

OUT OF STEP?

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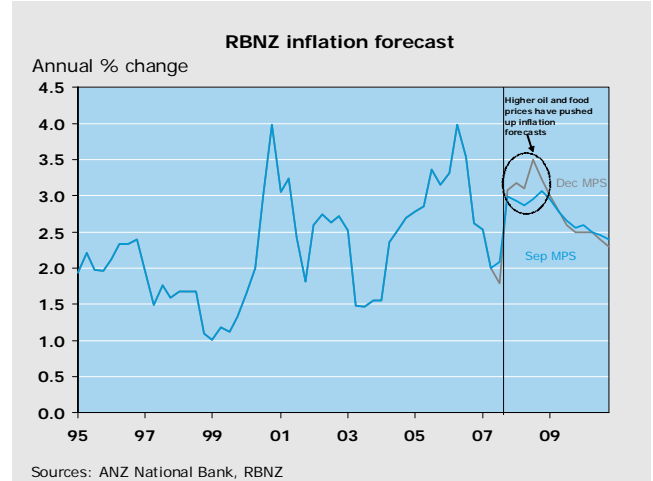
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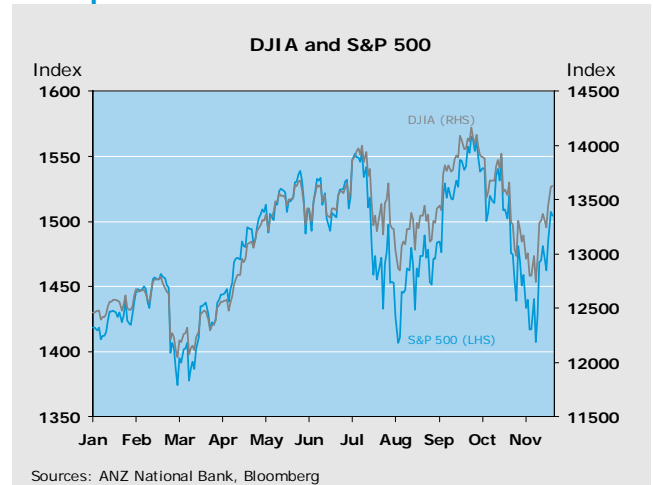
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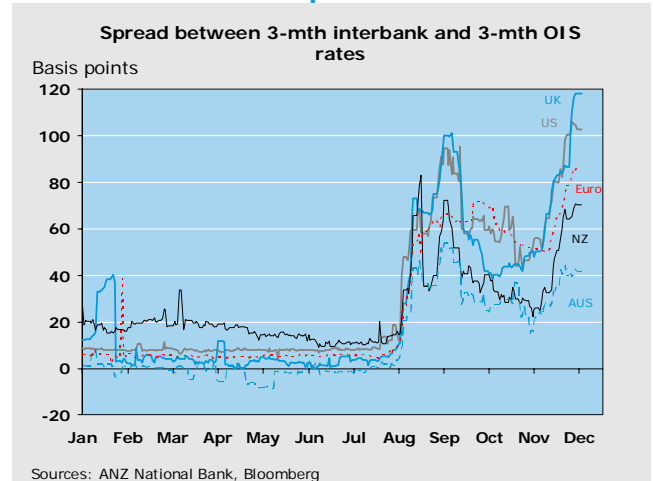
RBNZ has no inflation headroom.



US equities stabilise...



...while bill-LIBOR spreads remain wide



ECONOMIC OVERVIEW

Internationally, there was a notable dichotomy across central banks last week in response to credit dislocation. With zero inflation headroom, the RBNZ's hands are implicitly tied, as pricing concerns dominate. Looking at the broad picture, we expect continued topsy-turvy volatile times, as markets weigh up abundant liquidity, the outlook for the US, inflation pressure, and credit dislocation risks.

What's ahead?

- **REINZ November Housing Report** (circa 10 December). House sales to possibly experience a small rebound, median days to sell to continue trending upwards and annual house price growth to soften.
- **NZ Q3 Overseas Trade Indexes** (Tuesday 1045 NZDT). Terms of trade up strongly due to surging world dairy prices over the quarter and a small fall in global oil prices.
- **NZ October Retail Trade Survey** (Thursday 1045 NZDT). Credit card spending fell over the month. This should be reflected in this survey.
- **NZ Q3 Economic Survey of Manufacturing** (Friday 1045 NZDT). A lower NZD/AUD and still resilient PMI survey suggest manufacturing activity was reasonably solid over the quarter.

What's the view?

Zero headroom. That was the implicit message from the Reserve Bank last week, which delivered a hawkish assessment in the December *Monetary Policy Statement*. While hawkish nuances were generally expected, it was the weight of text directed at inflationary pressures (glossing over the global picture) and signalling interest rates being higher for longer that caught everyone's attention.

To be fair, the Reserve Bank was effectively backed into a corner. An undercurrent of capacity pressure, surging food and petrol prices, and potential inflation pressure from meeting NZ's emissions targets make for an uncomfortable backdrop. We suspect the inflationary barking was also partly aimed at ensuring the market sides with the inflation side of the equation and does not get excited by pending weak real economy data, trying to front-run an easing cycle. Unfortunately, the inflationary barking, in combination with a weaker AUD has now eliminated the one leg of support to the export sector, namely a favourable NZD/AUD. Our commodity adjusted exchange rates have risen noticeable for the non-commodity manufacturing and service industries (refer page 10). The collateral damage to the export sector continues, and abstracting for dairy, confidence in the rural industry is weak (refer page 4). Financial

conditions – which we noted last week were the tightest since 1996, are now even tighter.

If there is a key question at the moment, it centres on why the Reserve Bank looks so out of step with global counterparts whom seem much more alert to credit dislocation in the global economy. Both the BOC and BOE cut rates, while the RBA took on a very-much wait and see stance relative to that expected. There look to be two reasons.

- The RBNZ has more inflation pressure, and hence less flexibility to be mindful of global and real economic developments or risks.
- Current inflation pressure is known, whereas the outlook for the global economy is not. The Reserve Bank notes that the situation remains "tenuous" with "risks firmly to the downside". Yet they simply don't have the headroom to wait for a potential "event" to assist on the inflation front.

Stepping back, there is no question of the challenges that lay ahead. Inflation is not growth friendly. The ECB delivered an assessment similar to the RBNZ as it weighed up inflation and growth (credit cycle) risks. Globally, inflation undertones continue to percolate as evidenced by the reference to upside inflation risks by the major inflation-targeting central banks around the world.

Central banks have a blunt tool. The housing market – as a key cyclical industry - is in an awkward position, being the key transmission mechanism monetary policy operates through. A further rate hike cannot be ruled out in the current inflationary environment, although we are certainly not taking this view at present. This largely reflects our view that house prices will fall in 2008 as opposed to flat-line as assumed by the Reserve Bank, and the outlook for the global economy is weaker than the lagging consensus view underpinning the Bank's projections.

We continue to have palpitations over how the current re-pricing of risk will impact the global economy as the credit accelerator unfolds, and how a small credit and trade dependent country such as New Zealand fares. Last week's announcement in the US surrounding a rescue package for some subprime mortgage holders has provided some much needed confidence. The US equity market continues to play bungy-nomics, recovering ground lost the week prior. Liquidity continues to be put to work on dips. However, with bills-LIBOR and global swap spreads remaining wide, there is a considerable undercurrent of nervousness as people look towards the end of year reporting season.

To date, the impact on NZ has been muted, although the cost of credit across financial intermediaries has risen substantially, and this is a

cost that will progressively work its way through the economy over the coming year.

Looking at the broad NZ economy, we see a good base. Last week's commodity price figures for November showed a mixed picture – wool up, dairy flat, but timber prices, which are sensitive to the global growth cycle, down. Wholesale and building work data were robust in Q3 and point to a reasonable ½ percent outcome for GDP. It is the property market that looks under the gun and one sector we harbour concerns about. Last week's Barfoot and Thompson real estate report on the Auckland market showed volumes stabilising, but a sizeable rise in the number of listings. Media reports continue to emphasise difficulties across non-bank financials. The IRD is now more aggressively flexing its muscle towards the property sector, and the size of the property for sale segments across the major newspapers has growth exponentially. Section developments are now the next tier we expect to see considerable weakness.

Looking at this week, we receive the final pieces of the GDP puzzle in the form of the trade indices and manufacturing data, which will enable us to firm up our view around Q3 GDP growth. The trade indices are likely to confirm net exports detracted from growth over the quarter, although the most interesting component will be the extent of the increase in the terms of trade. We are expecting an increase in the vicinity of 5 percent over the quarter given dairy price surges in the period. Manufacturing data is likely to print reasonably solidly given solid activity shown by the PMI over the quarter.

In other local data this week, we should get the latest instalment from the REINZ. As mentioned above, the Barfoot and Thompson data showed a rebound in house sales over November and this is likely to be mirrored in the REINZ report. Despite this though, the report will generally be soft, with median days to sell expected to rise, and annual house price growth continuing to ease. October retail sales data is also due this week and is expected to be weak. Credit card spending fell over the month, plus the fact that a large number of New Zealanders were overseas at the Rugby World Cup (and hence not spending money locally) should weigh on spending.

Also likely to grab some attention this week is an announcement by Fonterra of its revised forecast for the 2007/08 payout. Its current projection is \$6.40/kgms but we expect this to be nudged up given where commodity prices tracked over August and September. We do note, however, that USDA milk powder prices have eased over recent weeks and the NZD has squeezed higher, therefore Fonterra is likely to maintain a degree of conservatism.

Offshore, global credit developments will remain the focus, and hence equity market performance will be key. However, the big event is the Federal Reserve's interest rate decision. Markets are fully pricing in a 25bps cut (with a small probability of a 50bps cut), but it will be the tone of the accompanying statement that will be most important to gauge whether the Fed are going to continue on this easing cycle. Data-wise, Australian labour market data, Japanese Tankan survey, and US inflation data will also be important. We expect recent topsy-turvy volatile times to continue.

Recent data...

- **ANZ Commodity Price Index (Nov).** The world price index rose 0.8 percent.
- **RBNZ December *Monetary Policy Statement*.** The OCR was left unchanged as expected, although the tone of the *Statement* was decidedly hawkish in nature.
- **NZ Wholesale Trade Survey (Sep qtr).** Total wholesale trade sales increased 2.1 percent.
- **NZ Value of Building Work Put in Place (Sep qtr).** Total real building work rose 2.1 percent in the quarter led by a 5.1 percent increase in residential construction work.

ON THE EDGE?

(The wrap from our rural expert)

Growing conditions this spring have not been favourable over much of the country.

Low wool and sheep prices plus high interest rates are not helping sheep and beef farm profitability.

The rural land market has a huge disparity in demand.

The capital proposal put forward by Fonterra directors is a huge leading edge mindshift for a traditional co-operative industry.

The late winter and spring has been cold and windy or cold and wet. The spring weather conditions have exacerbated an already difficult situation on much of the East coast of both islands after a droughty autumn and dry winter. Rainfall is up to 50 percent below average in many parts of these districts. As at last Tuesday, drought conditions applied to the East coast of both islands, the Eastern Bay of Plenty and Central Otago. A green drought existed in the Western Bay of Plenty, Waikato, Taranaki, Manawatu and Dunedin. Rivers on the West Coast are also very low.

Grass growth has been slow with livestock demand right up with supply. Milk production has struggled to be on a par with last year and live weight gains in livestock lower than normal. The lack of a real spring flush has also reduced the amount of bailing, silage and hay made compared to normal at this time of the year.

The position is not lost but on the edge for many. Ten days of widespread and steady rain would be a great Christmas present for the farming community.

There will be a wide disparity between the profitability of dairy and sheep farms in 2007/08

The dairy industry has a much improved cash flow with the advance price up about a dollar a kilogram milksolids on last year. Costs are also up. Indicative international fertiliser prices are up 40 to 180 percent in NZD terms on 12 months ago and this has been reflected in the domestic price. The price of feed supplements and grazing has also increased. But a forecast 2007/08 payout at the high end of \$6/kilogram milk solids (or over \$7 by some pundits) will still leave a healthy profit result.

Sheep and beef farmers are not doing so well. Lambing percentages are generally back on last year (dry autumn). The impact on profit (loss?) forecasts for 2007/08 is accentuated by lower stock

numbers wintered on East coast properties (again because of the dry/drought autumn). Meat schedule prices for prime livestock are around 10 percent below the comparable week in 2006 and strong wool is also 10 percent down on a YTD basis.

The dry, lower prices for prime meat, and changing farm practices on traditional lamb and cattle finishing country are pushing down the price for store livestock as finishers attempt to maintain a profit margin or are not buying full stop. Alternative land use for finishers includes conversion to dairying or a change to a dairy support unit growing feed crops and grazing dairy heifers.

Profitability for the sheep and cattle breeder is being squeezed regardless of whether droughts are adding to the problem. Finishing livestock on traditional store country is usually not an option. Store stock properties are just that because they have limitations of contour and/or rainfall.

The disparity in the outlook for the dairy compared with sheep and beef is being reflected in the land market.

Rural Land Market

The number of farm (economic) units sold in the year end June 2007 at 686 was the lowest in 22 years of data. The trend in the number of unit sales was the same for the three major categories of dairy, sheep and beef and horticulture.

The rate of increase in land prices also slowed quite sharply in year end 2007 when measured by the change in average price between years.

Year on year Real Estate Institute of New Zealand data shows a slight up tick in the volume of rural sales (excluding life style). While the year on year median price is up 44 percent, the trend over the past four months has been a much slower increase.

What is the data saying? One interpretation would be that current land values are being supported on a much thinner market.

It is considered that the trend to fewer unit sales is only partly due to fewer units being farmed. While it is true that the trend is to larger farm businesses, that trend does not necessarily mean farms are always getting bigger. Big farm businesses often have more than one farm so the number of units may not be falling as fast as the number of farm businesses.

The rest of the explanation for fewer unit sales is thought to be associated with the relatively low profitability of farming over the period 2004 to 2007 and increasing interest rates. Rural interest rates are now near 13 year highs and forecast to stay there until well into 2009.

Does the data reflect a turning point from increasing land values to a decline? Certainly, rural unit sales are reported as almost non-existent in districts that are removed from a dairy influence, albeit there is no shortage of property on offer. But land prices and sales are hot in dairy districts.

Implications

Another difficult weather and/or financial year to June 2008 would leave a number of sheep and beef farmers under huge psychological and financial pressure. A further increase in the number of units offered for sale under "pressured" circumstances could be expected to result in an easing in land prices in sheep and beef districts without alternative land use.

Fonterra Capital Proposal

The capital proposal put forward by Fonterra directors is a huge leading edge mindshift for an industry that has grown successfully on the back of the co-operative model for nearly 130 years.

The concept is to transfer all the assets of Fonterra Co-operative Group Limited (FC) to a new company, at this stage called Fonterra Limited (FL). The proposal includes publicly listing and offering a suggested 20 percent of FL to non farmers in 2010.

The capital structure proposed for Fonterra goes a long way to satisfying two of the issues identified by directors of providing a farmer investment choice and access to capital for growth. It provides permanent capital for Fonterra Limited (FL). It is silent on many important issues for the new Fonterra Co-operative. A potential redemption risk still appears to exist for FC (the third issue). The milk price mechanism will be critical.

The Basis of the concept

The concept is based on the Irish example, Kerry Group plc. This public company has grown and diversified to be a very successful food company. The Kerry Co-operative has also been a financial success for its shareholders on the back of Kerry Group. The co-op has had its proportion of ownership in Kerry Group reduced by dilution and by a deliberately staged transfer of its shareholding in Kerry Group to co-operative shareholders. The Kerry Co-op now has 23 percent of ownership. It is unclear what proportion of Kerry Group is owned by dairy farmers on their own account.

Fonterra Co-operative

The only assets of FC will (at least initially) be shares in FL. Some (very) simplistic arithmetic suggests that 80 percent of the farmer value at a listing will be held by FC. The proposal is silent on many co-operative issues including how much

permanent capital FC will have, where it will come from and how fair value entry and exit will work.

The milk price mechanism is almost the single most critical factor to getting listing accepted and for the longer term success of NZ farmer suppliers as farmers. Solving the issue of balancing the reward for capital against paying for New Zealand milk when that milk is likely to be a declining proportion of FL's business will be a challenge. The milk pricing mechanism must be robust, transparent and have the confidence of both supplying farmers and public shareholders.

Fonterra Limited

The proposal maintains the vision of Fonterra as a global dairy (food?) company. It provides continuity for FL and provides with permanent capital. It also leaves the company as a fully operational integrated entity with its existing synergies and systems. It is very likely that the existing trend of reducing the reliance on New Zealand milk will continue. FL will have to adopt the new International Financial Reporting Standards (IFRS) which provide added transparency to financial statements. Being a listed public company will also add some transparency and rigour for the scrutiny of financial performance by analysts and all shareholders.

The Detail and On Farm Implications

There is a lot of work to be done (revealed) on the many issues involved. The devil will be in the detail.

The lack of detail makes it difficult to constructively comment on the implications of the proposal for farm businesses. Does the timing of implementing decisions to enter, expand, retrench or exit the industry need to be changed? Property rentals based on milk price and share milking agreements will also ultimately need reviewing.

Longer Term

There will be some longer term tensions between FC and FL. It is conceivable that the next generation of New Zealand dairy farmers will not want/be able to buy tradable shares and the suggested 20 percent public holding becomes 35 percent or more. The converse could also apply.

The real question for all participants is not what the structure will be on day one but what it will look like in 10 or 15 years. It will be a long and very intriguing ride for all interested parties.

HYEFU 2007 AND BPS 2008 PREVIEW

(due 1230 NZDT on 18 December)

Next week's HYEFU and BPS will show upwardly revised tax and operating surplus forecasts. In a well signalled move, some of the additional tax revenue will likely be earmarked for tax cuts but details will be light. Fiscal policy very much presents upside risks to inflation.

The *Half Year Economic and Fiscal Update* (HYEFU) and the *Budget Policy Statement* (BPS) typically elicits a yawn from financial markets. However, next week's releases will attract more than the usual amount of attention. Specifically, there are three main things of interest to us and the markets:

- The extent of the upward revisions to Treasury's forecasts for tax revenue, and therefore, the operating surplus. This will determine the scope that the Government has to splurge on election promises next year.
- The size of the tax cut package that will be earmarked for next year's *Budget*, and any details on the policy design. In particular, interest will be on the deviation from what was factored by the RBNZ into their December *MPS*.
- Any further details on the Government's proposed carbon emission trading scheme. The RBNZ did not explicitly incorporate the inflation impact from this into their projections, but will do so as further details become available.

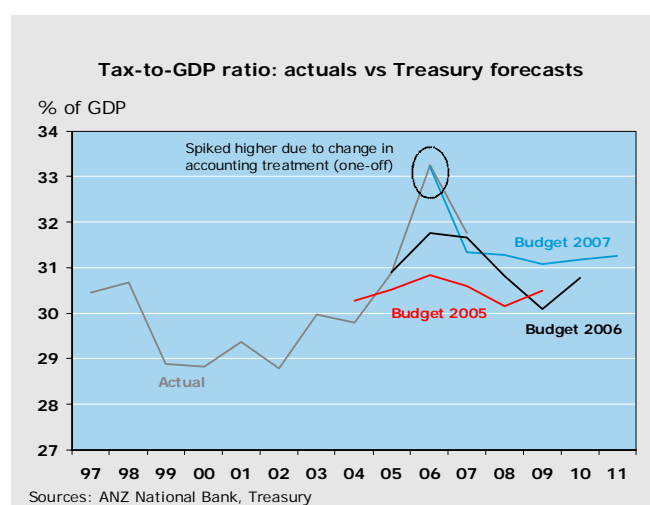
To give credit, the Government has proven to be a prudent fiscal manager to date. But ongoing upward revisions to the operating surplus have become a source of embarrassment for the Government. Surpluses in the 1 to 2 percent of GDP range are seen as being fiscally responsible. Surpluses of 3 to 4 percent are increasingly being viewed as over-taxing, and have become a political liability.

In terms of the tax forecasts, the Treasury will be revising their tax base upwards given the higher inflation and much stronger terms of trade than what they were expecting in May. Although Treasury's forecast for the real economy is unlikely to change substantially from their *Budget* forecasts, the higher GDP deflator will result in additional tax revenues.

However, it is the Treasury's change in view on the structural nature of the operating surpluses that will potentially result in a more substantial upward revision to the tax revenue forecasts, flowing through into a larger operating surplus. Dr Cullen

has indicated that Treasury now believes the surpluses are structural. This is a critical assumption in the Treasury's forecasts, for it means that the tax take will be consistently higher throughout the forecast horizon for a given level of economic activity (or to put it simply, the tax-to-GDP ratio is now permanently higher).

Over the previous few *Budgets*, Treasury has been expecting the tax-to-GDP ratio to flatten or even decline slightly. Part of the rise in the tax-to-GDP ratio is due to fiscal drag, but Treasury assumed that some of that rise is cyclical, and therefore temporary. However, Treasury has been forced to revise up their tax-to-GDP ratio over the last few *Budgets* as the actual ratio kept coming in higher.¹ All up, we suspect the tax forecasts will be revised upwards by as much as \$2b per annum.



On the issue of tax cuts, we expect details to be light. Certainly, the RBNZ's explicit incorporation of tax cuts into their December *MPS* has taken some of the suspense away. But nonetheless, it will still be of considerable interest in terms of:

- the size of the tax package relative to what the RBNZ had assumed (\$1.5b per annum)
- any specifics on how it will be structured and the timing (the RBNZ assumed it would be across-the-board from early 2009).

There is also the obvious question of whether tax cuts will indeed be included in the *HYEFU* and *BPS* in the first place. Dr Cullen has outlined four tests for considering the shape and scope of personal tax changes:

1. No borrowing to fund tax cuts.
2. No cut to services.
3. Will not exacerbate inflationary pressures.

¹ In *Budget 2003*, the forecast was for a 30.2 percent tax-to-GDP ratio over the five year forecast horizon. This has been revised up to 31.2 percent in *Budget 2007*. The current actual ratio is 31.8 percent.

4. Will not cut taxes in a way that leads to greater inequalities.

The first two tests will be easily passed, given that Treasury will be revising their tax forecasts upwards. The fourth test only relates to how the package is ultimately designed.

The third test could be a sticking point, but may not prove to be as hard a test as it initially seems. Though the RBNZ clearly views it as adding to more inflationary pressure, the fact that it has now been formally incorporated into the last week's decision effectively gives the Government a green light to go ahead. In any case, despite the RBNZ's views to the contrary, Dr Cullen will likely continue to run with his line that so long as large surpluses are being projected, fiscal policy will not be adding to inflationary pressure.

In this regard, Dr Cullen will likely refer to the Treasury's estimate of the fiscal impulse to prove his case. We suspect the fiscal impulse measure will not show a material change despite more spending being earmarked for tax cuts. This is because the higher tax revenue being collected is merely being "recycled". Moreover, fiscal impulse measures fail to capture the direct impact charges are having on inflation. It is not just the spending or tax side that is giving the Reserve Bank palpitations.

All up, we expect around \$1b to \$1.5b to be allocated for the tax package, with most of this to be charged to *Budget 2009* and the operating allowance for future *Budgets* to remain at \$2b. There is still scope to increase the size of the tax package at next year's *Budget* should the tax take continue to surprise to the upside. The operating surplus will be revised higher towards 3 percent of GDP by the end of the forecast period. This still provides the Government with a sizeable war-chest for the usual pre-election spending promises

towards the end of next year – something that will keep the RBNZ on its toes.

In terms of the other policy initiatives, the Government's climate change policy, specifically those relating to the carbon emissions trading scheme, will be of most interest. However, we are unlikely to get much policy details on the day, with the Government preferring to wait until next year's *Budget*. We do not anticipate any big policy show-stoppers here or in any other policy areas to be announced.

The bond tender programme is expected to remain unchanged. The Government's residual cash position is running ahead of forecast due to the usual delays in operating and capital spending (\$67m cash surplus in the four months to October 2007 compared to a forecast cash deficit of \$15m), and the upward revisions to tax revenue means there will be upward revisions to the cash forecasts as well. While there is scope to reduce the bond tender programme, we expect the DMO to stick to the \$2.5 billion per annum issuance.

Financial Market Implications

The risk profile is firmly tilted towards greater fiscal stimulus next year, but some of that has already been pre-empted by the RBNZ last week. Fiscal policy will remain a source of inflationary bugbear for the RBNZ, and will bias the risk profile for rates to the upside. But the devil is in the detail, which we are unlikely to get much of from the *HYEFU* and *BPS*. Therefore, the lack of policy detail means the true extent of any inflationary pressure will not be known until next year's *Budget*. But fiscal policy will continue to keep the RBNZ on high alert nonetheless.

Fiscal Forecasts – HYEFU 2007* (*Budget 2007 forecasts in brackets*)

June Years	2006/07(a)	2007/08	2008/09	2009/10	2010/11
Operating Balance - \$ million ¹	8,663 (6,568)	7,200 (6,431)	6,500 (5,569)	6,000 (5,310)	6,000 (5,366)
- % GDP	5.2 (4.0)	4.1 (3.7)	3.5 (3.1)	3.1 (2.8)	3.0 (2.7)
Net Core Crown Debt - % GDP	2.1 (2.8)	2.0 (2.7)	2.0 (3.1)	1.8 (3.3)	1.8 (3.5)
Gross Sovereign-Issued Debt (% of GDP)	21.7 (22.6)	23.0 (23.3)	22.0 (22.5)	21.0 (21.3)	20.0 (21.8)
Bond tender - \$ million	2,294 (2,511)	2,500 (2,520)	2,500 (2,500)	2,500 (2,483)	2,500 (2,500)

* *HYEFU 2007 numbers are ANZ National's expectations of the Treasury's forecasts. Note that 2006/07 are based on old GAAP while 2007/08 onwards are based on new GAAP.*

INTEREST RATE STRATEGY

Hawkish RBNZ ensures that rates will remain at the top of the range. Global developments will still have an influence but RBNZ holding up the front end of the curve for now.

Market themes...

- RBNZ sends yield curve higher with their inflation unease. Other central bank reactions to credit crisis varied.
- Some better US data and White House subprime rescue plan helped calm markets.

Outlook...

Last week was notable for the differing views that the various central banks took over the potential impact of the global financial market situation, and the weight each placed on domestic considerations versus global in their policy decisions. Concerns over the dysfunction in credit markets and the downside risks this poses to growth was enough for the BoC and BoE to cut interest rates, despite both seeing upside inflation risks in their own economies and both having just raised interest rates in July. The credit turmoil was also enough for the RBA to back off from further hikes. The RBNZ and ECB on the other hand, remain concerned over upside inflation risks with the former hardening their language. Although both left their policy rates unchanged, there is no doubt where the bias resides.

With the RBNZ laying their inflation cards on the table, the front end of the yield curve will be firmly held up. We still expect the 2-year swap yield to trade within a 8.5 to 8.65 percent range, but mostly to the topside. Movements outside of the top of that range will require stronger economic data. Receivers will be sitting out for now, with only a further deterioration in the global situation likely to tempt them back in. Given the possibility of further RBNZ action while the Fed is likely to ease further, there will be ongoing pressure on the NZ-US 10-year bond spread to widen, though we continue to note that current levels look over-extended. There will also be pressure on the 2s10s curve to invert further should the market contemplate further hikes from the RBNZ.

Despite the RBNZ's 90-day projections showing easings being pushed out until the second half of 2009, OIS pricing only has a 22 percent chance of another hike priced in. While the market remains attuned to the RBNZ's inflation concerns, it also recognises that the Bank has heavily discounted global developments, and there is still the potential for credit markets to take another turn for the worse. Easings are still priced in for late next year.

Offshore focus this week is firmly on the Fed, though inflation data from US and Euro, UK PPI and

partial data on the state of the US economy will give the market plenty to chew on.

Gauges for NZ interest rates yields		
Gauge	Direction	Comment
RBNZ	↔/↑	Hawkish tone signaling discomfort at inflation outlook.
NZ data	↔	Terms of trade to show dairy price impact but retail sales for October to be soft.
Fed Funds/front end	↔/↓	Fed set to cut again this week. Focus on tone of the FOMC statement.
RBA	↔	RBA backs off citing global uncertainty. In neutral mode at the moment.
US 10 year	↔	Some consolidation expected after Fed and White House subprime rescue plan.
NZ swap spreads	↔/↑	After the significant narrowing seen over recent weeks, we expect a corrective move wider.
Flow	↔	Focus will be on US Fed this week. AUD and NZD flows to be thin. 2-year at top of its range.
Technicals	↔/↑	Technically, US 10-year bonds look to have established a bearish undertone.

Borrowing strategies we favour at present

The RBNZ has offered little comfort for fixed and/or floating rate payer. Rates will continue to trade their recent range and the cautious tone has set the scene for rates to remain higher for longer. As such we still favour fixed rate payers target the 3-5-year areas of the swap curve with those obligated to pay fixed further out be well advised to shorten their duration should offshore developments cause the RBNZ to change its stance.

Probability of 25bps increase as implied by market pricing

OCR dates	Last week	This week
Thu 6-Dec-07	2	8
Thu 24-Jan-08	2	16
Thu 6-Mar-08	2	22
Thu 24-Apr-08	-6	6
Thu 5-Jun-08	-30	6
Thu 24-Jul-08	-30	-26
Thu 11-Sep-08	-30	-26

Trading themes we favour at present

Given the RBNZ's inflation concerns, we favour paying on rallies. We are mindful that strong economic data could trigger an aggressive selloff.

CURRENCY STRATEGY

Hawkish rhetoric from the RBNZ in contrast to other central banks should provide support for the NZD. The key event this week is the Fed's interest rate decision in an environment where risk appetites look to be returning.

Market themes...

- RBNZ more hawkish than expected – interest rates higher for longer.
- Risk appetites return as the White House and central banks provide support.
- Fed interest rate decision a key focus this week.

Outlook...

Risk appetites slowly returned last week on the back of improved US economic data, and central banks as well as the White House stepping in to provide a boost to investor confidence. Both the BoE and BoC cut their policy rates by 25bps, while the RBA moved to an unexpected wait-and-see stance (with the market expecting them to keep a hawkish rhetoric). The interest rate cuts (and the expectation of further cuts) provided support to global equity markets and as a result carry trade positioning increased – sending the NZD higher.

The move higher in the NZD was underpinned by a hawkish rhetoric from the RBNZ (in stark contrast to their central bank counterparts). Although the RBNZ acknowledged the uncertainty surrounding the global outlook, it is clearly inflation that remains their greatest concern. The Bank explicitly stated that they expect interest rates to remain higher for longer due to upside inflationary risks, and this should provide a base of support for the kiwi. With the RBA seemingly backing off, the NZD looks set to continue to outperform the AUD in the near-term. However, we continue to expect the Australian economy to outperform NZ's and on this basis, the NZD/AUD should eventually start to head lower.

The big event this week will be the US Fed's interest rate decision on Wednesday NZDT. Markets are fully expecting a 25bp cut, with the small possibility of a 50bp cut (although stronger than expected non-farm payrolls data released at the end of last week appears to have reduced the chances of an aggressive cut). With a 25bp cut all but assured, it will be the Fed's accompanying statement, and signals of further policy moves, that will likely grab the most attention.

Locally, we receive the final partial indicators for Q3 GDP in the form of trade indices and manufacturing data. Both are unlikely to get too much attention. Instead, the November REINZ report and October retail sales, which are both expected to be soft, will get some focus. However, with the RBNZ on

inflation watch, any weaker data is likely to only have a short-term impact on the currency, with interest rate differentials providing support. The NZD/AUD looks to have the greatest potential for retracement given where we see the respective data over the week, with Australian employment likely to print solidly.

Technically, 0.7830 is a major topside resistance level for the NZD/USD. Support should continue to be provided by the 200 moving average at 0.7420. For the NZD TWI, currently near the top of its 68.70-72.30 trading band, if it breaks to the upside, new post-float highs for this index could be posted.

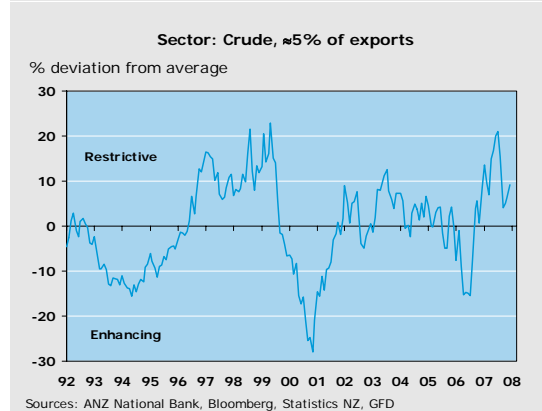
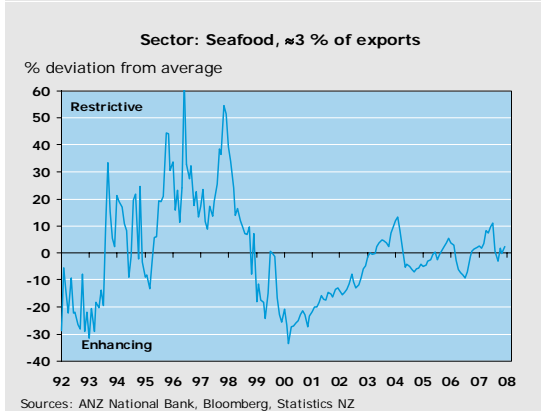
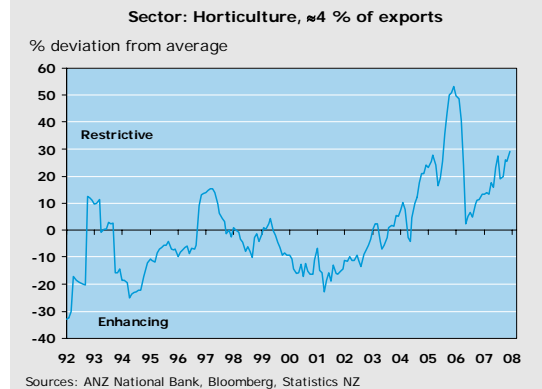
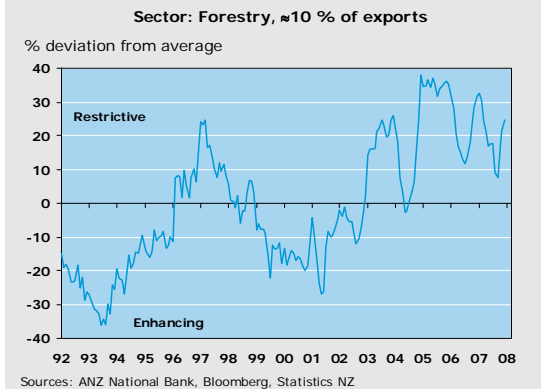
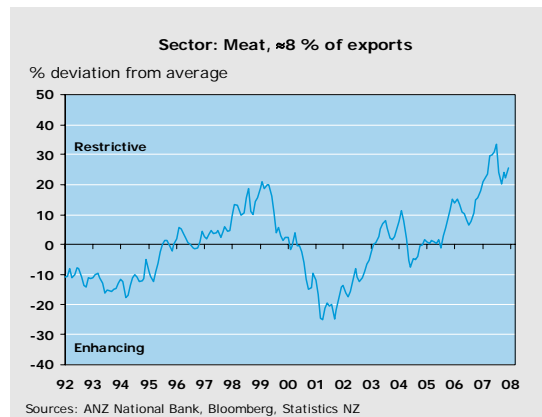
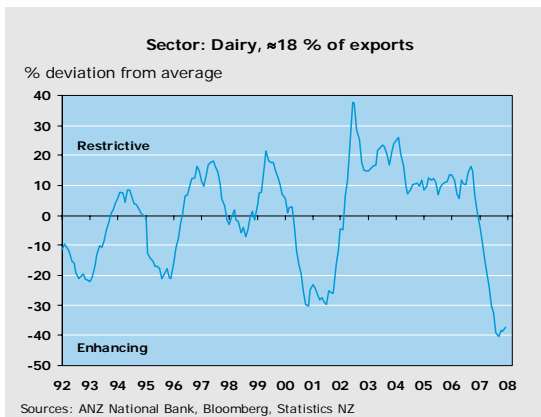
NZD vs AUD: monthly directional gauges		
Gauge	Direction	Comment
Fair value	↓	Growth differentials favouring AUD.
Yield	↑	RBNZ more hawkish.
Commodities	↔	Still supportive of both.
Partial indicators	↓	Better across the Tasman. Terms of trade shocks bigger there.
Technicals	↑	Break of 0.8630 suggests consolidation.
Sentiment	↓	AUD data is better.
Other	↓	Elections over. Back to fundamentals.
On balance	↔/↓	0.8630-0.8900.

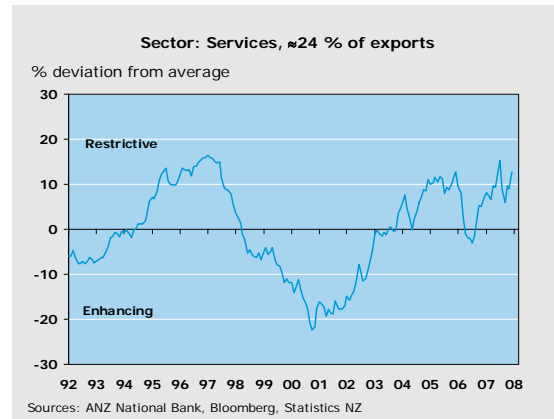
NZD vs USD: monthly directional gauges		
Gauge	Direction	Comment
Fair value – long-term	↓	Fair value 0.65 (and rising) given a structural shift in commodity prices.
Fair value – short-term	↑	US data is woeful.
Yield	↑	1 year forwards above 300 points is impossible to fight.
Commodities	↑	Higher commodity prices are still a major factor.
Risk aversion	↓	Credit concerns are weighing.
Partial indicators	↔	NZ domestic economy is soft, but US is softer.
Technicals	↔	200 day ma at 0.7420 to contain downside. 0.7830 major level top side.
AUD	↑	Election over. Business as usual.
Sentiment	↔	Neutral in NZ, bearish in US.
Other	↑/↔	USD disliked globally.
On balance	↑	Still yield v risk aversion, but feeling like yield will win.

EFFECTIVE EXCHANGE RATES (UPDATE)

Regular readers will know that we track real effective exchange rate measures across various export industries. These measures adjust for the impact of commodity prices and are weighted by the export destination. They highlight that the performance of the NZD has a contrasting impact on different sectors of the New Zealand export community.

In a very similar situation to last month, all the commodity adjusted real exchange rates we monitor deteriorated over the month. Nevertheless, the story remains very dichotomised. The dairy sector continues to experience near record enhancing conditions. Excluding the seafood sector, which is relatively neutral, commodity adjusted real exchange rates for all other sectors remain restrictive. The sharp appreciation in the NZD/AUD recently has seen the manufacturing commodity adjusted real exchange rate approach its August 2007 level. Given the hawkish rhetoric from the RBNZ – which should provide renewed support to the NZD – and very early signs that some commodity prices are starting to soften (particularly lumber), we expect these restrictive conditions for most sectors to be sustained or even intensify.





DATA AND EVENT CALENDAR

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
Dec 10	JN	Machine Tool Orders (Oct) – mom	6.2%	-7.6%	12:50
		Broad Liquidity (Nov) – yoy	3.5%	3.6%	12:50
	AU	ANZ Job Advertisements (Nov) – mom	-	2.7%	13:30
		Home Loans (Oct)	1.0%	-2.4%	13:30
		Investment Lending (Oct)	-	-3.3%	13:30
	GE	Trade Balance (Oct)	16.8B	18.1B	20:00
		Imports (Oct) – mom	2.4%	-2.6%	20:00
		Exports (Oct) – mom	0.0%	0.6%	20:00
	EU	ECB's Liikanen speaks in Helsinki	-	-	22:00
	UK	PPI Input (Nov) – mom	1.4%	1.8%	22:30
		PPI Output (Nov) – mom	0.4%	0.6%	22:30
		PPI Output – Core (Nov) – mom	0.2%	0.3%	22:30
		DCLG House Prices (Oct) – yoy	10.8%	10.8%	22:30
11 Dec	US	Pending Home Sales (Oct) – mom	-1.0%	0.2%	04:00
	UK	Leading Indicator Index (Oct) – mom	-	-0.1%	04:30
		Coincident Indicator Index (Oct) – mom	-	0.1%	04:30
	NZ	Terms of Trade (3Q) – qoq	3.0%	0.6%	10:45
	AU	NAB Business Confidence (Nov)	-	9	13:30
		NAB Business Conditions (Nov)	-	20	13:30
		RBA Governor Stevens speaks	-	-	20:00
	JN	Consumer Confidence Households (Nov)	43.0	42.8	18:00
	UK	Total Trade Balance (Oct)	-4,600m	-5,051m	22:30
	GE	ZEW Survey (Econ. Sentiment) (Dec)	-34.5	-32.5	23:00
		ZEW Survey (Current Situation) (Dec)	67.3	70.0	23:00
	EU	ZEW Survey (Econ. Sentiment) (Dec)	-35.0	-30.0	23:00
12 Dec	US	IBD/TIPP Economic Optimism (Dec)	43.0	43.8	04:00
		Wholesale Inventories (Oct)	0.5%	0.8%	04:00
		FOMC interest rate decision	4.25%	4.25%	08:15
	AU	Westpac Consumer Confidence (Dec)	-	-4.2%	12:30
	JN	Domestic CGPI (Nov) – mom	0.1%	0.3%	12:50
		Current Account Total (Oct)	2,040.0B	2,883.1B	12:50
		Bankruptcies (Nov) – yoy	-	8.1%	17:30
	UK	Claimant Count Rate (Nov)	2.6%	2.6%	22:30
		Jobless Claims Change (Nov)	-5.0k	-9.9k	22:30
		Average Earnings inc Bonus (Oct) – 3m/yoy	4.2%	4.1%	22:30
		ILO Unemployment Rate (Oct) – 3mths	5.4%	5.4%	22:30

Continued over page

Date	Country	Data/Event	Mkt.	Last	Time (NZDT)
12 Dec cont.	EU	Employment (3Q) – qoq	-	0.5%	23:00
		Industrial Production (Oct) – mom	0.2%	-0.7%	23:00
		ECB's Papademos speaks in Frankfurt	-	-	02:30
13 Dec	US	Trade Balance (Oct)	-57.3B	56.5B	02:30
		Import Price Index (Nov) – mom	2.0%	1.8%	02:30
		Monthly Budget Statement (Nov)	-86.0B	-73.0B	08:00
	NZ	Retail Sales (Oct) – mom	0.0	1.0%	10:45
		Retail Sales Ex-Auto (Oct) – mom	0.0	0.5%	10:45
		Business NZ PMI (Nov)	-	56.9	10:45
	AU	Consumer Inflation Expectation (Dec)	-	13.4%	12:30
		Employment Change (Nov)	20k	12.9k	13:30
		Unemployment Rate (Nov)	4.3%	4.3%	13:30
		Participation Rate (Nov)	65.0%	65.0%	13:30
	UK	RICS House Price Balance (Nov)	-28.5%	-22.2%	13:01
		BOJ Deputy Governor Iwata to speak at Financial Conference	-	-	20:00
	EU	ECB Publishes December Monthly Report	-	-	22:00
		Labour Costs (3Q) – yoy	2.6%	2.5%	23:00
14 Dec	US	Producer Price Index (Nov) – mom	1.5%	0.1%	02:30
		PPI Ex Food & Energy (Nov) – mom	0.2%	0.0%	02:30
		Advance Retail Sales (Nov)	0.6%	0.2%	02:30
		Retail Sales Less Autos (Nov)	0.6%	0.2%	02:30
		Business Inventories (Oct)	0.3%	0.4%	04:00
	NZ	Manufacturing Activity (3Q) – qoq	-	1.7%	10:45
	JN	Tankan Large Manufacturers Index (4Q)	21	23	12:50
		Tankan Large Manufacturers Outlook (4Q)	18	19	12:50
		Tankan Non-Manufacturing (4Q)	18	20	12:50
		Tankan Non-Manufacturing Outlook (4Q)	17	21	12:50
		Tankan Large All Industry Capex (4Q)	9.0%	8.7%	12:50
	EU	ECB's Liescher speaks in Vienna	-	-	22:00
		CPI (Nov) – mom	0.5%	0.5%	23:00
		CPI (Nov) – yoy	3.0%	2.6%	23:00
		CPI – Core (Nov)	2.0%	1.9%	23:00
15 Dec	US	CPI (Nov) – mom	0.6%	0.3%	02:30
		CPI (Nov) – yoy	4.1%	3.5%	02:30
		CPI – Core (Nov) – mom	0.2%	0.2%	02:30
		CPI – Core (Nov) – yoy	2.3%	2.2%	02:30
		Industrial Production (Nov)	0.1%	-0.5%	03:15
		Capacity Utilisation (Nov)	81.7%	81.7%	03:15

Key: AU: Australia, EU: Euro-zone, GE: Germany, JN: Japan, NZ: New Zealand, UK: United Kingdom, US: United States.

Sources: Dow Jones, Reuters, Bloomberg, ANZ National Bank. All \$ values in local currency. (Note: all surveys are preliminary and subject to change).

NEW ZEALAND DATA WATCH

Key focus over the next four weeks: The Reserve Bank has made it clear that inflation is their major concern and on this front there is unlikely to be any goods news over the coming months. Major data in the lead up to Christmas includes the September quarter Balance of Payments and GDP. However, the REINZ housing report and retail sales this week will also be of interest.

Date	Data/Event	Economic Signal	Comment
circa 10 Dec	REINZ Housing report (November)	Soft	House sales to possibly experience a small rebound, median days to sell to continue trending upwards and annual house price growth to soften.
Tue 11 Dec (10.45)	Overseas Trade Indexes (Sep qtr)	Terms of trade up strongly	Surging world dairy prices and a small fall in global oil prices are expected to contribute to a large increase in the terms of trade.
Thu 13 Dec (10.45)	Retail Trade Survey (October)	Soft	Recent monthly results show that consumer spending is slowly moderating. We expect this trend to continue.
Fri 14 Dec (10.45)	Economic Survey of Manufacturing (Sep qtr)	Resilient	A lower NZD/AUD and still resilient PMI survey suggest manufacturing activity was reasonably solid over the quarter.
Tue 18 Dec (15.00)	NBNZ Business Outlook (Dec)	-	-
Wed 19 Dec (01.00)	Westpac McDermott Miller Consumer Confidence (Dec qtr)	Holding Up	Confidence expected to remain resilient in the face of higher mortgage rates and petrol prices.
Wed 19 Dec (10.45)	External Migration (Nov)	Easing	Net inflows have eased over the year. We feel a base is likely to form around current levels, although the risks appear to lie to the downside.
Thu 20 Dec (10.45)	Balance of Payments (Sep qtr)	Unchanged by set to improve	We expect the current account deficit to remain around 8.2 percent of GDP. However, an expected strong improvement in the terms of trade over Q4 and 2008 is set to see the current account deficit reduce.
Fri 21 Dec (10.45)	Gross Domestic Product (Sep qtr)	Pull-back from strong H1	We have penciled in growth of 0.2 percent in the quarter with soft private consumption and net exports once again detracting from growth. However, recent data has posed upside risk to this estimate. We will finalise our projection at the end of this week.
Fri 21 Dec (15.00)	Credit Card Spending (Nov)	Softening	A moderation in consumer spending is expected to continue though higher petrol prices will inflate billings. The interest bearing component of outstanding balances will be interesting to watch after experiencing a reasonable tick-up last month.
Fri 28 Dec (15.00)	Credit Growth (Nov)	Trending lower	We expect another monthly release showing credit growth around 0.8 percent.
On Balance		Sub-trend but respectable	All about inflation from here.

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SUMMARY OF KEY ECONOMIC FORECASTS

	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08
GDP (% qoq)	0.4	0.8	1.2	0.7	0.2	0.3	0.3	0.4	0.4	0.6
GDP (% yoy)	1.0	2.1	2.5	3.2	3.0	2.5	1.5	1.2	1.4	1.7
CPI (% qoq)	0.7	-0.2	0.5	1.0	0.5	1.0	0.5	0.8	0.9	0.8
CPI (% yoy)	3.5	2.6	2.5	2.0	1.8	3.0	3.0	2.7	3.1	2.9
Employment (% qoq)	-0.3	0.0	1.2	0.6	-0.3	0.4	0.4	0.2	0.2	0.2
Employment (% yoy)	1.5	1.4	1.7	1.6	1.5	1.9	1.1	0.7	1.2	1.0
Unemployment Rate (% sa)	3.8	3.7	3.7	3.6	3.5	3.6	3.7	3.8	3.9	4.0
Current Account (% GDP)	-8.8	-8.7	-8.3	-8.2	-8.2	-7.9	-7.4	-6.9	-6.8	-6.8
Terms of Trade (% qoq)	-2.2	2.5	1.5	0.6	5.5	2.8	0.5	-0.3	-0.5	-0.4
Terms of Trade (% yoy)	-1.3	3.8	4.5	2.5	10.5	10.8	9.7	8.6	2.4	-0.7

Figures in bold are forecasts. qoq: Quarter-on-Quarter yoy: Year-on-Year

KEY ECONOMIC INDICATORS

	Feb-07	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07
Retail Sales (% mom)	2.2	0.9	-1.3	1.1	-0.4	0.2	0.3	1.0
Retail Sales (% yoy)	6.4	7.4	7.4	6.7	4.8	5.7	6.3	4.1
Credit Card Billings (% mom)	1.5	1.0	-1.0	0.8	1.8	0.1	0.2	2.7	-0.5	..
Credit Card Billings (% yoy)	8.2	7.2	7.9	5.8	9.0	7.9	8.6	9.4	7.8	..
Car Registrations (% mom)	-9.3	0.7	-1.4	6.0	-4.7	7.0	1.2	-6.6	5.7	-3.6
Car Registrations (% yoy)	-12.5	-11.0	-4.8	-2.5	-1.5	7.0	10.9	0.1	4.7	2.3
Building Consents (% mom)	6.8	-1.0	0.8	5.2	12.7	-16.0	4.8	-10.3	-4.8	..
Building Consents (% yoy)	-8.5	3.4	9.3	2.9	33.1	-4.1	-1.3	-15.6	-16.1	..
REINZ House Price (% yoy)	13.6	13.7	14.4	14.8	12.1	10.4	12.9	12.3	8.0	..
Household Lending Growth (% mom)	1.1	1.2	1.1	1.1	1.1	0.9	0.9	0.8	0.8	..
Household Lending Growth (% yoy)	13.1	13.3	13.5	13.5	13.5	13.5	13.4	13.1	12.9	..
Roy Morgan Consumer Confidence	133.8	129.3	128.6	122.1	121.0	121.1	122.4	121.3	122.0	121.9
NBNZ Business Confidence	-5.9	-12.5	-19.4	-48.3	-37.2	-38.5	-33.8	-26.5	-12.9	-19.6
NBNZ Own Activity Outlook	25.7	24.1	22.5	7.8	14.8	12.4	16.7	17.2	20.3	15.7
Trade Balance (\$m)	-127	60	-215	8	-518	-808	-945	-573	-690	..
Trade Balance (\$m annual)	-5767	-5776	-6024	-5900	-6226	-6340	-6334	-6282	-5798	..
ANZ World Commodity Price Index (% mom)	1.4	2.0	4.9	2.6	6.3	4.6	1.4	0.4	1.8	0.8
ANZ World Commodity Price Index (% yoy)	13.0	17.1	20.9	21.1	29.8	35.1	36.3	35.7	37.8	36.0
Net Migration (sa)	520	620	220	410	590	470	720	660	260	..
Net Migration (annual)	13151	12081	11222	10682	10078	8966	8730	8309	7517	..

SUMMARY OF KEY MARKET FORECASTS

NZ FX rates	Actual		Current	Forecast (end month)						
	Oct 07	Nov 07	10 Dec 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09
NZD/USD	0.760	0.763	0.775	0.760	0.740	0.710	0.680	0.660	0.640	0.630
NZD/AUD	0.847	0.851	0.885	0.800	0.771	0.763	0.756	0.759	0.762	0.768
NZD/EUR	0.534	0.520	0.529	0.517	0.507	0.500	0.489	0.489	0.485	0.488
NZD/JPY	88.1	84.8	86.5	83.6	79.9	75.3	72.1	71.3	70.4	71.2
NZD/GBP	0.372	0.368	0.382	0.369	0.361	0.351	0.342	0.340	0.333	0.335
NZ\$ TWI	71.1	70.3	72.0	69.2	67.2	65.2	63.2	62.5	61.6	61.7
NZ interest rates	Oct 07	Nov 07	10 Dec 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09
OCR	8.30	8.33	8.25	8.25	8.25	8.00	7.50	7.00	6.75	6.75
90 day bill	8.68	8.74	8.85	8.70	8.60	8.00	7.50	7.00	7.00	7.00
10 year bond	6.38	6.39	6.50	6.40	6.70	6.80	6.70	6.70	6.50	6.80
International	Oct 07	Nov 07	10 Dec 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09
US Fed funds	4.50	4.50	4.50	4.25	4.25	4.25	4.50	5.50	5.75	5.75
US 3-mth	4.89	4.95	5.14	4.50	4.40	4.65	5.00	5.75	6.10	6.00
AU cash	6.50	6.75	6.75	7.00	7.25	7.25	7.25	7.25	7.25	7.25
AU 3-mth	7.01	7.17	7.25	7.30	7.50	7.50	7.50	7.50	7.40	7.40

KEY RATES

	7 Nov	3 Dec	4 Dec	5 Dec	6 Dec	7 Dec
Official Cash Rate	8.25	8.25	8.25	8.25	8.25	8.25
30 day bank bill	8.55	8.70	8.70	8.70	8.71	8.73
90 day bank bill	8.70	8.85	8.88	8.88	8.88	8.86
NZGB 07/09	7.34	7.44	7.44	7.44	7.57	7.57
NZGB 11/11	7.12	7.10	7.11	7.11	7.24	7.24
NZGB 04/13	6.98	6.87	6.87	6.87	7.00	7.00
NZGB 12/17	6.57	6.31	6.32	6.33	6.44	6.44
1 year swap	8.90	8.78	8.79	8.76	8.84	8.85
2 year swap	8.77	8.58	8.58	8.54	8.66	8.66
5 year swap	8.31	8.08	8.07	8.05	8.14	8.13
RBNZ TWI	72.2	70.5	70.7	70.3	71.6	72.2
NZD/USD	0.7858	0.7613	0.7634	0.7604	0.7712	0.7783
NZD/AUD	0.8400	0.8661	0.8731	0.8738	0.8835	0.8863
NZD/JPY	89.88	84.18	84.34	83.72	85.56	86.66
NZD/GBP	0.3754	0.3703	0.3699	0.3697	0.3801	0.3844
NZD/EUR	0.5372	0.5195	0.5210	0.5150	0.5282	0.5319
AUD/USD	0.9355	0.8790	0.8744	0.8702	0.8729	0.8781
EUR/USD	1.4628	1.4655	1.4653	1.4765	1.4600	1.4633
USD/JPY	114.38	110.57	110.48	110.10	110.95	111.34
GBP/USD	2.0932	2.0560	2.0637	2.0568	2.0289	2.0249
Oil	95.67	88.60	89.29	88.31	87.45	90.25
Gold	833.40	786.70	790.20	802.20	792.20	801.60
Electricity (Haywards)	3.81	5.34	6.30	6.25	21.50	6.08

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