caught us by surprise, forestalling any major downturn in residential consent



numbers. By the December quarter, annual building cost inflation had started to slow, without ever outpacing the rate of increase in existing house prices.

Still favouring building

Annual % change in Tobin's Q ratio



Graph 4.2

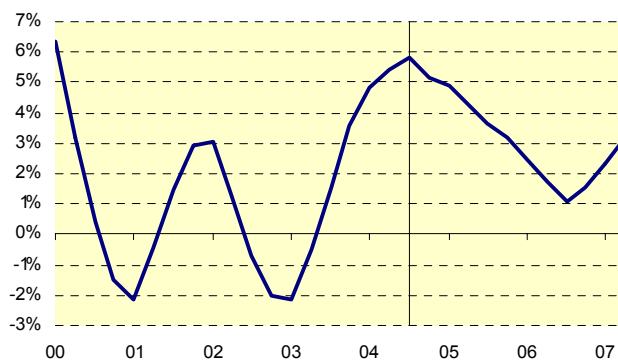
We are looking for things to switch round during the first half of this year. The shift will come through stagnating (or slightly falling house prices), and could be exacerbated by higher building costs as the new regulations take effect. This turnaround could be reasonably significant, given increased building costs and the effects of higher debt-servicing costs on existing house prices.

Good income prospects allow us to spread out

Readers of our previous forecasts may wonder about the consistency of our medium-term outlook, with the annual consent total still sitting at close to 24,000 by March 2007. In the past, we have highlighted the overbuilding that is currently taking place, and the need for the build rate to drop back below medium-term demand so the excess dwellings in the housing stock can be absorbed.

Slowing, but still positive

Real disposable income, ann avg % change



Graph 4.3

The strength of the economy and, in particular, the labour market, is critical to our more optimistic building forecast. With good job security and healthy income prospects, the occupancy rate is likely to decline

faster than expected and the vacancy rate will rise further than would otherwise have been the case. In other words:

- young people will feel more able to leave home and/or live in less crowded flats given the stability of their income;
- more households will be comfortable with purchasing a second home, whether it is a “crash pad” in the city or a holiday home out of town.

The main adjustment is likely to be through a lower occupancy rate and we predict that 2,200 more households will be formed in each of the next two years than we had assumed in our November forecast report.

The faster rate of household formation does not disguise the fact that overbuilding is occurring, and is likely to continue doing so throughout the forecast period. However, resilient GDP growth provides the economy with more flex in absorbing the excess stock over a 3-5 year horizon.

A larger slowdown in economic growth would risk exposing the excess supply of housing, and lead to a sharper drop-off in residential building activity.



Housing market influences

Years ended	Real HH consumption	Real HH disposable income	Net external migration	Housing consents	Occupied private dwellings	Household formation	Real house prices	Nominal house prices	Real mortgage rates
March	Annual average % changes	Annual average % changes	Number	Number	'000	Number	Annual average % changes	Annual average % changes	Percent
1976/77	-2.2	-1.6	-19,072	30,154	1,004.6	24,624	-7.1	6.7	-5.5
1977/78	-3.5	-4.5	-26,708	21,205	1,025.1	20,485	-9.8	2.6	-3.4
1978/79	1.3	4.6	-40,200	19,050	1,040.9	15,815	-7.4	3.0	0.8
1979/80	1.0	2.7	-34,417	15,197	1,053.6	12,737	-9.8	5.8	-3.1
1980/81	0.5	-1.6	-24,825	14,442	1,064.7	11,038	-1.2	14.4	-2.1
1981/82	1.7	3.1	-11,482	19,006	1,079.2	14,541	14.1	32.9	0.3
1982/83	-0.2	-4.1	3,180	15,999	1,093.6	14,435	3.0	14.9	1.6
1983/84	3.1	1.2	6,558	20,226	1,108.6	14,965	6.4	10.8	10.9
1984/85	3.9	4.6	-8,084	21,782	1,126.3	17,725	0.0	13.0	6.1
1985/86	1.4	1.5	-21,613	23,035	1,146.3	19,954	-0.7	11.9	3.2
1986/87	4.2	2.7	-14,269	20,128	1,167.1	20,803	-5.9	11.7	4.4
1987/88	2.4	2.8	-15,625	19,886	1,184.4	17,301	10.1	18.8	6.1
1988/89	2.1	1.3	-24,708	19,583	1,202.3	17,937	1.5	6.2	10.8
1989/90	0.6	0.1	-4,018	22,851	1,222.7	20,379	0.9	8.4	8.5
1990/91	0.2	-2.7	11,616	20,820	1,244.2	21,440	0.5	4.3	9.4
1991/92	-1.5	1.0	4,287	17,563	1,264.0	19,848	-3.8	-2.2	10.1
1992/93	0.4	-1.0	6,848	17,905	1,279.7	15,700	0.6	1.6	8.5
1993/94	3.8	4.2	15,587	19,361	1,296.4	16,700	4.3	5.7	6.8
1994/95	6.2	2.0	21,697	23,681	1,315.6	19,200	9.8	12.5	6.9
1995/96	3.7	4.1	29,832	21,256	1,335.3	19,700	6.2	9.7	7.3
1996/97	4.5	4.0	20,948	22,418	1,355.1	19,800	8.0	10.3	8.6
1997/98	2.2	0.1	2,707	25,565	1,376.3	21,200	3.9	5.0	8.9
1998/99	3.1	3.1	-10,196	20,695	1,395.4	19,100	-3.5	-2.6	7.5
1999/00	3.3	6.4	-8,987	25,858	1,417.6	22,200	2.2	2.5	6.6
2000/01	1.9	-2.1	-12,600	19,370	1,436.6	19,000	-3.7	-0.9	5.5
2001/02	2.9	3.0	25,640	21,302	1,453.6	17,000	-0.1	2.4	4.7
2002/03	4.6	-2.1	41,230	28,320	1,474.9	21,300	8.1	11.0	5.1
2003/04*	5.6	4.8	27,980	31,823	1,501.1	26,200	19.6	21.5	5.8
2004/05*	5.2	4.9	12,482	30,476	1,525.5	24,419	10.6	13.3	5.7
2005/06*	3.3	2.4	8,275	24,229	1,545.7	20,157	-2.5	0.5	5.6
2006/07*	3.3	2.3	12,020	23,944	1,566.2	20,479	1.7	5.0	4.9

Sources: Quotable Value NZ, Statistics NZ, RBNZ, Infometrics estimates and forecasts.

Table 4.2

New dwelling consents by region

Year ended June

	Northland		Auckland		Waikato/Bay of Plenty/Gisborne		Hawke's Bay		Taranaki/Manawatu/Wanganui	
	Number	APC ⁽¹⁾	Number	APC ⁽¹⁾	Number	APC ⁽¹⁾	Number	APC ⁽¹⁾	Number	APC ⁽¹⁾
1998	1,212	15%	9,259	10%	5,544	5%	386	-18%	605	-6%
1999	1,095	-10%	9,209	-1%	4,705	-15%	382	-1%	649	7%
2000	1,100	0%	9,965	8%	4,638	-1%	457	20%	875	35%
2001	936	-15%	7,407	-26%	3,489	-25%	432	-5%	732	-16%
2002	882	-6%	9,374	27%	3,939	13%	494	14%	840	15%
2003	1,082	23%	12,277	31%	4,828	23%	611	24%	947	13%
2004	1,408	30%	12,537	2%	6,293	30%	734	20%	1,301	37%
2005*	1,260	-11%	10,248	-18%	5,491	-13%	621	-15%	1,163	-11%
2006*	1,162	-8%	9,322	-9%	4,995	-9%	490	-21%	902	-22%
2007*	1,122	-3%	9,060	-3%	4,836	-3%	448	-9%	832	-8%

	Wellington		Nelson/Marlborough		Christchurch		Other Canterbury/Westland		Otago/Southland	
	Number	APC ⁽¹⁾	Number	APC ⁽¹⁾	Number	APC ⁽¹⁾	Number	APC ⁽¹⁾	Number	APC ⁽¹⁾
1998	2,323	51%	914	5%	2,117	4%	1,325	0%	553	-43%
1999	2,104	-9%	745	-18%	1,906	-10%	1,282	-3%	529	-4%
2000	2,451	16%	801	8%	1,744	-8%	1,370	7%	842	59%
2001	2,157	-12%	775	-3%	1,342	-23%	1,132	-17%	941	12%
2002	1,934	-10%	954	23%	1,530	14%	1,270	12%	1,315	40%
2003	2,574	33%	1,298	36%	2,338	53%	1,556	23%	1,562	19%
2004	2,592	1%	1,318	2%	2,539	9%	2,111	36%	2,015	29%
2005*	2,156	-17%	1,051	-20%	2,017	-21%	1,882	-11%	1,781	-12%
2006*	2,037	-6%	843	-20%	1,755	-13%	1,621	-14%	1,214	-32%
2007*	1,995	-2%	769	-9%	1,635	-7%	1,548	-4%	1,188	-2%

Source: Statistics New Zealand; * Infometrics forecasts

(1) Annual percentage change

Table 4.3



Residential investment

Quarterly data

	03 Dec	04 Mar	Jun	Sep	Dec	05 Mar	Jun	Sep	Dec	06 Mar	Jun	Sep	Dec	07 Mar	Jun
New dwelling consents															
Non-apartment consents	6803	6373	6607	6091	5766	5719	4977	5127	5472	5250	5090	5504	5298	4847	4619
Apartment consents	1348	1865	1927	850	1944	1572	752	635	1172	845	750	763	1014	678	711
Total new dwelling consents	8151	8238	8534	6941	7710	7291	5729	5761	6644	6095	5840	6267	6313	5525	5330
Seas adj, non-apartments	6769	6649	6669	5754	5726	5966	5024	4843	5434	5477	5138	5199	5262	5056	4662
Quarterly percentage change	1.0%	-1.8%	0.3%	-13.7%	-0.5%	4.2%	-15.8%	-3.6%	12.2%	0.8%	-6.2%	1.2%	1.2%	-3.9%	-7.8%
Avg floor area, all consents	185	179	173	193	177	180	189	190	184	191	194	198	193	197	197
Avg floor area, non-apartments	201	206	201	205	208	206	204	203	204	206	209	212	212	212	213
Avg floor area, apartments	105	89	76	109	87	87	89	91	93	92	93	94	95	95	95
Activity at 1995-96 prices															
New dwellings	1161	1015	1233	1225	1002	1073	932	1034	907	906	833	926	858	866	775
Additions and alterations	221	195	211	201	224	191	194	208	208	184	190	208	208	183	193
Total residential WPIP	1382	1210	1445	1426	1226	1264	1127	1242	1115	1090	1023	1133	1066	1049	968
Fees and taxes	594	543	591	563	510	420	475	449	419	393	468	471	431	415	503
Total residential investment	1976	1753	2036	1989	1736	1685	1601	1691	1534	1483	1491	1605	1496	1464	1471
Sales of existing houses	4000	3872	3293	3094	3436	2995	2643	2470	2822	2803	2609	2589	2901	2957	2802
Activity at current prices															
New dwellings, \$m	1469	1309	1631	1654	1375	1479	1280	1419	1241	1233	1143	1284	1205	1229	1109
Additions and alterations, \$m	279	251	280	271	308	263	267	285	284	250	261	288	292	260	276
Total residential WPIP, \$m	1748	1561	1910	1925	1682	1742	1547	1704	1525	1483	1403	1572	1497	1489	1385
Fees and taxes, \$m	768	720	803	774	700	579	652	616	573	535	643	653	605	589	720
Total residential invest., \$m	2516	2281	2713	2699	2382	2321	2199	2320	2098	2018	2046	2226	2102	2078	2104
Sales of existing houses, \$m	6575	6625	5775	5554	6297	5363	4700	4409	5103	5140	4875	4867	5502	5682	5507
Costs and prices															
Cost of new dwellings	1.265	1.290	1.322	1.350	1.372	1.378	1.373	1.372	1.368	1.361	1.372	1.387	1.405	1.419	1.430
Price of existing houses	1.644	1.711	1.754	1.795	1.833	1.791	1.778	1.785	1.808	1.834	1.869	1.880	1.897	1.921	1.966

Table 4.4

**Residential investment***Annual percentage changes in quarterly data*

	03	04				05				06				07	
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
New dwelling consents															
Non-apartment consents	20.7	14.9	9.0	-14.1	-15.2	-10.3	-24.7	-15.8	-5.1	-8.2	2.3	7.4	-3.2	-7.7	-9.3
Apartment consents	-50.8	137.9	84.9	-31.1	44.2	-15.7	-61.0	-25.3	-39.7	-46.3	-0.2	20.3	-13.5	-19.7	-5.2
Total new dwelling consents	-2.7	30.2	20.1	-16.7	-5.4	-11.5	-32.9	-17.0	-13.8	-16.4	1.9	8.8	-5.0	-9.4	-8.7
Avg floor area, all consents	15.9	-4.4	-5.8	6.1	-4.4	0.5	9.2	-1.5	4.0	5.7	2.8	4.0	4.9	3.5	1.3
Avg floor area, non-apartments	0.3	2.5	0.5	4.4	3.2	0.0	1.4	-1.1	-1.9	0.3	2.5	4.8	4.1	2.5	1.6
Avg floor area, apartments	38.5	-5.4	-12.9	8.6	-17.5	-1.7	16.7	-16.9	7.2	5.8	3.9	3.6	1.9	2.5	2.4
Activity at 1995-96 prices															
New dwellings	13.5	9.7	15.3	4.6	-13.7	5.8	-24.4	-15.6	-9.5	-15.6	-10.6	-10.5	-5.5	-4.4	-6.9
Additions and alterations	13.1	15.2	12.0	-6.9	1.5	-2.0	-8.1	3.4	-7.4	-3.9	-2.3	0.0	0.2	-0.1	1.5
Total residential WPIP	13.4	10.6	14.8	2.8	-11.3	4.5	-22.0	-12.9	-9.1	-13.8	-9.2	-8.7	-4.4	-3.7	-5.4
Fees and taxes	12.8	8.2	6.0	-6.2	-14.1	-22.7	-19.7	-20.2	-17.9	-6.4	-1.3	4.8	2.8	5.5	7.4
Total residential investment	13.2	9.8	12.1	0.1	-12.1	-3.9	-21.4	-15.0	-11.7	-12.0	-6.8	-5.1	-2.4	-1.3	-1.4
Sales of existing houses	23.2	-1.8	-9.0	-20.2	-14.1	-22.7	-19.7	-20.2	-17.9	-6.4	-1.3	4.8	2.8	5.5	7.4
Activity at current prices															
New dwellings, \$m	23.0	19.6	26.6	15.3	-6.4	12.9	-21.5	-14.2	-9.7	-16.6	-10.7	-9.5	-2.9	-0.4	-3.0
Additions and alterations, \$m	22.6	25.6	23.0	2.6	10.2	4.7	-4.5	5.1	-7.7	-5.1	-2.4	1.1	2.9	4.2	5.8
Total residential WPIP, \$m	22.9	20.5	26.1	13.4	-3.8	11.6	-19.0	-11.5	-9.4	-14.9	-9.3	-7.7	-1.8	0.4	-1.3
Fees and taxes, \$m	22.5	19.9	17.1	3.1	-8.8	-19.6	-18.8	-20.4	-18.1	-7.5	-1.4	6.0	5.6	10.0	12.0
Total residential invest., \$m	22.8	20.3	23.3	10.2	-5.3	1.7	-19.0	-14.0	-11.9	-13.0	-6.9	-4.1	0.2	3.0	2.8
Sales of existing houses, \$m	53.8	21.1	11.2	-7.1	-4.2	-19.1	-18.6	-20.6	-19.0	-4.2	3.7	10.4	7.8	10.6	13.0
Costs and prices															
Cost of new dwellings	8.4	9.0	9.8	10.2	8.5	6.8	3.9	1.6	-0.3	-1.2	-0.1	1.1	2.7	4.3	4.3
Price of existing houses	24.8	23.3	22.2	16.4	11.5	4.6	1.4	-0.6	-1.3	2.4	5.1	5.3	4.9	4.8	5.2

Table 4.5



Residential investment

Annual data

	03 Dec	04 Mar	Jun	Sep	Dec	05 Mar	Jun	Sep	Dec	06 Mar	Jun	Sep	Dec	07 Mar	Jun
New dwelling consents															
Non-apartment consents	25506	26334	26877	25874	24837	24183	22553	21588	21294	20825	20938	21315	21142	20739	20268
Apartment consents	4408	5489	6374	5990	6586	6293	5118	4902	4131	3403	3402	3531	3373	3206	3167
Total new dwelling consents	29914	31823	33251	31864	31423	30476	27670	26491	25425	24229	24340	24846	24515	23944	23434
Avg floor area, all consents	185	183	180	182	180	181	185	184	186	188	190	192	194	196	196
Avg floor area, non-apartments	200	201	201	203	205	205	206	205	204	204	206	208	210	211	212
Avg floor area, apartments	98	95	91	91	87	87	91	88	90	92	92	93	94	94	95
Activity at 1995-96 prices															
New dwellings	4326	4416	4580	4635	4475	4534	4233	4042	3947	3779	3681	3572	3523	3483	3425
Additions and alterations	795	820	843	828	831	828	811	817	801	793	789	789	789	789	792
Total residential WPIP	5121	5237	5423	5463	5307	5362	5043	4859	4747	4573	4469	4361	4312	4272	4217
Fees and taxes	2254	2295	2329	2291	2208	2084	1968	1854	1763	1736	1730	1752	1763	1785	1820
Total residential investment	7375	7532	7752	7754	7514	7446	7011	6713	6511	6309	6199	6113	6075	6057	6036
Sales of existing houses	15441	15369	15041	14258	13695	12818	12168	11544	10930	10738	10704	10823	10902	11056	11249
Activity at current prices															
New dwellings, \$m	5286	5500	5843	6063	5968	6138	5787	5552	5418	5173	5036	4901	4865	4861	4827
Additions and alterations, \$m	971	1022	1075	1081	1110	1122	1109	1123	1099	1086	1079	1082	1091	1101	1116
Total residential WPIP, \$m	6257	6522	6917	7144	7078	7259	6896	6675	6517	6259	6115	5984	5956	5962	5944
Fees and taxes, \$m	2805	2925	3042	3065	2997	2856	2705	2547	2420	2377	2368	2404	2436	2490	2567
Total residential invest., \$m	9062	9447	9959	10209	10075	10115	9601	9222	8938	8635	8483	8388	8393	8452	8511
Sales of existing houses, \$m	23220	24373	24953	24529	24252	22989	21914	20769	19575	19352	19527	19985	20384	20927	21559
Costs and prices															
Cost of new dwellings	1.219	1.246	1.275	1.307	1.334	1.355	1.368	1.374	1.373	1.369	1.368	1.372	1.381	1.396	1.410
Price of existing houses	1.502	1.583	1.663	1.726	1.773	1.793	1.799	1.797	1.791	1.801	1.824	1.848	1.870	1.892	1.916

Table 4.6



Residential investment

Annual percentage changes in annual data

	03	04				05				06				07	
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
New dwelling consents															
Non-apartment consents	18.1	17.0	16.3	6.3	-2.6	-8.2	-16.1	-16.6	-14.3	-13.9	-7.2	-1.3	-0.7	-0.4	-3.2
Apartment consents	-21.4	-5.6	6.8	3.3	49.4	14.6	-19.7	-18.2	-37.3	-45.9	-33.5	-28.0	-18.4	-5.8	-6.9
Total new dwelling consents	9.9	12.4	14.4	5.7	5.0	-4.2	-16.8	-16.9	-19.1	-20.5	-12.0	-6.2	-3.6	-1.2	-3.7
Avg floor area, all consents	4.7	3.8	2.1	2.7	-2.4	-1.2	2.5	0.7	3.0	4.4	2.8	4.4	4.6	3.8	3.5
Avg floor area, non-apartments	0.4	0.9	0.7	1.9	2.6	2.0	2.3	0.9	-0.4	-0.3	-0.1	1.3	2.9	3.5	3.2
Avg floor area, apartments	9.6	10.6	5.8	6.6	-10.8	-8.9	0.2	-3.9	2.9	5.6	1.5	5.9	4.2	2.7	2.4
Activity at 1995-96 prices															
New dwellings	24.2	18.4	14.5	10.7	3.4	2.7	-7.6	-12.8	-11.8	-16.6	-13.0	-11.6	-10.7	-7.9	-7.0
Additions and alterations	10.4	10.8	12.1	7.7	4.6	0.9	-3.8	-1.3	-3.7	-4.2	-2.7	-3.5	-1.4	-0.5	0.4
Total residential WPIP	21.9	17.1	14.1	10.2	3.6	2.4	-7.0	-11.1	-10.5	-14.7	-11.4	-10.2	-9.2	-6.6	-5.7
Fees and taxes	15.5	13.1	10.5	4.8	-2.1	-9.2	-15.5	-19.1	-20.1	-16.7	-12.1	-5.5	0.0	2.8	5.2
Total residential investment	19.8	15.9	13.0	8.5	1.9	-1.1	-9.6	-13.4	-13.4	-15.3	-11.6	-8.9	-6.7	-4.0	-2.6
Sales of existing houses	17.2	15.2	9.7	-2.9	-11.3	-16.6	-19.1	-19.0	-20.2	-16.2	-12.0	-6.2	-0.3	3.0	5.1
Activity at current prices															
New dwellings, \$m	32.1	27.0	24.1	21.0	12.9	11.6	-0.9	-8.4	-9.2	-15.7	-13.0	-11.7	-10.2	-6.0	-4.1
Additions and alterations, \$m	17.5	19.1	21.6	17.6	14.3	9.7	3.2	3.8	-1.0	-3.2	-2.7	-3.6	-0.8	1.4	3.5
Total residential WPIP, \$m	29.6	25.7	23.7	20.5	13.1	11.3	-0.3	-6.6	-7.9	-13.8	-11.3	-10.4	-8.6	-4.7	-2.8
Fees and taxes, \$m	23.7	21.8	20.5	15.0	6.8	-2.4	-11.1	-16.9	-19.2	-16.8	-12.5	-5.6	0.7	4.8	8.4
Total residential invest., \$m	27.7	24.5	22.7	18.8	11.2	7.1	-3.6	-9.7	-11.3	-14.6	-11.6	-9.0	-6.1	-2.1	0.3
Sales of existing houses, \$m	40.2	39.6	34.0	17.2	4.4	-5.7	-12.2	-15.3	-19.3	-15.8	-10.9	-3.8	4.1	8.1	10.4
Costs and prices															
Cost of new dwellings	6.3	7.4	8.5	9.3	9.4	8.8	7.3	5.1	2.9	1.0	0.0	-0.1	0.6	2.0	3.1
Price of existing houses	19.3	21.5	22.9	21.5	18.1	13.3	8.2	4.1	1.0	0.5	1.4	2.8	4.4	5.0	5.0

Table 4.7



5. NON-RESIDENTIAL PROPERTY MARKET

Bubbling along

Commercial property returns are comfortably outperforming those available in the high profile residential market. The fundamentals in the commercial sector look attractive with low vacancy rates, some prospect of rental increase and a decade of meagre building activity. There is plenty to be exuberant about, but it would be odd if there weren't clouds somewhere on the horizon. There are – building costs, inflation, interest rates and a dwindling supply of labour. The bubbling sensation could signal a bubble.

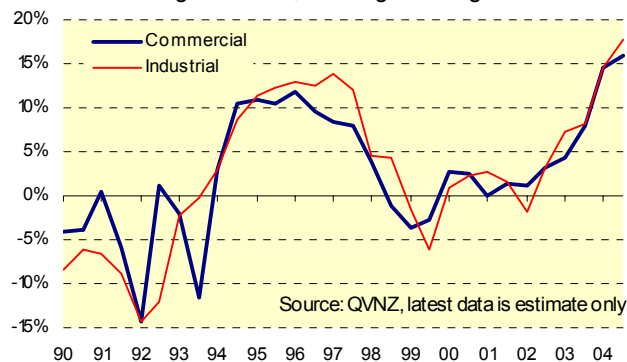
All systems are go!

It took a long time, but the non-residential property market gradually worked its way back to some sort of equilibrium by 2002-04. Surplus space was slowly soaked up by new CBD tenants such as apartment dwellers, hotels, and education businesses. The big fall in interest rates over the 1990s was also a critical part of the adjustment that has helped put commercial property back on the investment radar.

With vacancy rates at, or close to, 15 year lows at a time when businesses are recording strong earnings growth and employment growth is zipping along at around 3%pa, the consequences for rents and property values are mostly good. Over the past year commercial property price inflation has lifted to around 15% – higher than at the peak of the mid-1990s boom.

Commercial and industrial prices

Annual % change in index, existing buildings



Graph 5.1

Employment growth in the key financial, insurance, and business services sectors (7%) comfortably exceeded economy-wide employment growth over 2004 of just over 4.4%pa. However, service sector employment growth has been much faster in Auckland over the year ended February 2004 than it has in Wellington where service sector employee count fell 5.6%, see Table 5.1.

Given the rapid increase in employment it is no great surprise that the country is running out of labour – employment growth will slow and the cost of labour will rise over the next two years. Both trends are likely to

result in a softening in demand for space either through firms simply not expanding as fast, or being more wary of rent increases given the rising cost of labour.

Change in employment 2003 to 2004

	Wellington	Auckland	New Zealand
Finance & insurance	-4840	350	-4630
Property & business services	1150	6580	13990
Government administration	-200	160	-170
Total	-3890	7090	9190
Year end Feb 2004 % change	-5.6%	6.0%	3.0%

Source: Statistics NZ, Business Demographics, employee count

Table 5.1

Retail sales have boomed over the past three years as a result of:

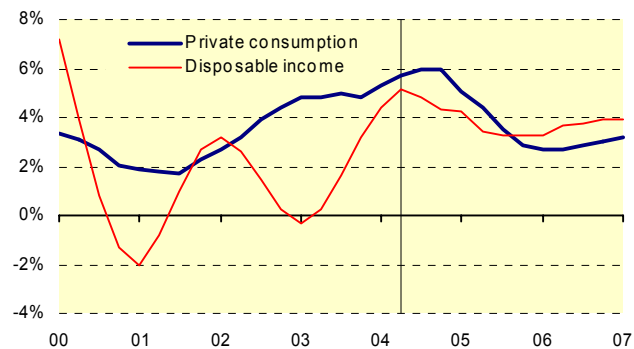
- more consumers (including tourists);
- more people being in work;
- higher consumer confidence.

Consequently the demand for new, refurbished and sophisticated retail space has increased, including for restaurants and cafes. Wealthier consumers are becoming choosier about what they buy and where they shop. Furthermore, there is more competition in the retail market, particularly in terms of home goods (Bunnings, Spotlight).

We predict consumer spending growth will slow over the forecast period, but remain positive. The main risk, in terms of demand, for the retail property sector is a more dramatic than anticipated correction in the residential property market over the next year or so.

Consumption vs. income

Year ended % change, real



Graph 5.2

Rents flatten as space increases

Market conditions would appear to support an acceleration in rental inflation – space is tight, tenants’ businesses are doing well – what better time to push up prices? Rents in the office sector, and to a lesser degree in other property categories, generally remain at or below the levels prevailing at the beginning of the 1990s, implying a significant drop in the



real cost of space. For some organisations that means that the high rents they locked into in, say, 1990 will now get them far better space than they have been occupying.

For most businesses the cost of space has fallen as a proportion of total costs. That, however, does not mean that firms are ready to pay much higher rents. Despite our prediction that inflation will sit at or above 3% for much of the next two years most of that inflation will come via import and export prices as the currency slips. There will not be much scope for businesses to hand on significant increases in rents and wages.

We do not expect same-space rents to rise by more than 5%pa over the forecast period for the majority of property. There will be exceptions for specific sites, property categories and in some regions. As the volume of non-residential construction rises the pressure on rents will be down as supply catches up with, and in some cases exceeds, demand.

A growing number of businesses and organisations are looking for more modern, high quality, efficient space and are prepared to pay higher rents to obtain it – hence the construction of new, state of the art, industrial and office buildings. The real question is: how big is this demand, and therefore how quickly might it be satisfied by the current level of new construction and refurbishment? At the current rate of new construction it may take less than two years to oversupply the market.

Yields to reverse recent falls

Commercial property yields have edged down as money has poured into this investment class. After being badly burnt in the commercial property sector over the 1990s major investment institutions are returning to this market at the same time foreigners have become more interested and private investors' love affair with property has been rekindled. In short, the perceived risk premium on property has shrunk and interest rates have fallen – hence the lower yields.

Real bond interest rate

10-year gov't bond rate less CPI one yr ahead



Graph 5.3

Despite funding rates at the short end of the yield curve rising over the past year, the benchmark ten year bond rate has remained pretty stable at around 6%. The real bond rate, which we view as the basis for thinking about the appropriate level of investment returns, has fallen steadily since 2002. But we predict it will bottom out this year and rise

slightly over 2006. Furthermore, as the existing stock of commercial space increases and quality improves the risk of supply outstripping demand increases. That should lead to some upward revision of the required risk premium. These trends imply that yields will need to rise from 2006 – not much, but sufficiently to put a brake on property values.

With non-residential building costs rising at around 10%pa it won't take much of a slowdown in existing property price inflation to shift the focus of buyers and tenants to the existing space rather than new.



6. NON-RESIDENTIAL CONSTRUCTION

Unparalleled growth

Strong growth in the total value of non-residential building consents indicates the significant lift in construction work will continue into the first half of 2005. We expect the rush of consents to slow this year as higher building costs cramp further growth and fewer large projects are proposed. Softening employment growth will also undermine continued demand growth for commercial buildings, which have been the largest contributor to growth over the last year. Although growth in construction will slow, the non-residential sector will sustain most of the current rise in activity levels.

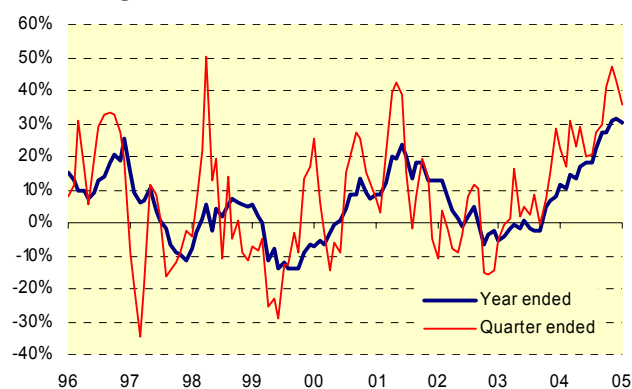
Confident businesses demand space

Non-residential construction activity has been growing strongly for the past 12 months. Building activity has outpaced even the most bullish of forecasts. Healthy economic growth has translated into growth in investment spending, brought on by increasing business confidence.

Office and administration buildings have lead the surge in construction work, with employment growth driving demand for high-quality space, particularly as businesses look to expand or upgrade in the wake of earnings growth. On the back of this trend, Wellington is experiencing a sustained boom in activity – the value of non-residential consents in the region over the year to January was more than double the previous year's total.

The hostel and boarding houses sector has also displayed notable growth. This is likely to have been driven by a surge in prison construction work, which is set to continue with the construction of a number of prisons beginning early this year.

Annual growth in consent values



Graph 6.1

Government construction spending increased markedly over 2004, with the total value of government sector consents 40% higher over the year ended January 2005.

However, rising construction costs are slowly undermining the business case for new buildings. Non-residential building cost inflation hit 10%pa

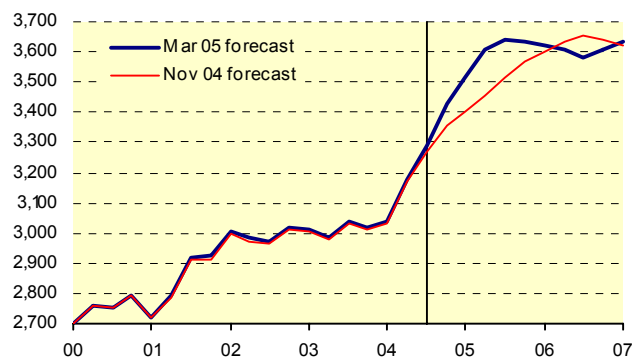
in the December quarter, as capacity in the construction sector continued to be highly stretched. We expect cost inflation to ease over 2005, as capacity becomes available from the residential sector. There will be some shift in employment from residential to non-residential construction.

Expand... and hold

We have revised up our forecasts of total non-residential work put in place over the coming year. Consent activity is running at a higher level than we anticipated, and implies stronger growth in building work than we had previously allowed for. And with economic growth continuing to come in above expectations, firms are rapidly looking to expand their premises to cope with additional demand.

Forecast comparison

Year end work put in place, 1995-96 \$m



Graph 6.2

Property market fundamentals have improved even further since November – vacancy rates are at very low levels, and yields have been forced down as investor demand has pushed up the price of existing property.

But by 2006, we expect growth to construction activity to fade. As the New Zealand economy cools off slightly, growth in the non-residential building sector will also ease. Weaker employment growth will occur at the same time as some large new developments come online, limiting demand for further new buildings. The emptying of lower grade office space in Wellington and, to a lesser extent, in Auckland is likely to force developers to consider how they can better utilise existing buildings.

That said, we do not predict a sharp drop in non-residential construction. Activity is likely to plateau at a level around 20% higher than it was three years earlier.

Activity by sector

Towering growth in offices

Office building has been the star non-residential performer over the last year, contributing 35% of the growth in consent values, and growing its share of the total non-residential sector from 14% to 19%. There is strong demand for high-quality office space, with large projects generally being well-tenanted in advance (in the order of 75%).



The main issue confronting the commercial sector over the coming year is slowing employment growth. Total employment rose 4.4% over 2004, but we expect that growth rate to have faded to just 1.3%pa by the end of 2005, and to hold in the 1-1.5%pa range over the rest of the forecast period. That implies much slower growth in demand for space over 2006 and 2007.

Office and shop building activity

Year end WPIP, 1995/96 \$m



Graph 6.3

When completed, the projects that are currently underway in Wellington are likely to satisfy demand over the medium term. In comparison, the larger size of the Auckland market means that it has the ability to absorb a number of large projects without becoming particularly oversupplied.

The space left vacant by tenants moving to premium space may prove difficult to fill. Yields are already low and less attractive buildings could be revalued downwards.

Spending frenzy feeds retail

Retail consent values are up 20% on a year ago as household consumption growth has continued unabated. There has recently been some anecdotal evidence that growth in retail activity is beginning to cool, although it seems to be a limited group of companies at the lower end of the retail spectrum that has been affected.

As higher interest rates take their effect, we expect spending growth to ease over the next year, from a peak of 6.1%pa in September 2004 to 3.1% by mid-2006. This is likely to slow growth in retail activity and consequently demand for additional space. However, we must stress that this is not a collapse in consumer spending. Overall consumer confidence is high, and will continue to be buoyed by a tight labour market, implying good job security and the potential for higher incomes.

Overall commercial activity levels are close to surpassing their 1995 peak. We expect work put in place to peak in the second half of this year, before some easing back as demand for new space is satisfied in some areas and economic growth slows. By 2007, however, commercial construction will still be stronger than at any time since the late-1980s boom wound down in 1990.

Industrial set to feel the pressure

The last year has been a good one for the industrial sector, with the annual value of consents for factories lifting 50%, from \$358m in January 2004 to \$538m by January this year. The value of consents for this building type has now surpassed the peak recorded in 1996. Growth in warehouse building has been more long-lived, with consent values on a strongly upward trend since mid-2002.

Spare capacity in the industrial sector has been absorbed by sustained economic growth since 2001. Growth in export activity was the initial driver of the lift in activity, but as the dollar has appreciated and held up, the domestic economy has become the key factor underpinning demand for industrial space.

Over the next two years, we expect the New Zealand dollar to maintain most of its current strength, as our interest rates remain high and continue to attract international investment. Thus there is unlikely to be significant increases in demand for space from export-focused industries. A cooling in the domestic economy from the strong growth of the last year and rising long-term interest rates will also contribute to a peak in industrial building within the next 18 months. Nevertheless, we expect industrial building activity will remain at levels not seen since before the Asian crisis.

Factory and warehouse buildings

Year end WPIP, 1995/96 \$m



Graph 6.4

Accommodated at Her Majesty's pleasure

Growth in this sector has occurred in the hostels and boarding houses subcategory (up 59% over the year ended January). This is not generally the type of accommodation to house overseas visitors – the bulk of the work falling into this area is prisons.

The new prison in Northland is now almost complete. However, the women's prison in Manukau and Otago Region prison are just getting underway, and are expected to be completed next year. There is also another prison near Meremere that will not be finished until mid-2007.

The value of consents for hotels, motels, etc fell 11% over the year ended January. Activity is still at a relatively high level, but growth in the tourism sector will be difficult to achieve over the next two years as the currency remains strong. The effect of the high dollar is dual – not only does it limit



growth in foreign arrivals, it also encourages New Zealanders to holiday overseas. Cheap Trans-Tasman fares are simply assisting this trend.

An oversupply of apartments in Auckland may also undermine demand for traditional hotel accommodation – in the face of high vacancy rates, apartment owners may be forced to lease their units to short-term tenants.

Overall, accommodation construction work will be at a high level over the forecast period, but drop in 2006 as some of the prison work is completed.

Accommodation buildings

Year end WPIP, 1995/96 \$m



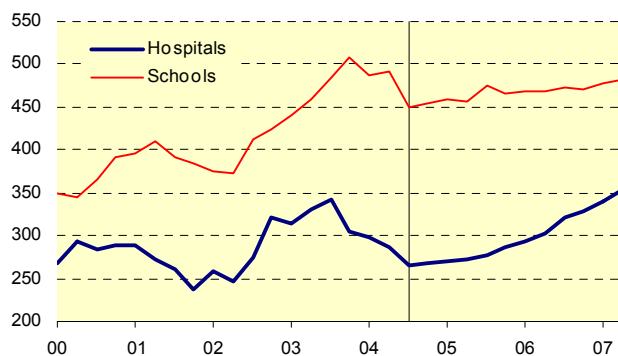
Graph 6.5

Free and easy government money

Hospital consents and work put in place have come off their peak following the completion of Auckland City Hospital. However, construction at Wellington Hospital will continue until 2007/08.

Government sector building

Year end, 1995/96 \$m



Graph 6.6

The value of hospital consents for the year ended January was up 10% on the previous year. The latest growth has come on the back of an increased focus by the government on health needs outside the main centres, including in Masterton, Horowhenua, Thames, Tauranga, and Hamilton. Construction in Wellington will provide a solid base for activity over the next two years, and it is likely that the ever-increasing demands

on the health system will underpin growth in hospital building over the medium term.

Education building work put in place has dipped 10% over the last year (ended September), a shift that has not occurred in consents. In fact, consents for the year to January were up 21% on the previous year, boosted recently by a number of projects at Massey University in Palmerston North.

Education construction is primarily a government-funded area, and this year's budget is likely to contain increased capital expenditure for school buildings. We expect education construction to drift slowly higher over the forecast period – the continuation of a trend that has been in place since 1996.

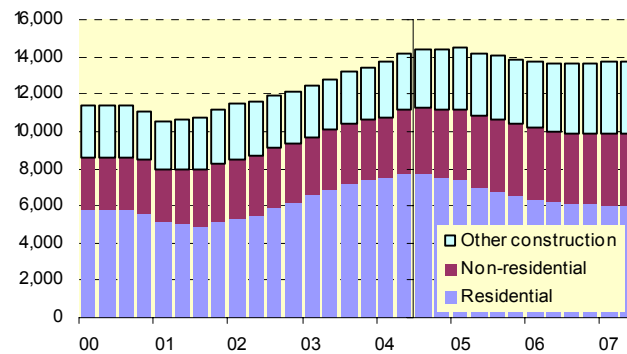
Total building activity

Total building activity (including other construction – i.e. infrastructure) is likely to peak in March 2005, before drifting back around 3% over the following March year. The softening will be entirely caused by a drop in residential building activity – the number of new dwelling consents is already down 17% on a year ago (three months ended January).

Infrastructure spending has historically been the smallest of the three construction components. However, continued government spending in this area, and a catch-up following underinvestment throughout much of the 1990s, means that the infrastructure sector will be almost as large as non-residential construction by the end of the forecast period.

Total building activity

Year end, GFCF basis, 1995/96 \$m



Graph 6.7



Non-residential building activity

Quarterly data

	03			04			05			06			07		
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
ACTIVITY AT 1995/96 PRICES															
Consents	692	660	689	840	902	672	705	781	738	713	713	797	768	735	769
Work put in place(1)	799	700	833	957	938	786	925	990	932	775	912	960	960	806	925
Work put in place - by sector															
Government	222	184	232	212	229	190	233	238	231	199	247	263	238	223	269
Private(2)	578	516	602	744	709	597	692	752	701	576	665	697	722	583	657
Work put in place by building type															
Accommodation	78	65	92	144											
Commercial	224	196	224	280											
Industrial	111	101	108	106											
Hospitals & nursing homes	60	57	68	81											
Educational	137	100	118	96											
Miscellaneous & multi-purpose(3)	189	182	223	249											
ACTIVITY AT CURRENT PRICES															
Consents	772	753	818	1013	1106	828	866	964	910	883	886	993	963	930	975
Work put in place(1)	892	799	989	1153	1150	968	1137	1221	1150	960	1133	1196	1203	1019	1173
Work put in place - by sector															
Government	248	210	275	256	281	234	287	294	285	246	307	327	298	282	340
Private(2)	645	589	714	897	869	735	851	927	865	714	826	869	905	736	833
Work put in place by building type															
Accommodation	87	74	110	174											
Commercial	250	224	265	338											
Industrial	124	115	128	127											
Hospitals & nursing homes	68	65	81	97											
Educational	153	114	140	115											
Miscellaneous & multi-purpose(3)	211	208	265	300											
PRICES & TURNOVER															
Capital goods price index(4)	1.114	1.140	1.186	1.204	1.226	1.231	1.228	1.233	1.233	1.238	1.242	1.245	1.253	1.263	1.267
Commercial price index(4)	1.598		1.720												
Commercial turnover(5)	875		501												
Industrial price index(4)	1.879		2.025												
Industrial turnover(5)	416		272												

(1) Excludes fees and duties

(2) Includes Government enterprises

(3) Includes social, cultural, religious, recreational & farm buildings.

Table 6.1

Non-residential building activity

Annual % changes in quarterly data

	03			04			05			06			07		
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
ACTIVITY AT 1995/96 PRICES															
Consents	22.2	19.6	10.4	18.5	30.3	1.8	2.2	-7.0	-18.2	6.1	1.2	2.0	4.1	3.1	7.8
Work put in place(1)	-2.5	3.4	20.2	12.9	17.3	12.3	11.0	3.5	-0.6	-1.5	-1.5	-3.0	3.0	4.0	1.5
Work put in place - by sector															
Government	-2.6	2.5	18.3	-10.8	3.2	3.2	0.5	12.3	0.9	4.9	6.0	10.2	3.0	12.2	8.7
Private(2)	-2.5	3.7	21.0	22.2	22.7	15.6	15.1	1.0	-1.1	-3.5	-4.0	-7.2	3.0	1.2	-1.2
Work put in place by building type															
Accommodation	28.4	80.0	82.9	94.6											
Commercial	3.9	5.1	24.2	18.8											
Industrial	19.4	27.3	32.4	-5.9											
Hospitals & nursing homes	-38.2	-13.3	-13.9	-19.7											
Educational	21.4	-17.7	3.8	-29.5											
Miscellaneous & multi-purpose(3)	-21.2	-3.6	18.6	32.2											
ACTIVITY AT CURRENT PRICES															
Consents	28.4	27.0	19.8	29.9	43.2	9.9	5.9	-4.8	-17.7	6.7	2.3	3.0	5.8	5.2	10.0
Work put in place(1)	2.4	9.7	30.5	23.9	28.9	21.2	15.0	5.9	0.0	-0.9	-0.4	-2.1	4.6	6.1	3.5
Work put in place - by sector															
Government	2.3	8.9	28.3	-2.2	13.4	11.4	4.1	15.0	1.5	5.5	7.1	11.3	4.7	14.4	10.9
Private(2)	2.4	10.1	31.4	34.1	34.8	24.8	19.2	3.4	-0.5	-2.9	-2.9	-6.3	4.6	3.2	0.8
Work put in place by building type															
Accommodation	34.9	91.1	98.5	113.5											
Commercial	9.1	11.6	34.8	30.3											
Industrial	25.4	35.1	43.7	3.2											
Hospitals & nursing homes	-35.1	-8.0	-6.5	-11.9											
Educational	27.5	-12.6	12.7	-22.7											
Miscellaneous & multi-purpose(3)	-17.3	2.4	28.8	45.0											
PRICES & TURNOVER															
Capital goods price index(4)	5.2	6.2	8.6	9.8	10.0	8.0	3.5	2.4	0.6	0.6	1.1	1.0	1.6	2.0	2.0
Commercial price index(4)	14.6		15.8												
Commercial turnover(5)	41.9		-18.7												
Industrial price index(4)	14.6		17.8												
Industrial turnover(5)	47.5		0.2												

(1) Excludes fees and duties

(2) Includes Government enterprises

(3) Includes social, cultural, religious, recreational & farm buildings.

Table 6.2



Non-residential building activity

Annual data

	03			04			05			06			07		
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
ACTIVITY AT 1995/96 PRICES															
Consents	2577	2686	2751	2881	3091	3103	3119	3060	2896	2937	2945	2961	2991	3014	3070
Work put in place(1)	3017	3039	3180	3289	3428	3514	3606	3639	3633	3622	3608	3578	3606	3637	3650
Work put in place - by sector															
Government	835	840	875	850	857	863	864	890	892	901	915	940	946	971	992
Private(2)	2182	2200	2304	2440	2571	2651	2742	2749	2741	2721	2693	2639	2659	2666	2658
Work put in place by building type															
Accommodation	239	267	309	379		389				412				371	
Commercial	826	836	879	924		1031				1071				1025	
Industrial	384	406	432	425		484				473				468	
Hospitals & nursing homes	306	297	286	266		270				293				341	
Educational	508	486	491	451		458				468				478	
Miscellaneous & multi-purpose(3)	754	747	782	843		880				905				953	
ACTIVITY AT CURRENT PRICES															
Consents	2827	2988	3123	3356	3690	3765	3813	3764	3569	3624	3644	3673	3726	3772	3861
Work put in place(1)	3309	3380	3611	3833	4091	4260	4409	4477	4477	4469	4464	4439	4492	4551	4591
Work put in place - by sector															
Government	916	933	994	988	1021	1045	1057	1095	1099	1112	1133	1166	1179	1215	1248
Private(2)	2393	2446	2617	2845	3069	3215	3352	3382	3378	3357	3332	3273	3313	3336	3343
Work put in place by building type															
Accommodation	263	298	352	445		470				508				464	
Commercial	906	929	998	1077		1251				1322				1283	
Industrial	422	451	490	494		588				584				586	
Hospitals & nursing homes	335	330	324	311		327				362				427	
Educational	557	540	556	522		556				577				599	
Miscellaneous & multi-purpose(3)	826	831	890	983		1067				1116				1192	
PRICES & TURNOVER															
Capital goods price index(4)	1.094	1.111	1.134	1.161	1.189	1.212	1.222	1.229	1.231	1.233	1.236	1.240	1.245	1.251	1.257
Commercial price index(4)	1.541		1.659												
Commercial turnover(5)	1492		1376												
Industrial price index(4)	1.799		1.952												
Industrial turnover(5)	687		688												

(1) Excludes fees and duties

(2) Includes Government enterprises

(3) Includes social, cultural, religious, recreational & farm buildings.

Table 6.3

Non-residential building activity

Annual % changes in annual data

	03			04			05			06			07		
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
ACTIVITY AT 1995/96 PRICES															
Consents	4.4	8.7	10.8	17.5	19.9	15.6	13.4	6.2	-6.3	-5.4	-5.6	-3.2	3.3	2.6	4.2
Work put in place(1)	0.0	0.8	6.5	8.3	13.6	15.6	13.4	10.6	6.0	3.1	0.1	-1.7	-0.8	0.4	1.2
Work put in place - by sector															
Government	2.6	3.3	5.0	1.0	2.6	2.7	-1.3	4.8	4.1	4.5	6.0	5.6	6.1	7.7	8.4
Private(2)	-1.0	0.0	7.1	11.1	17.8	20.5	19.0	12.7	6.6	2.6	-1.8	-4.0	-3.0	-2.0	-1.3
Work put in place by building type															
Accommodation	1.6	17.6	40.2	71.4		45.4				6.0					-9.9
Commercial	5.1	4.2	12.0	13.0		23.4				3.9					-4.3
Industrial	-2.7	11.1	21.7	16.2		19.4				-2.4					-0.9
Hospitals & nursing homes	-4.7	-5.2	-13.3	-22.4		-9.1				8.4					16.3
Educational	20.1	10.5	6.6	-6.8		-5.8				2.1					2.2
Miscellaneous & multi-purpose(3)	-12.1	-13.7	-6.3	4.7		17.8				2.8					5.3
ACTIVITY AT CURRENT PRICES															
Consents	8.3	13.7	17.4	26.3	30.5	26.0	22.1	12.2	-3.3	-3.7	-4.4	-2.4	4.4	4.1	6.0
Work put in place(1)	3.7	5.4	12.9	16.6	23.6	26.1	22.1	16.8	9.4	4.9	1.3	-0.9	0.3	1.8	2.8
Work put in place - by sector															
Government	6.4	7.9	11.3	8.5	11.5	12.0	6.3	10.8	7.6	6.4	7.2	6.5	7.3	9.2	10.2
Private(2)	2.7	4.5	13.5	19.7	28.3	31.4	28.1	18.9	10.1	4.4	-0.6	-3.2	-1.9	-0.6	0.3
Work put in place by building type															
Accommodation	5.6	23.2	49.1	85.2		58.0				8.0					-8.7
Commercial	9.0	9.0	18.7	21.6		34.6				5.7					-2.9
Industrial	1.0	16.2	29.0	24.7		30.3				-0.8					0.5
Hospitals & nursing homes	-1.3	-1.1	-8.4	-16.4		-0.7				10.5					18.0
Educational	24.5	15.3	12.7	-0.3		2.8				3.9					3.7
Miscellaneous & multi-purpose(3)	-9.0	-9.7	-0.5	13.0		28.4				4.7					6.8
PRICES & TURNOVER															
Capital goods price index(4)	3.7	4.7	6.0	7.5	8.7	9.1	7.7	5.9	3.5	1.8	1.2	0.8	1.1	1.4	1.7
Commercial price index(4)	11.4		15.3												
Commercial turnover(5)	37.6		11.6												
Industrial price index(4)	11.4		16.2												
Industrial turnover(5)	36.3		24.3												

(1) Excludes fees and duties

(2) Includes Government enterprises

(3) Includes social, cultural, religious, recreational & farm buildings.

Table 6.4



Total building activity

Annual data

	03 Dec	04 Mar	Jun	Sep	Dec	05 Mar	Jun	Sep	Dec	06 Mar	Jun	Sep	Dec	07 Mar	Jun
Activity at current prices															
Work put in place															
Residential, \$m	6,257	6,522	6,917	7,144	7,078	7,259	6,896	6,675	6,517	6,259	6,115	5,984	5,956	5,962	5,944
Non-residential, \$m	3,309	3,380	3,611	3,833	4,091	4,260	4,409	4,477	4,477	4,469	4,464	4,439	4,492	4,551	4,591
Other construction, \$m ⁽¹⁾	2,264	2,297	2,322	2,394	2,521	2,653	2,786	2,897	3,015	3,123	3,185	3,278	3,409	3,504	3,601
Total construction, \$m	11,830	12,199	12,850	13,372	13,690	14,172	14,091	14,049	14,010	13,851	13,764	13,700	13,857	14,017	14,135
Gross fixed capital formation ⁽²⁾															
Residential, \$m	9,062	9,447	9,959	10,209	10,075	10,115	9,601	9,222	8,938	8,635	8,483	8,388	8,393	8,452	8,511
Non-residential, \$m	3,523	3,596	3,837	4,069	4,342	4,522	4,681	4,759	4,759	4,750	4,745	4,718	4,775	4,837	4,880
Other construction, \$m	2,460	2,489	2,509	2,580	2,711	2,847	2,988	3,107	3,234	3,351	3,417	3,516	3,656	3,759	3,863
Total construction, \$m	15,045	15,532	16,305	16,858	17,129	17,484	17,271	17,088	16,931	16,736	16,644	16,622	16,824	17,048	17,253
Activity at 1995-96 prices															
Work put in place															
Residential	5,121	5,237	5,423	5,463	5,307	5,362	5,043	4,859	4,747	4,573	4,469	4,361	4,312	4,272	4,217
Non-residential	3,017	3,039	3,180	3,289	3,428	3,514	3,606	3,639	3,633	3,622	3,608	3,578	3,606	3,637	3,650
Other construction ⁽¹⁾	2,653	2,711	2,772	2,898	2,974	3,057	3,137	3,223	3,272	3,355	3,392	3,425	3,493	3,559	3,594
Total construction	10,791	10,987	11,375	11,650	11,708	11,932	11,786	11,722	11,653	11,550	11,470	11,364	11,411	11,468	11,461
Gross fixed capital formation ⁽²⁾															
Residential	7,375	7,532	7,752	7,754	7,514	7,446	7,011	6,713	6,511	6,309	6,199	6,113	6,075	6,057	6,036
Non-residential	3,212	3,234	3,379	3,492	3,639	3,729	3,829	3,868	3,862	3,850	3,835	3,803	3,833	3,866	3,880
Other construction	2,883	2,938	2,995	3,122	3,198	3,281	3,365	3,458	3,510	3,599	3,639	3,674	3,747	3,818	3,855
Total construction	13,470	13,704	14,126	14,368	14,351	14,457	14,205	14,039	13,882	13,758	13,673	13,590	13,655	13,741	13,772

(1) Infometrics estimates based on gross fixed capital formation data (2) Fees and taxes make up the difference between work put in place and gross fixed capital formation

Table 6.5

Total building activity

Annual percentage changes in annual data

	03	04				05				06				07	
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
Activity at current prices															
Work put in place															
Residential, \$m	29.6	25.7	23.7	20.5	13.1	11.3	-0.3	-6.6	-7.9	-13.8	-11.3	-10.4	-8.6	-4.7	-2.8
Non-residential, \$m	3.7	5.4	12.9	16.6	23.6	26.1	22.1	16.8	9.4	4.9	1.3	-0.9	0.3	1.8	2.8
Other construction, \$m ⁽¹⁾	4.9	6.4	7.2	7.5	11.4	15.5	20.0	21.0	19.6	17.8	14.3	13.1	13.1	12.2	13.1
Total construction, \$m	16.2	15.6	17.3	16.8	15.7	16.2	9.7	5.1	2.3	-2.3	-2.3	-2.5	-1.1	1.2	2.7
Gross fixed capital formation ⁽²⁾															
Residential, \$m	27.7	24.5	22.7	18.8	11.2	7.1	-3.6	-9.7	-11.3	-14.6	-11.6	-9.0	-6.1	-2.1	0.3
Non-residential, \$m	3.5	5.1	12.5	16.2	23.3	25.7	22.0	17.0	9.6	5.0	1.4	-0.9	0.3	1.8	2.8
Other construction, \$m	2.9	4.8	5.8	6.3	10.2	14.4	19.1	20.4	19.3	17.7	14.3	13.1	13.1	12.2	13.1
Total construction, \$m	16.7	16.0	17.3	16.1	13.9	12.6	5.9	1.4	-1.2	-4.3	-3.6	-2.7	-0.6	1.9	3.7
Activity at 1995-96 prices															
Work put in place															
Residential	21.9	17.1	14.1	10.2	3.6	2.4	-7.0	-11.1	-10.5	-14.7	-11.4	-10.2	-9.2	-6.6	-5.7
Non-residential	0.0	0.8	6.5	8.3	13.6	15.6	13.4	10.6	6.0	3.1	0.1	-1.7	-0.8	0.4	1.2
Other construction ⁽¹⁾	6.4	8.3	10.1	11.6	12.1	12.7	13.2	11.2	10.0	9.8	8.1	6.3	6.8	6.1	5.9
Total construction	11.1	10.0	10.9	10.0	8.5	8.6	3.6	0.6	-0.5	-3.2	-2.7	-3.0	-2.1	-0.7	-0.1
Gross fixed capital formation ⁽²⁾															
Residential	19.8	15.9	13.0	8.5	1.9	-1.1	-9.6	-13.4	-13.4	-15.3	-11.6	-8.9	-6.7	-4.0	-2.6
Non-residential	-0.2	0.5	6.1	7.9	13.3	15.3	13.3	10.8	6.1	3.2	0.2	-1.7	-0.8	0.4	1.2
Other construction	4.3	6.7	8.7	10.3	10.9	11.7	12.4	10.8	9.8	9.7	8.1	6.3	6.8	6.1	5.9
Total construction	11.0	9.9	10.4	8.8	6.5	5.5	0.6	-2.3	-3.3	-4.8	-3.7	-3.2	-1.6	-0.1	0.7

(1) Infometrics estimates based on gross fixed capital formation data (2) Fees and taxes make up the difference between work put in place and gross fixed capital formation

Table 6.6



7. BUILDING AND PROPERTY ARTICLE

Effects of the mortgage rate war

So activity in the housing market has rallied over November and December, bringing comments from the Real Estate Institute that “the only people who won’t be happy will be those who have spent the whole year predicting a decline in the residential property market, for them this is obviously disappointing.” We would venture to suggest that people looking to purchase their first home probably aren’t that thrilled either.

Monthly sales volumes climbed 21% between October and December (seasonally adjusted), the largest rise over a two-month period in three years. The median house price also lifted by another \$7,500.

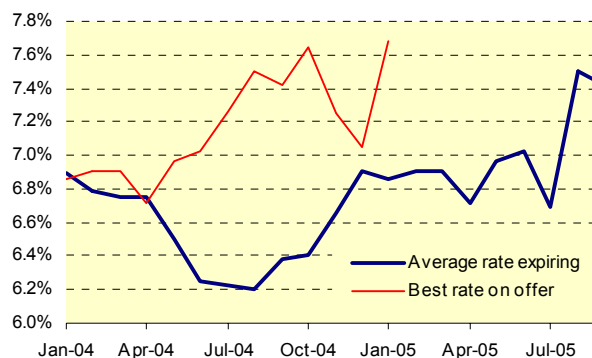
Commentators, including ourselves, have been quick to conclude that the surge in activity over the last two months has been a result of the sharp drop in fixed mortgage rates that occurred. That is an appealing explanation – the battle between the banks received a lot of media coverage, and improved the affordability of buying property at a time when many buyers were being turned off by high prices. But how significant was the effect in reality?

Different for those in and out of the market

Let’s have a look first at existing homeowners with a mortgage. The graph below shows our estimate of the interest rate on fixed mortgages expiring through 2004, and the best rates on offer for refinancing. The gap had opened to more than one percentage point in August, but closed quickly over the last two months of the year as fixed rates fell. The implication? There was little reduction in the disposable income of homeowners who were due to re-fix rates at the end of 2004. For people looking to “trade up” their property, this could have been an ideal opportunity to do so while financing costs were relatively favourable.

Fixed rate expiry hurts

Best rates on offer cf. fixed rates expiring



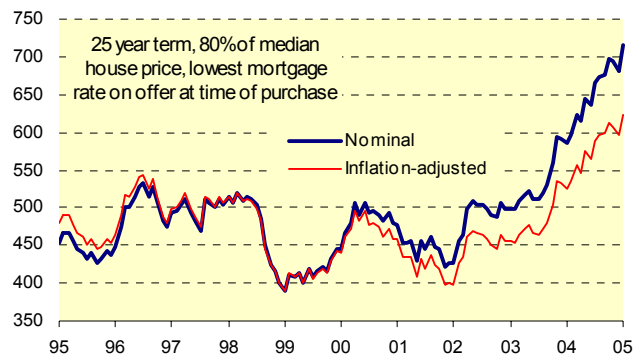
Graph 7.1

For those looking to enter the property market, however, the dip in mortgage rates didn’t aid their aspirations much. The next graph shows fortnightly mortgage repayments for people buying a house for the median price with a 20% deposit, and choosing the lowest mortgage rate

available. Between 1995 and 2003, mortgage repayments for a first-home buyer in any given month held between \$390 and \$535 per fortnight. Towards the end of last year that figure was almost \$700, before the mortgage rate battle knocked a small amount (\$16) off repayments. That reduction was hardly significant, and left housing affordability considerably worse than at any other time in the last decade.

Off the chart

Fortnightly mortgage repayments



Graph 7.2

A head case?

Thus the real effect of the drop in mortgage rates was not that large – particularly when it comes to bringing first-time buyers into the market. Psychologically, however, some buyers may have seen the offer as too good to pass up. Rises in mortgage rates throughout 2004 had been well publicised as the Reserve Bank tightened monetary policy, and the likelihood of further rises probably persuaded some buyers that mortgage rates below 7% weren't likely to appear again in the near future. Although property prices remain relatively expensive, the perception may have been that housing affordability isn't going to improve over 2005.

It is also possible that there is a segment of the market for which affordability is not an important issue, and the lower mortgage rates simply added to their propensity to buy. Some of these people will be amateur property investors betting on another 15-20% price gain over the next couple of years. Others will be people buying a holiday house or second home. **The main factors spurring demand of the latter group are good job security and the strong performance of the economy.**

After the dust settles

Although the drop in mortgage rates received a lot of attention, the subsequent bounce back up in rates has largely been passed over by the media. The first graph shows it has restored the gap between expiring fixed rates and best current rates to about 0.8 percentage points, and short of another mortgage rate war, that gap is likely to hold through until August this year.

The second graph shows that the issue of housing affordability continues to become more and more acute. The increase in the median house price over the last quarter has pushed required mortgage repayments for first-home buyers even higher.



The “unaffordability” of housing makes us confident that housing market activity will continue to decline throughout 2005. At this stage, there has been no drop-off in prices, making the property market slowdown a relatively orderly one. House price inflation will continue to weaken this year as sales volumes droop, and we continue to forecast modest (up to 5%) price falls. Sharper price falls are unlikely unless mortgage rates climb significantly higher right along the yield curve. **The ongoing strength of the economy suggests that some buyers will be willing to stretch themselves to buy property, confident that they will be able to maintain or improve their incomes.**