

THE CHICKEN AND THE EGG

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Page 2: Economic overview

- > We agree with the RBNZ's economic assessment that entails weak growth in 2008 and a soft prognosis for a number of years as the household sector consolidates. While the big picture is now clearly pointing towards a substantial interest rate easing cycle, particular attention needs to be paid to the currency and commodity prices. Last week's oil price action has done the Bank no favours. Data this week is expected to once again reinforce economic weakness.

Page 5: Economic comment – global watch

- > Barring a surge in the unemployment rate, all US data surprised on the upside last week. However, the move in the unemployment rate should not be discounted and reinforces the US economy is weak. In UK and Europe, data continues to weaken, while it was a mixed bag in Asia and Australia.

Page 6: Interest rate strategy

- > RBNZ has moved to a conditional easing bias and the rates market has responded appropriately. Bias all towards the receive-side and we expect further pressure on the curve to steepen towards topside levels.

Page 7: Currency strategy

- > The RBNZ has moved to an easing bias given a more favourable medium-term inflation outlook – reinforcing a heavy NZD. Further falls against the AUD and EUR look likely but the near-term outlook against the USD is more uncertain.

Page 8: Currency comment – macro-momentum currency gauge

- > Our currency macro-momentum gauge is a composite growth index that has tracked the NZD over the past decade. It reinforces the view that the NZD ultimately tracks growth as opposed to yield, although the two are often far from divorced. The gauge has been softening since October 2007. It currently suggests the NZD is around 6 percent "expensive" at present. Massive divergences in the indicator relative to the current TWI level have typically seen aggressive snap-backs in the latter.

Page 9: Currency comment – effective exchange rate update

- > A lower NZD across the board and generally higher world commodity prices have seen all the commodity adjusted real exchange rates fall (become more enhancing) this month. Big moves were recorded in all sectors barring dairy and forestry, which experienced lower world prices.

Page 11: Data and event calendar

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ECONOMIC OVERVIEW

We agree with the RBNZ's economic assessment that entails weak growth in 2008 and a soft prognosis for a number of years as the household sector consolidates. While the big picture is now clearly pointing towards a substantial interest rate easing cycle, particular attention needs to be paid to the currency and commodity prices. Last week's oil price action has done the Bank no favours. Data this week is expected to once again reinforce economic weakness.

What's ahead?

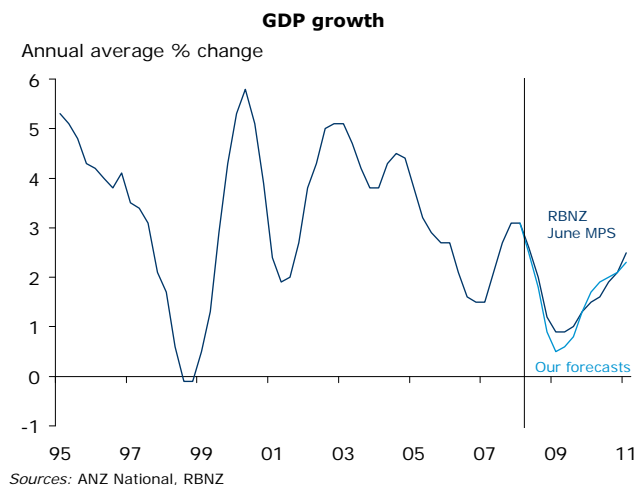
- > **NZ Q1 Value of Building Work Put in Place** (Monday 1045 NZST). We expect both residential and non-residential construction to have contracted in the quarter.
- > **NZ Q1 Overseas Trade Indexes** (Wednesday 1045 NZST). The terms of trade is expected to rise by 1.5 percent in the quarter due to still elevated export prices. Volume data should confirm that net exports will contract from growth in Q1.
- > **REINZ May Housing Market Report** (circa 11 June). House sales to remain weak. Prices are expected to continue to fall and days to sell to rise.
- > **NZ Food Price Index** (Thursday 1045 NZST). On a monthly basis, food prices are volatile. However, given elevated commodity prices around the globe, annual food price inflation is expected to remain at high levels.
- > **NZ April Retail Trade Survey** (Friday 1045 NZST). We expect retail sales to rebound by 0.6 percent in April given the early Easter-induced weakness in March. Nevertheless, the underlying trend will remain weak.

What's the view?

It was, of course, all about the RBNZ last week, and for those looking for some action, they did not disappoint. Although the OCR was left unchanged at 8.25 percent, the Bank has now formally shifted to an easing bias. One sentence from the *Monetary Policy Statement* says it all: "we are now likely to be in a position to lower the OCR later this year, which is sooner than previously envisaged".

Why the change? You need to look no further than the RBNZ's economic projections, which have anaemic growth over the coming year: 1.2 percent in calendar 2008, 1.3 percent in calendar 2009, and 2.1 percent in 2010. The first is marginally higher than our own view, while the latter are eerily similar to what we released in our quarterly economic forecasts a week earlier. Like the RBNZ, we also see a sustained period of household consolidation, a theme that has been constant through our commentary for months.

We didn't quite think the RBNZ would yet be in that space on the growth (or medium-term inflation) front. However, the message is clear: growth is very weak; medium-term inflation prospects have improved; look forward to rate cuts from September. Moreover, it was a clear signal the RBNZ is prepared to use the full flexibility of the policy targets agreement, and is firmly focused on medium-term inflation as opposed to the near-term blip in the headline rate to 4.7 percent.



We concur with the RBNZ's assessment entirely. However, there are still a number of key areas to watch.

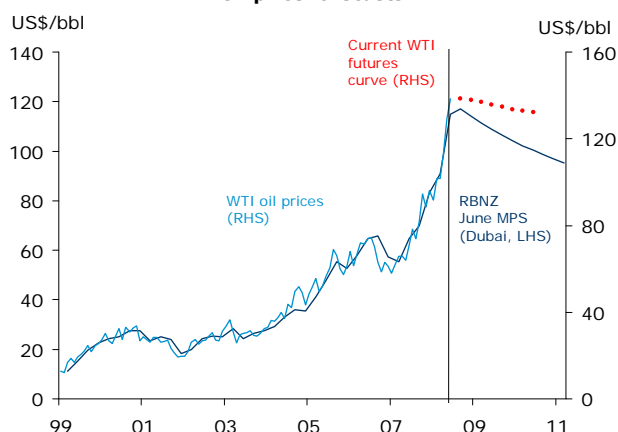
- > Cutting interest rates in a rising headline inflation rate environment is not without risk. The Bank's inflation forecasts have been revised significantly higher, peaking at 4.7 percent in the September quarter, largely due to fuel and food price increases. Inflation is expected to remain at or above the top of the Bank's target band until 2010. A high inflation rate in turn creates some upside risk to future inflation through increasing inflation expectations.
- > International commodity prices are doing the Bank no favours (with particular regard to Friday's record US\$117/bbl surge in WTI oil prices). If sustained at these levels, we could well see a headline inflation rate with a five in front of it. Sure it's a one off, but try selling a five percent headline inflation rate to the RBNZ board, who oversee the Governor's performance! The RBNZ's June projections assumed a receding trajectory from US\$117/bbl (Dubai), versus US\$122/bbl currently. We do note that a wedge has developed between WTI and Dubai prices – with the former rising to a record on Friday night, but the latter not so. The June forecasts also assessed that the downward growth implications of higher oil (which lowers the medium-term outlook) outweighed the near-term blip. Strictly speaking the same should apply following Friday's move. But once again, inflation with a five in front of it? If oil markets do not stabilise, we need to closely watch the reason for the spike. Asian (demand) induced, or geopolitically determined.

The monetary policy implications are very different.

- > The path for the currency. The RBNZ's forecasts have an orderly interest rate and currency adjustment. The RBNZ is forecasting the TWI to depreciate by around 15 percent over the next three years in a relatively stable manner. However, history tells us that falls in the NZD are typically sharper, and markets do not work in orderly fashion. The past two years have seen 10 cent moves at some time or another. The NZD/AUD has already fallen significantly and is below 0.80 for the first time in seven years. As a very rough rule of thumb, a 10 percent fall in the TWI typically corresponds to a 1 percent increase in the CPI. Once again we could be back to the chicken and the egg. The NZD is already starting to pre-empt an easing cycle. Yet, if the NZD was to fall too sharply, the RBNZ may not be able to lower interest rates as quickly, given their lack of inflation headroom (or more bluntly, no inflation headroom!) and the risk of further imported inflation feeding into inflation expectations. We'll be plugging some numbers into our financial conditions index over the week to try and assess how far the currency could move before financial conditions become too reflationary.

Looking at the big picture for rates, we need to keep in mind they could fall at least 200 basis points. This would take rates back to near the neutral level, but easing cycles seldom end at neutral. We have repeatedly noted that we see monetary policy as struggling to reflate the economy on the easing cycle given the strong prevalence of fixed rate borrowing and the role the credit channel will play. It will be a very difficult environment for firms to pass on the costs associated with a lower currency due to a weak domestic economy.

Oil price forecasts



Sources: ANZ National, RBNZ, Bloomberg

Yet something just doesn't feel right. The economy is trying to navigate through three shocks all at once. The first is the housing shock (induced by aggressive rate hikes in 2007), a necessary condition to taming inflation. The second is a credit shock, a major risk to the NZ economy given our level of indebtedness. Finally, we have a global cost shock, which represents

a huge income boost in the form of soft commodity prices (and the latest ANZ Commodity Price Index showed firmness broadening beyond dairy) but also a significant inflation threat.

Everyone expects monetary policy to be the economy's saviour and navigate us through unscathed. Yet we typically ask, and expect, too much of monetary policy. One instrument (the OCR), one target (inflation). It's mathematically impossible to do anything more. Monetary policy needs mates, and the other avenue to look to is fiscal policy. Policymakers are not impotent, and we are going to throw something out there. Maybe there is a case for cutting the petrol excise duty or looking at other forms of assistance that will provide some near-term inflation relief. While we would not normally condone tinkering with "sin" taxes to achieve other objectives, we also need to be realistic: exceptional times call for exceptional measures. It may well be the case that the government has to temporarily cut the tax on petrol as one avenue of mitigating the extreme nature of the squeeze on disposable income, and helping out the RBNZ on the inflation front.

Some people will have kittens over the prospect, and of course you need to be careful given the precedent this could set. Why stop just at petrol tax, why not get rid of GST on food etc? Because we also need to be pragmatic and not impose unnecessary burden on businesses who are already struggling with a slowing economy and rising compliance costs. These are the most challenging times for the economy in 40 years. Petrol at \$1.90 a litre, if we temporarily cut the tax component by 10 cents a litre (at a fiscal cost of \$350m a year), is hardly going to reflate the economy and hence alter the medium-term inflation outlook. Yet it would certainly help the RBNZ out by taking some pressure off near-term inflation, considering the threat is now a headline inflation rate of five percent. Policymakers can ill afford to stay on the sidelines and expect monetary policy to run solo.

Turning back to monetary policy, we are pencilling in a series of steady 25bp interest rate cuts starting from September, taking the OCR towards the neutral zone of around 6 to 6.5 percent by the end of 2009. However, the RBNZ's wariness over elevated inflation expectations, and their concerns over the impact of a disorderly currency adjustment, means that we could be in for a staggered and elongated easing cycle. Just as we outlined in our 19 May *Market Focus*, this would take the form of three or four rate cuts, followed by a pause to reassess, then the start of another mini easing cycle. Looking at how central banks overseas have responded over the past year to events, we have some sympathy for the Bank of England approach of cutting and pausing, before cutting again. The GBP has only fallen around 5 percent against the USD since the BoE started cutting rates in December last year (although it has fallen more against the EUR and it was at a time that the greenback was under severe downward pressure). It is, after all, overall financial conditions that are important as opposed to the OCR itself. But we do admit that it is a dangerous strategy to target more than one financial instrument at a time.

While a staggered easing cycle will prevent the currency from falling too far too fast, it also means that growth will under-perform for a longer period of time.

Looking at offshore events last week, it was also reasonably eventful. Interest rate decisions from the RBA, BoE and ECB all panned out as expected, with all leaving rates unchanged. However, the RBA delivered a less hawkish than expected statement, which took some by surprise given the minutes from their meeting prior discussed rate hikes at length. Nevertheless, our Australian colleagues remain comfortable calling rate hikes over the Tasman largely due to the view that inflation is yet to peak. Although the economy is showing signs of slowing, it is not slowing as fast as the RBA expected, with GDP growing by 0.6 percent in the March quarter. We find it difficult to see non-farm GDP growth slowing to 1¾ percent by the end of the year as the RBA expect when growth is currently at 3.6 percent and the boom in the terms of trade that is pending. The ECB on the other hand, were as hawkish as they could be without actually pulling the interest rate trigger. ECB President Trichet stated that *"we could decide to move rates (by) a small amount in our next meeting in order to secure the solid anchoring of inflation expectations."* Fed Chairman Bernanke also emphasised his concern over inflation expectations as well as a view to a stronger USD, signalling that the Fed are on hold for now.

On the global growth front, the prevailing theme at present remains one of the US economy still weak, but finding a base. US data was largely stronger than market expectations last week, with payrolls dropping by less than expected, but a surprisingly sharp rise in the unemployment rate to 5.5 percent from 5 percent. Across the Atlantic, the dataflow has been printing consistently weaker than expected. European retail sales contracted for the third month in a row in April and the fifth month out of seven. Sales are now down 2.9 percent on a year ago. Seeing as this is a nominal figure, so it includes petrol and food price increases, underlying spending is likely to be particularly weak. Over in the UK, PMI measures showed a contraction in activity for all sectors measured, while mortgage approvals for April fell to a record low. The data and official comments highlight an interesting and widely diverging policy outlook across central banks. The ECB and RBA on one spectrum ready to deliver hikes (despite the weaker data for the former), the RBNZ (and still potentially the BoE) at the other end looking to cut rates and the Fed right in the middle standing pat.

Looking forward to the local calendar this week, there are two important releases that will enable us to get a better feel for March quarter GDP, namely construction work done and overseas trade indexes. Both are expected to confirm that the economy contracted in the quarter and we currently have a 0.3 percent fall pencilled in for GDP growth as a whole. The value of building work put in place should show residential construction work particularly weak, while non-residential work should also fall following a reasonable surge last quarter. Although the overseas trade

indexes data will likely report another solid rise in the terms of trade, the volume data is expected to show that the net external sector will contract from GDP growth over the quarter. Primary export volumes are likely to be particularly weak.

The other data for the week will reinforce that the March quarter weakness is not just a flash in the pan. Activity over the June quarter is looking equally as soft. The REINZ house report is likely to resemble the Barfoot and Thompson data last week, which showed another large fall in house sales. We also expect the REINZ report to show another fall in house prices and a rise in the median days to sell a house. All-up, the data will confirm that the housing market is yet to find a nadir. April retail sales data (due on Friday) should rebound slightly from the early Easter-induced weakness in March. Headline sales are expected to rise by 0.6 percent in the month largely due to a large increase in motor vehicle retailing, which a significant rise in car registrations has foreshadowed. However, core sales are expected to only rise by 0.2 percent, reinforcing that the underlying trend in spending remains weak.

Internationally, it is relatively quiet in terms of data, with Australian labour market, US retail sales and inflation data, and the BoE Inflation Attitudes survey the pick of the bunch. The major focus is likely to centre on a number of speeches from Fed officials as we build to the next Fed interest rate announcement at the end of the month.

Recent data...

ANZ Commodity Price Index (May): The world prices rose by 1.0 percent over the month, taking the index to a new record high.

RBNZ June Monetary Policy Statement: The OCR was left unchanged at 8.25 percent, but the RBNZ has now shifted to an easing bias and expects to cut rates later this year.

NZ Wholesale Trade Survey (March quarter): Seasonally adjusted total wholesale trade sales rose by 0.2 percent. Stocks rose by 6.0 percent.

Barfoot & Thompson House Sales (May): The number of seasonally adjusted house sales fell 4.5 percent, and are down 54 percent compared with May 2007.

GLOBAL WATCH

We present a table of global data outturns over the past week given the significance of the international backdrop at present. Barring a surge in the unemployment rate, all US data surprised on the upside last week. However, the move in the unemployment rate should not be discounted and reinforces the US economy is weak. In UK and Europe, data continues to weaken, while it was a mixed bag in Asia and Australia.

Country/ Area	Indicator	Mkt	Actual	Last	Outturn vs market
US	Construction Spending (Apr) – mom	-0.6%	-0.4%	-0.6%	Stronger
	ISM Manufacturing (May)	48.5	49.6	48.6	Stronger
	Factory Orders (Apr)	-0.1%	1.1%	1.5%	Stronger
	ISM Non-Manufacturing (May)	51.0	51.7	52.0	Stronger
	Change in Non-Farm Payrolls (May)	-60k	-49k	-28k	Stronger
	Unemployment Rate (May)	5.1%	5.5%	5.0%	Weaker
Europe	PMI Manufacturing (May F)	50.5	50.6	50.5	Stronger
	PPI (Apr) – mom	0.8%	0.8%	0.8%	In-line
	Retail Sales (Apr) – mom	0.2%	-0.6%	-0.9%	Weaker
	ECB Interest Rate Announcement	4.00%	4.00%	4.00%	In-line
UK	Net Consumer Credit (Apr)	1.0B	0.9B	1.2B	Weaker
	Mortgage Approvals (Apr)	65k	58k	63k	Weaker
	PMI Manufacturing (May)	50.5	50.0	51.0	Weaker
	PMI Services (May)	50.5	49.8	50.4	Weaker
	BoE Interest Rate Announcement	5.00%	5.00%	5.00%	In-line
Asia Ex-Japan					
<i>Singapore</i>	Purchasing Managers Index (May)	49.0	49.0	49.3	In-line
	Electronics Sector Index (May)	49.8	49.4	50.2	Weaker
<i>Taiwan</i>	CPI (May) – yoy	4.10%	3.71%	3.85%	Weaker
<i>Malaysia</i>	Exports (Apr) – yoy	7.2%	20.9%	5.5%	Stronger
	Imports (Apr) – yoy	4.0%	10.0%	2.9%	Stronger
<i>South Korea</i>	Exports (May P) – yoy	22.6%	27.2%	26.4%	Stronger
	Imports (May P) – yoy	28.7%	28.8%	28.5%	In-line
	CPI (May) – yoy	4.4%	4.9%	4.1%	Stronger
<i>Philippines</i>	CPI (May) – yoy	8.9%	9.6%	8.3%	Stronger
<i>India</i>	Exports (Apr) – yoy	-	31.5%	26.6%	-
	Imports (Apr) – yoy	-	36.6%	35.2%	-
<i>Indonesia</i>	Inflation (May) – yoy	9.9%	10.4%	9.0%	Stronger
	Exports (Apr) – yoy	33.2%	23.1%	31.2%	Weaker
	Imports (Ex Trade Zones) (Apr)	43.2%	66.2%	40.0%	Stronger
	Bank of Indonesia Reference Rate	8.75%	8.50%	8.25%	Weaker
Japan	Labour Cash Earnings (Apr) – yoy	1.3%	0.6%	1.5%	Weaker
	Capital Spending (1Q)	-9.6%	-4.9%	-7.7%	Stronger
Australia	Retail Sales (Apr)	0.2%	-0.2%	0.2%	Weaker
	Company Operating Profit (1Q) – qoq	1.5%	2.2%	4.1%	Stronger
	Building Approvals (Apr) – mom	-0.5%	7.8%	-5.5%	Stronger
	RBA Interest Rate Announcement	7.25%	7.25%	7.25%	In-line
	GDP (1Q) – qoq	0.3%	0.6%	0.7%	Stronger

INTEREST RATE STRATEGY

RBNZ has moved to a conditional easing bias and the rates market has responded appropriately. Bias all towards the receive-side and we expect further pressure on the curve to steepen towards topside levels.

Market themes...

- > RBNZ "now likely to be in a position to lower the OCR later this year".
- > ECB "could decide to move our rates a small amount in our next meeting."
- > Bernanke sees policy "well positioned" for now.
- > Australia Q1 GDP puts heat on RBA.

Review and outlook...

Last week saw a diverging contrast amongst central banks' respective policy outlooks. Despite all grappling with the same issue of high near-term inflation, differences in economic outlooks mean each has to balance the growth/inflation trade-off differently. The deteriorating economic outlook in NZ has seen the RBNZ move to a conditional easing bias despite near-term inflation forecast to peak at 4.7 percent. We believe the conditions will be met, and a September rate cut will be delivered. The currency is a sticking point, but for now we expect 25bp moves to take the OCR towards neutral.

The NZ rates market rallied and has now priced in around 116bps worth of cuts over the next 12 months. With the market now fully priced for September, it is a case of trading off the upcoming dataflow with a view towards whether the data will weaken sufficiently for the RBNZ to contemplate hiking as soon as July. We are not there yet, but given that the labour market surprised everyone by turning early, we could also be surprised at how fast non-tradable inflation eases. Especially if Q1 GDP turns out weaker than even what the RBNZ was forecasting. For now, expect the bias to be firmly on the receive-side, with the 2s10s curve to steepen towards topside resistance of -30bps.

The ECB too surprised the markets last week with talk of rate hikes. The message from ECB President Trichet couldn't be clearer, and the market now expects the ECB to deliver next month. The Federal Reserve on the other hand, looks set to stand pat for a while, with Fed Chairman Bernanke describing policy as being "well positioned", for now at least. The dataflow in the US has been coming in soft, but still better than expected. This week's Beige Book, CPI and retail sales data are key reads, along with various Fed speakers who are likely to sound inflation warnings.

Things are looking interesting on the rates front across the Tasman. Australian Q1 GDP surprised with its resilience despite recent weak partial data, and suggests growth will be stronger than what the RBA was expecting. A strong employment report this week will certainly add to the case of another rate hike.

Given this, NZ's cash rate could well head below Australia's by the end of this year.

Gauges for NZ interest rates yields		
Gauge	Direction	Comment
RBNZ	↓	RBNZ now on easing bias. September cut expected.
NZ data	↔/↓	Upcoming dataflow to show continued slowdown in economy.
Fed Funds/front end	↔	Fed Chairman's speech indicates Fed funds on hold for now.
RBA	↔/↑	Stronger than expected Q1 GDP raises the prospect of another hike from the RBA.
US 10 year	↔/↑	Yields retreated on safe haven flows but inflation concerns still linger.
NZ swap curve	↔/↓	Curve bias is to steepen. US data on Friday will increase the bias.
Flow	↔/↓	Receive side flows expected to dominate.
Technicals	↔/↓	Technically the picture is primed for a downward move.

Borrowing strategies we favour at present

We continue to favour borrowers targeting the 1-year space, which benefits from positive pick-up and also based on our core economic view that the RBNZ will ease from September. If borrowers are still worried about inflation (oil prices) delaying the easing cycle, they can consider borrowing in the 2-year space.

Probability of 25bps increase as implied by market pricing

OCR dates	Last week	This week
Thu 24-Jul-08	-9	-32
Thu 11-Sep-08	-33	-96
Thu 23-Oct-08	-85	-168
Thu 4-Dec-08	-141	-244
Thu 22-Jan-09	-201	-304
Thu 5-Mar-09	-261	-360
Thu 23-Apr-09	-321	-412

Trading themes we favour at present

Stick with core strategy of receiving the belly of the curve (3-5 year), but consider selling December bank bill futures as a hedge in case inflation worries and increased dairy payout further delay easings.

CURRENCY STRATEGY

The RBNZ has moved to an easing bias given a more favourable medium-term inflation outlook – reinforcing a heavy NZD. Further falls against the AUD and EUR look likely but the near-term outlook against the USD is more uncertain.

Market themes...

- > A change in stance from RBNZ reinforces downward bias for NZD.
- > How sharply the NZD falls will be determined by market pricing for interest rate cuts.
- > But wider USD sentiment also likely to dictate direction.

Review and outlook...

Was last week a watershed for the NZD? The RBNZ delivered a *Monetary Policy Statement* that was more dovish than the market was expecting and the NZD fell over a cent and a half against the USD. The RBNZ has acknowledged that the economy is slowing sharply and is likely to remain subdued for some time. As a result, the medium-term inflation outlook has become more favourable and interest rate cuts look likely to be delivered before the end of the year.

The NZD is heavy and there is likely to be a trend is your friend bias lower emerge, reinforced by the tenor of the local data. However, the speed of any fall in the NZD will still be dependent on how aggressively the market prices in interest rate cuts. If the early 2006 episode is anything to go by, the NZD could potentially fall quite sharply. However, recent oil price moves may limit the RBNZ's ability to cut rates aggressively.

On a trade-weighted basis, the NZD should continue to fall, with the AUD and EUR potentially large movers. The kiwi has already broken through the psychological 0.80 barrier against the AUD, with Australian GDP data last week confirming that the economy is not slowing as fast as the RBA were expecting. Support levels should also be tested against the euro, with the ECB last week all but confirming an interest rate hike at their next meeting given inflation concerns. Key to watch this week will be global equity sentiment and risk gauges. Credit spreads have started to widen again with the combination of surging oil prices and weak prospects for the US economy (following poor unemployment figures) raising fears that stage two of the credit crisis may be upon us, namely traditional credit as opposed to liquidity risk.

For now, the near-term outlook for the NZD/USD is slightly more uncertain. Correlations with the EUR/USD remain strong. Expectations of hikes from the ECB have dented the renewed optimism towards the USD following Bernanke's support for a stronger USD. It seems everyone needs a stronger currency to dampen imported inflation, a dangerous juncture to be in. This week, a number of Fed speeches will be important as markets will be looking for any reinforcement of these messages as well as any insight into the monetary policy outlook.

The local dataflow this week, with Building Work Put in Place, Overseas Trade Indexes, the REINZ housing report and Retail Sales, should all reinforce a slower economy and a weaker NZD. The only potential piece of supportive information will likely be food price data. Internationally, Australian and UK employment data, and US retail sales, CPI and consumer confidence data are all potential market movers.

Technically, the NZD looks rangy for the week ahead, with resistance levels at 0.7700, 0.7740 and 0.7780. A break back as high as 0.7780 but then a re-test of 0.7530 is the trade of choice this week. NZD/JPY is this week's wildcard, with uridashi issuance completed early in the week, the possibility of a break lower looks possible again. NZD/AUD break below 0.8000 appears a little premature and we prefer to look for 0.8050 to be seen before downside momentum returns.

NZD vs AUD: monthly directional gauges		
Gauge	Direction	Comment
Fair value	↓	Growth differentials favouring AUD.
Yield	↓	RBA to hike. RBNZ cut.
Commodities	↔	Same picture for both.
Partial indicators	↓	Better across the Tasman.
Technicals	↓	Solid resistance at 0.8100 sell here if you can.
Sentiment	↓	Terms of trade says it all.
Other	↑	Watch market positioning.
On balance	↓	Trend is clear.

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	↔	Yield and commodity story factored. AUD strength supporting.
Yield	↔/↓	Watch Fed speeches this week.
Commodities	↔	Still a key one to watch.
Risk aversion	↔/↑	Positive sentiment but not borne out in equities.
Partial indicators	↓	NZ data now looking weaker than US.
Technicals	↔/↓	Range with bearish bias.
AUD	↔/↑	AUD to test parity.
Sentiment	↓	Market wants to believe Fed is done.
Other	↔	Inflation all round?
On balance	↔/↓	RBNZ will need to cut to break range.

MACRO-MOMENTUM CURRENCY GAUGE

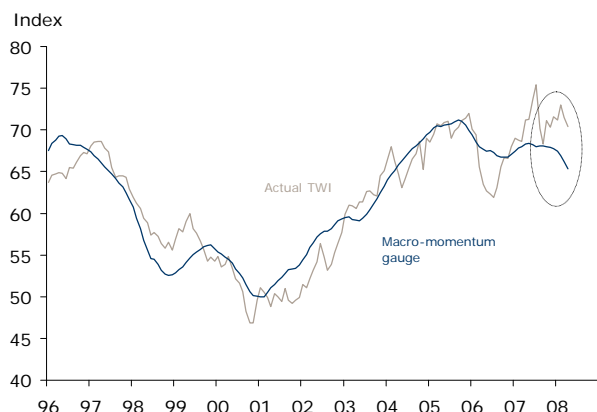
Our currency macro-momentum gauge is a composite growth index that has tracked the NZD over the past decade. It reinforces the view that the NZD ultimately tracks growth as opposed to yield, although the two are often far from divorced. The gauge has been softening since October 2007. It currently suggests the NZD is around 6 percent "expensive" at present. Massive divergences in the indicator relative to the current TWI level have typically seen aggressive snap-backs in the latter.

Which matters more for the NZD, growth or yield? Of course the two cannot be divorced. Slowing growth is typically associated with falling interest rates, particularly in the 90-day to 2-year part of the curve. Typically we see the early lead indicators turn, the bond (swaps) market re-assess the timing of monetary policy moves, and the NZ dollar follows.

Over a year ago we developed a currency macro-momentum gauge. Currencies are hugely responsive to more timely data nowadays, yet we have no indicator that gives us a reading on whether some sort of growth tipping point has been reached.

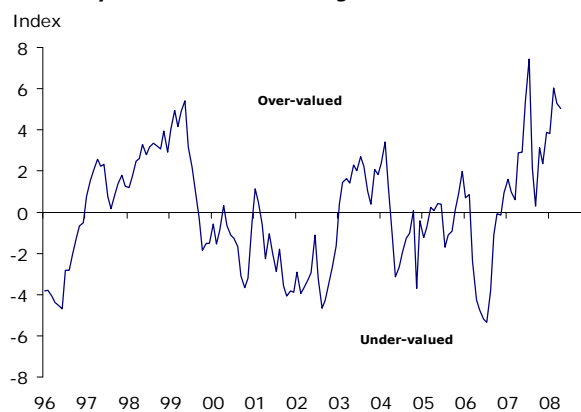
Our gauge is in effect an extension of our leading and composite growth indicators, overlaid on the NZ dollar. The macro-momentum gauge uses timely indicators that we know the currency market tends to react to. These include monthly trend information from confidence surveys, retail sales, the housing market, commodity prices and imports. We use two measures for each – one being directional (positive or negative), and the other the relative magnitude of either weakness or strength. The measures are then weighted to give us an impression of the overall tenor of the data. The results are then overlaid on the currency (on a TWI basis) using cumulative movements. We use cumulative movements because ultimately it is the trend in the data over time that is influential, such as sustained weakness or strength. Just as sub-par performance sees a share price fall, sub-par (trend) performance over time should see a currency decline. A simple regression links the index more explicitly to the actual TWI.

Currency Macro-Momentum Gauge



Sources: ANZ National

Currency Macro-Momentum Gauge - deviation from TWI



Sources: ANZ National

Does our gauge track the NZD? The answer is an overwhelming yes. Obviously divergences can and do occur. Our index includes no offshore factors. Yet it is striking how the two are still closely correlated based solely on macro-momentum for the NZ economy.

Of course our indicator is not saying where the currency should be in a structural sense, or likely to be on average – we rely on a host of other measures for that. But our indicator gives a useful guide and benchmark as to whether the NZD has diverged materially from where it should be in a cyclical sense, and whether the tenor of the data says it should be going up or down.

So what does the indicator tell us at this present stage?

The message is very similar to a couple of months ago, when we last updated the gauge. It shows macro-momentum continues to fall after it "peaked" in October last year. Also, the pace of the deceleration is intensifying, which is not surprising given the extent of weakness shown in leading gauges. Finally, the "disequilibrium" gap between the gauge and the NZ dollar has reduced marginally of late (largely due to a lower NZD/AUD). However, the gap remains large and at levels that historically have resulted in the currency "correcting" aggressively.

The upshot

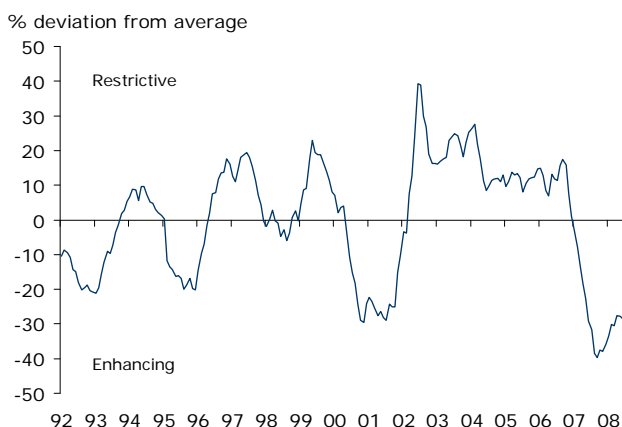
History tells us that the NZD does not stay high in a weak growth environment and our index is suggesting that the NZD is vulnerable to "snapping back" given the negative tenor of the domestic data and the divergence that has developed. The rubber band is taut. Headwinds for the NZD are likely to intensify, particularly as we expect March quarter GDP (due at the end of June) to be negative and June quarter GDP is shaping as no better.

EFFECTIVE EXCHANGE RATES UPDATE

We present an update of our real effective exchange rate measures across New Zealand's main export industries. The measures take into account the world prices that exporters are able to command (commodity prices in the case of commodity exporters), and adjust them by currency movements based on the export destinations. While it is generally acknowledged that a high NZD is eroding the competitiveness of the export sector, our real effective exchange rate measures show a contrasting impact on different sectors of the export community.

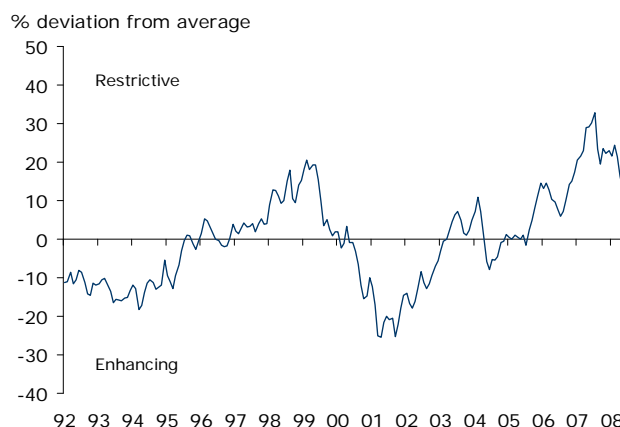
A lower NZD across the board and generally higher world commodity prices have seen all the commodity adjusted real exchange rates fall (become more enhancing) this month. Big moves were recorded in all sectors barring dairy and forestry, which experienced lower world prices. The commodity price strength that was predominately a dairy story 12 months ago has now become more broad-based. As a result, conditions have improved solidly for the meat, horticulture, seafood, crude, and manufacturing sectors over recent months. Conditions remain particularly difficult for the forestry sector.

Sector: Dairy, ≈18% of exports



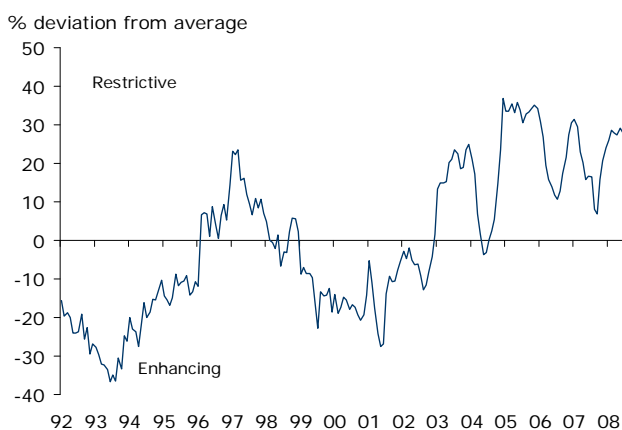
Sources: ANZ National, Bloomberg, Statistics NZ

Sector: Meat, ≈8% of exports



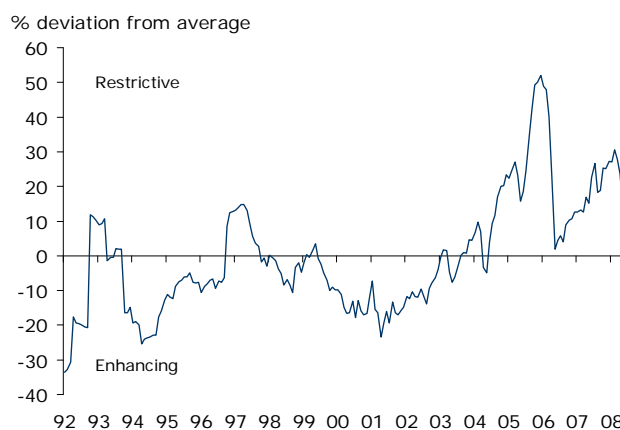
Sources: ANZ National, Bloomberg, Statistics NZ

Sector: Forestry, ≈10% of exports



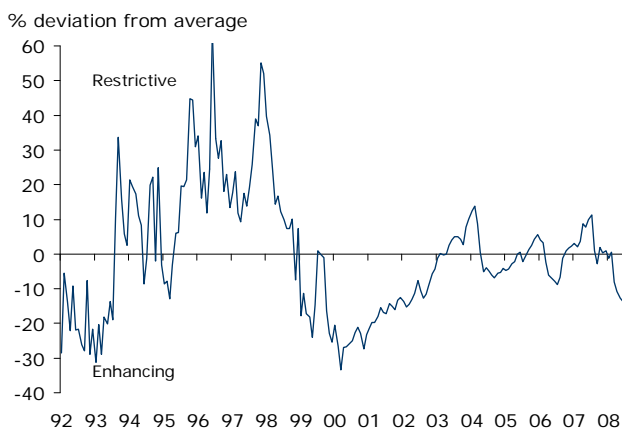
Sources: ANZ National, Bloomberg, Statistics NZ

Sector: Horticulture, ≈4% of exports



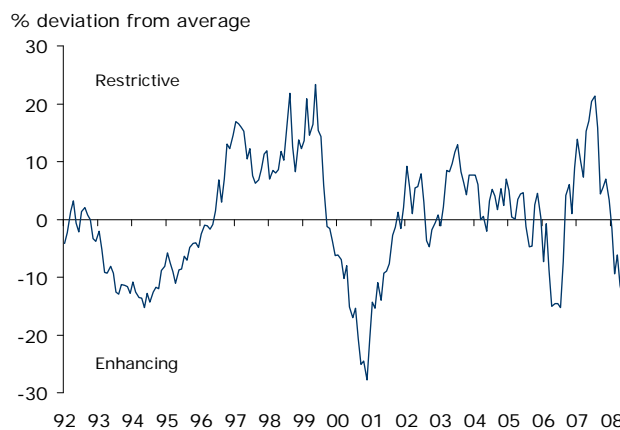
Sources: ANZ National, Bloomberg, Statistics NZ

Sector: Seafood, ≈3% of exports



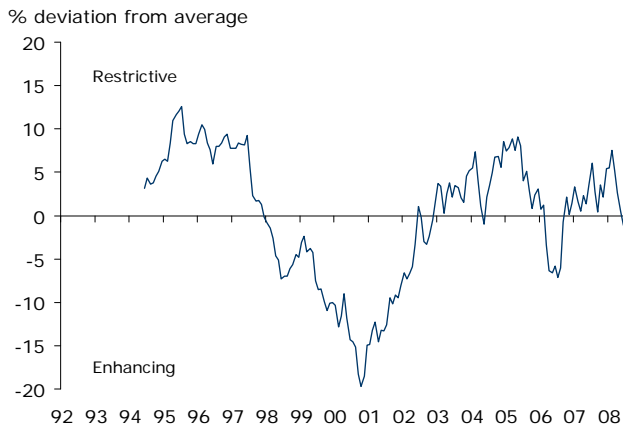
Sources: ANZ National, Bloomberg, Statistics NZ

Sector: Crude, ≈5% of exports

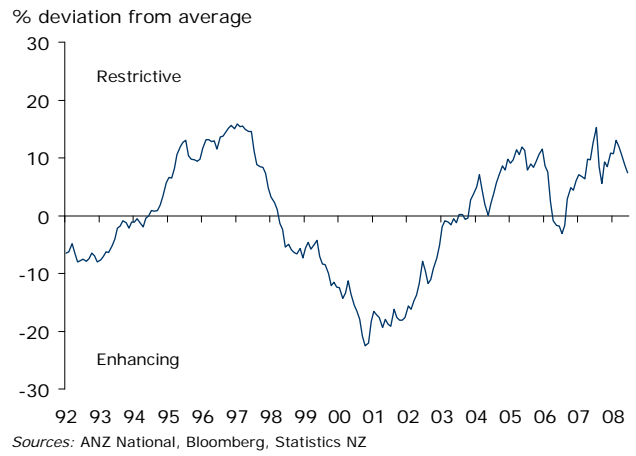


Sources: ANZ National, Bloomberg, Statistics NZ

Sector: Manufacturing, ≈20% of exports



Sector: Services, ≈24% of exports



DATA AND EVENT CALENDAR

Date	Country	Data/Event	Mkt.	Last	Time (NZST)
9 June	NZ	Value of Building Work Done (1Q)	-	3.9%	10.45
	JN	M3 Money Stock (May) – yoy	0.8%	0.9%	11:50
		Bankruptcies (May) – yoy	-	8.3%	16:30
		Leading Economic Index CI (Apr P)	92.9%	94.1%	17:00
		Coincident Index CI (Apr P)	102.1%	30.0%	17:00
		Eco Watchers Survey: Current (May)	34.0	35.5	19:00
		Eco Watchers Survey: Outlook (May)	-	36.1	19:00
	GE	Trade Balance (Apr)	15.6B	16.7B	18:00
		Current Account (Apr)	14.7B	17.2B	18:00
		Imports (Apr) – mom	0.2%	0.6%	18:00
		Exports (Apr) – mom	0.5%	-0.8%	18:00
	UK	PPI Input (May) – mom	2.6%	2.4%	20:30
		PPI Output (May) – mom	0.8%	1.4%	20:30
		PPI Output – Core (May) – mom	0.4%	1.0%	20:30
10 June	US	Pending Home Sales (Apr) – mom	-0.5%	-1.0%	02:00
		Fed's Geithner speaks about Economy in New York	-	-	04:15
		Fed's Rosengren gives welcome remarks at Bank's Conference	-	-	09:00
		Fed's Bernanke speaks at Boston Fed Conference on Inflation	-	-	11:15
	EU	ECB's Tricet speaks at Event in Paris	-	-	04:30
	JN	Machine Orders (Apr) – mom	3.0%	-8.3%	11:50
	AU	Home Loans (Apr)	-2.0%	-6.1%	13:30
		Investment Lending (Apr)	-	-7.2%	13:30
		ANZ Job Advertisements (May) - mom	-	3.1%	13:30
		NAB Business Confidence (May)	-	-8	13:30
		NAB Business Conditions (May)	-	7	13:30
	UK	Industrial Production (Apr) – mom	0.0%	-0.5%	20:30
		Manufacturing Production (Apr) – mom	0.0%	-0.5%	20:30
		DCLG House Prices (Apr) – yoy	3.4%	5.2%	20:30
11 June	US	Fed's Fisher speaks in New York on Monetary Policy	-	-	00:00
		Trade Balance (Apr)	-\$59.9B	-\$58.2B	00:30
		IBD/TIPP Economic Optimism (Jun)	40.0	40.3	02:00
	NZ	Tax Receipts for April	-	-	10:00
		Terms of Trade (1Q) – qoq	0.9%	2.9%	10:45
	JN	Gross Domestic Product (1Q F) – qoq	0.9%	0.8%	11:50
		Domestic CGPI (May) – mom	0.7%	0.6%	11:50
		Current Account Total (Apr)	1,625.0B	2,882.5B	11:50
	AU	Westpac Consumer Confidence (Jun)	-	2.7%	12:30

Continued over page

Date	Country	Data/Event	Mkt.	Last	Time (NZST)
11 June cont.	UK	Claimant Count Rate (May)	2.5%	2.5%	20:30
		Jobless Claims Change (May)	8.0k	7.2K	20:30
		Average Earnings inc Bonus (Apr) – 3m/yoy	4.1%	4.0%	20:30
		ILO Unemployment Rate (Apr) – 3mths	5.2%	5.2%	20:30
		Total Trade Balance (Apr)	-4,000m	-4,031m	20:30
	EU	ECB's Noyer speaks in Paris	-	-	22:00
12 June	US	Fed's Kohn speaks at Boston Fed Conference on Inflation	-	-	03:30
		Fed's Kroszner, Pinalto speak at Community Development Summit	-	-	04:15
		Fed's Bullard to speak at Macroeconomic Conference	-	-	05:00
		Fed's Beige Book released	-	-	06:00
		Monthly Budget Statement (May)	-\$164.5B	-\$67.7B	06:00
	NZ	Food Prices (May) – mom	-	0.3%	10:45
		Business NZ PMI (May)	-	51.4	12:00
	AU	Consumer Inflation Expectation (Jun)	--	5.2%	13:00
		Employment Change (May)	13.5k	25.4k	13:30
		Unemployment Rate (May)	4.2%	4.2%	13:30
		Participation Rate (May)	65.4%	65.4%	13:30
	EU	ECB Publishes Monthly Report	-	-	20:00
		Industrial Production (Apr) – mom	0.0%	-0.2%	21:00
	UK	BoE Quarterly Inflation Attitudes Survey	-	-	20:30
13 June	US	Import Price Index (May) – mom	2.5%	1.8%	00:30
		Advance Retail Sales (May)	0.5%	-0.2%	00:30
		Retail Sales Less Autos (May)	0.7%	0.5%	00:30
		Business Inventories (Apr)	0.3%	0.1%	02:00
	NZ	Retail Sales (Apr) – mom	0.5%	-1.2%	10:45
		Retail Sales Less Autos (Apr) – mom	0.2%	-0.5%	10:45
	JN	BoJ Interest Rate Announcement	0.50%	0.50%	-
		Industrial Production (Apr F) – mom	-0.3%	1.8%	16:30
		Capacity Utilisation (Apr F) – mom	-	-3.5%	16:30
		Consumer Confidence – Households (May)	34.5	35.4	17:00
	AU	RBA's Stevens speaks in Melbourne	-	-	15:10
	GE	CPI (May F) – mom	0.6%	0.6%	18:00
	EU	Labour Costs (1Q) – yoy	2.9%	2.7%	21:00
		Employment (1Q) – qoq	-	0.2%	21:00
14 June	US	CPI (May) – mom	0.5%	0.2%	00:30
		CPI Ex Food & Energy (May) – mom	0.2%	0.1%	00:30
		University of Michigan Confidence (Jun P)	59.5	59.8	02:00

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 RBNZ have now shifted to an easing bias and interest rates look set to be moved lower later this year. The dataflow over the next four weeks is likely to confirm a very weak economy. However, despite a favourable demand-pull backdrop, close attention needs to be paid to cost-push forces such as the currency and commodity prices.

Date	Data/Event	Economic Signal	Comment
Mon 9 Jun (10.45)	Value of Building Work Put in Place (Mar qtr)	Contracting	We expect both residential and non-residential construction work to have contracted in the quarter.
Wed 11 Jun (10.45)	Overseas Trade Indexes (Mar qtr)	Higher terms of trade	The terms of trade is expected to rise in the quarter due to still elevated export prices. Volume data should confirm that net exports will contract from growth in Q1.
circa 11 Jun	REINZ Housing Report (May)	Weaker prices	House sales to remain weak. Prices are expected to continue to fall and days to sell to rise.
Thu 12 Jun (10.45)	Food Price Index (May)	Elevated	Given elevated commodity prices around the globe, annual food price inflation is expected to remain at high levels.
Fri 13 Jun (10.45)	Retail Sales (Apr)	Bounce	We expect retail sales to rebound slightly in April given the early Easter-induced weakness in March. Nevertheless, the underlying trend will remain weak.
Mon 16 Jun (10.45)	Economic Survey of Manufacturing (Mar qtr)	Softer	The Business NZ manufacturing PMI has begun to trend lower. We expect this to also show up in this survey.
Thu 19 Jun (10.45)	Electronic Card Transactions (May)	Weak	Given cost of living pressures eating into discretionary spending, we expect the underlying trend in retailing to remain soft.
Fri 20 Jun (10.45)	External Migration (May)	Stabilising	Monthly net inflows look to have stabilised around 300-400 people. We expect this to continue for the foreseeable future, although the risks remain to the downside.
Mon 23 Jun (15.00)	Credit Card Spending (May)	Weak	An early Easter this year has lead to significant volatility in recent monthly outturns. However, just like with the ECT data, we expect spending on credit cards to remain weak.
Wed 25 Jun (01.00)	Westpac McDermott Miller Confidence	Weakening	Following continued falls in the monthly Roy Morgan confidence survey, we expect the Westpac survey to post another decline as high cost of living pressures weigh on households.
Thu 26 Jun (10.45)	Balance of Payments (Mar qtr)	Improving	We expect a further improvement in the current account deficit for the quarter on the back of higher dairy prices and oil exports.
Fri 27 Jun (10.45)	Gross Domestic Product (Mar qtr)	Negative	We have a negative print penciled in for Q1. Private consumption, residential investment and net exports are all expected to detract from growth.
Fri 27 Jun (15.00)	Credit Growth (May)	Weak	With the housing market in the doldrums, credit growth will remain weak.
Mon 30 Jun (10.45)	Building Consents (May)	Correction	Given the surprising surge last month, we expect a relatively large downward correction in May.
Mon 30 Jun (15.00)	NBNZ <i>Business Outlook</i> (Jun)	-	-
Thu 3 Jul (15.00)	ANZ Commodity Price Index (Jun)	-	-
On Balance		An economy heading backwards, but with inflation	Growth indicators are weak. But inflation needs to be watched.

SUMMARY OF KEY ECONOMIC FORECASTS

	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09
GDP (% qoq)	1.2	0.9	0.5	1.0	-0.3	-0.3	0.2	0.3	0.3	0.5
GDP (% yoy)	2.3	3.2	3.3	3.7	2.1	0.9	0.6	-0.1	0.5	1.3
CPI (% qoq)	0.5	1.0	0.5	1.2	0.7	1.2	1.0	0.9	0.5	0.7
CPI (% yoy)	2.5	2.0	1.8	3.2	3.4	3.6	4.2	4.0	3.7	3.2
Employment (% qoq)	1.4	0.5	-0.3	0.9	-1.3	0.2	-0.2	0.0	0.1	0.1
Employment (% yoy)	1.8	1.5	1.6	2.5	-0.2	-0.6	-0.4	-1.3	0.1	0.0
Unemployment Rate (% sa)	3.7	3.6	3.5	3.4	3.6	3.8	4.0	4.2	4.3	4.5
Current Account (% GDP)	-8.2	-8.1	-8.4	-7.9	-7.5	-6.9	-6.5	-6.5	-6.5	-6.5
Terms of Trade (% qoq)	1.5	0.4	3.7	2.9	1.5	-0.1	-1.0	0.0	-1.6	-1.2
Terms of Trade (% yoy)	4.5	2.3	8.4	8.8	8.8	8.2	3.4	0.4	-2.6	-3.7

KEY ECONOMIC INDICATORS

	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08
Retail Sales (% mom)	0.2	1.1	-0.5	1.8	0.1	0.2	-0.6	-1.2
Retail Sales (% yoy)	6.3	4.1	5.8	7.2	5.4	6.3	7.7	-1.0
Credit Card Billings (% mom)	0.9	1.9	-0.4	1.1	0.7	-0.2	0.8	-3.6	4.4	..
Credit Card Billings (% yoy)	8.6	9.3	7.7	9.5	7.6	8.6	8.1	3.3	8.3	..
Car Registrations (% mom)	1.0	-6.7	5.6	-3.6	-2.7	5.3	-4.2	-13.0	12.3	-15.2
Car Registrations (% yoy)	10.9	0.1	4.7	2.3	1.4	1.7	1.9	-13.2	-1.0	-20.6
Building Consents (% mom)	5.9	-10.5	-5.3	0.9	-4.1	3.9	-5.5	-14.4	82.1	..
Building Consents (% yoy)	0.0	-15.5	-16.1	-4.5	-6.5	-5.2	-17.7	-27.1	30.9	..
REINZ House Price (% yoy)	12.9	12.3	8.0	6.7	4.5	4.0	0.7	1.6	-1.1	..
Household Lending Growth (% mom)	0.9	0.8	0.9	0.9	0.7	0.7	0.8	0.5	0.3	..
Household Lending Growth (% yoy)	13.6	13.2	13.0	12.8	12.3	11.9	11.6	10.8	9.9	..
Roy Morgan Consumer Confidence	122.4	121.3	122.0	121.9	126.6	121.2	116.0	111.7	99.9	89.2
NBNZ Business Confidence	-33.8	-26.5	-12.9	-19.6	-24.9	..	-43.9	-57.9	-54.8	-49.7
NBNZ Own Activity Outlook	16.7	17.2	20.3	15.7	18.2	..	2.4	-6.4	-3.8	-4.4
Trade Balance (\$m)	-947	-572	-774	-628	39	-311	244	-44	-334	..
Trade Balance (\$m annual)	-6336	-6282	-5883	-5691	-5307	-4793	-4421	-4525	-4645	..
ANZ World Commodity Price Index (% mom)	1.4	0.4	1.8	0.8	0.0	-1.4	1.1	2.0	-0.3	1.0
ANZ World Commodity Price Index (% yoy)	36.3	35.7	37.8	35.9	30.9	27.4	26.9	26.9	20.7	..
Net Migration (sa)	760	650	240	460	30	110	240	500	440	..
Net Migration (annual)	8730	8309	7517	6588	5491	4799	4643	4678	4666	..

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

SUMMARY OF KEY MARKET FORECASTS

NZ FX rates	Actual		Current	Forecast (end month)						
	Apr-08	May-08	9-Jun-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09
NZD/USD	0.791	0.778	0.768	0.790	0.770	0.750	0.720	0.680	0.640	0.630
NZD/AUD	0.851	0.819	0.799	0.823	0.762	0.721	0.720	0.723	0.719	0.724
NZD/EUR	0.502	0.500	0.487	0.500	0.494	0.484	0.468	0.453	0.441	0.450
NZD/JPY	81.1	81.1	80.3	81.4	80.1	78.0	75.6	73.4	70.4	69.3
NZD/GBP	0.399	0.395	0.390	0.399	0.393	0.389	0.379	0.364	0.346	0.346
NZ\$ TWI	70.4	69.4	68.2	69.9	67.8	65.9	64.0	61.9	59.6	59.6
NZ interest rates	Apr-08	May-08	9-Jun-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09
OCR	8.60	8.52	8.25	8.25	8.00	7.50	7.00	6.50	6.00	6.00
90 day bill	8.87	8.72	8.68	8.70	8.20	7.70	7.10	6.60	6.20	6.20
10 year bond	6.48	6.43	6.45	6.40	6.00	5.70	5.60	5.60	5.40	5.30
International	Apr-08	May-08	9-Jun-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09
US Fed funds	2.00	2.00	2.00	2.00	1.75	1.50	1.50	1.50	2.00	2.50
US 3-mth	2.85	2.68	2.70	2.50	2.25	2.00	1.75	2.00	2.50	3.00
AU cash	7.25	7.25	7.25	7.25	7.50	7.75	7.75	7.75	7.75	7.25
AU 3-mth	7.80	7.79	7.83	7.70	7.90	8.10	8.10	8.10	7.80	7.20

KEY RATES

	6 May	2 Jun	3 Jun	4 Jun	5 Jun	6 Jun
Official Cash Rate	8.25	n/a	8.25	8.25	8.25	8.25
90 day bank bill	8.84	n/a	8.65	8.66	8.66	8.68
NZGB 07/09	6.95	n/a	7.07	7.07	6.94	6.95
NZGB 11/11	6.68	n/a	6.72	6.72	6.61	6.61
NZGB 04/13	6.62	n/a	6.54	6.54	6.44	6.47
NZGB 12/17	6.45	n/a	6.44	6.44	6.34	6.42
2 year swap	8.04	n/a	8.06	8.05	7.80	7.83
5 year swap	7.59	n/a	7.68	7.65	7.49	7.52
RBNZ TWI	70.3	n/a	70.0	69.7	68.7	68.5
NZD/USD	0.7866	n/a	0.7846	0.7798	0.7664	0.7675
NZD/AUD	0.8298	n/a	0.8199	0.8157	0.8029	0.7997
NZD/JPY	82.42	n/a	81.90	82.00	80.86	81.45
NZD/GBP	0.3986	n/a	0.3997	0.3972	0.3928	0.3919
NZD/EUR	0.5068	n/a	0.5052	0.5045	0.4977	0.4927
AUD/USD	0.9479	n/a	0.9569	0.9560	0.9545	0.9597
EUR/USD	1.5522	n/a	1.5532	1.5458	1.5400	1.5578
USD/JPY	104.78	n/a	104.39	105.16	105.50	106.13
GBP/USD	1.9732	n/a	1.9628	1.9632	1.9513	1.9583
Oil	119.94	n/a	127.75	124.33	122.30	122.30
Gold	873.70	n/a	892.70	880.45	875.95	875.95
Electricity (Haywards)	24.03	27.79	32.08	39.21	40.36	34.88
Milk futures (US\$/contract)	139	144	144	144	144	144
Baltic Dry Freight Index	9855	11458	11503	11623	11689	11612

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