

SUMMARY OF ECONOMIC FORECASTS

Calendar Years	Actual	Estimate	Forecast				
	2005	2006	2007	2008	2009	2010	
Page 3	NZ Growth and Employment (annual average percent changes)						
	Real GDP	2.1	1.6	1.6	2.3	3.1	3.0
	Employment	2.8	2.1	0.2	0.6	0.9	1.6
	Unemployment Rate (Dec qtr)	3.6	3.7	4.0	4.3	4.5	4.5
Page 6	Global Growth (annual average percent changes)						
	US	3.2	3.4	2.5	3.0	3.2	3.2
	Australia	2.8	2.4	2.7	4.0	3.3	2.7
	Japan	1.9	2.2	2.3	2.0	2.1	1.9
	Trading Partners	3.3	3.6	3.3	3.6	3.6	3.4
Page 8	NZ Inflation (annual percent changes)						
	CPI Inflation	3.2	2.6	2.2	2.8	2.3	2.4
	Non-tradable Inflation	4.3	3.8	3.4	3.2	3.3	3.2
	Tradable Inflation	1.7	1.2	0.6	2.5	1.4	1.3
Page 9, 12	NZ Financial Markets (December quarter averages)						
	TWI	71.5	67.1	62.4	54.8	56.0	60.6
	NZD/USD	0.69	0.67	0.63	0.54	0.55	0.59
	Official Cash Rate	7.0	7.3	7.4	6.9	5.5	5.5
	90-day bank bill rate	7.5	7.6	7.4	6.9	5.6	5.6
	10-year bond rate	5.9	5.8	6.1	6.5	6.4	6.3
	Other Information						
	Current Account Balance (\$m)	-13,900	-14,100	-13,000	-13,400	-13,700	-14,300
	as % of GDP	-9.0	-8.9	-7.7	-7.6	-7.4	-7.4
Page 7	Govt. Operating Balance (\$m)*	6,200	11,500	6,300	6,200	5,000	5,600
	as % of GDP	4.1	7.3	3.8	3.6	2.8	3.0

Forecasts and text finalised 21 February 2007

* June years

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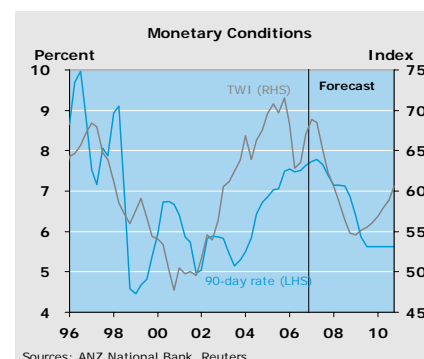
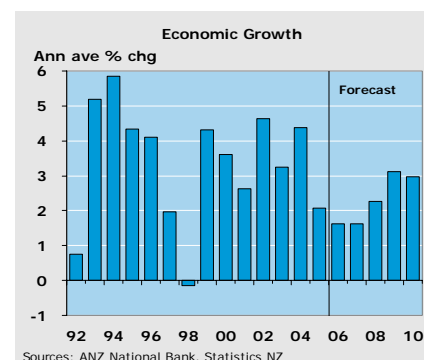
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SUMMARY

- **A soft landing has been achieved**, with growth slowing from 4.4 percent in 2004 to around 1.6 percent in 2006. The high level of the NZD, restrictive monetary policy settings and net migration coming off from record levels have been key drivers behind the slowdown seen to date.
- **This slowdown has not alleviated significant imbalances within the economy.** New Zealand's current account position remains perilous, core inflation is still high, capacity utilisation remains at an elevated level and the labour market continues to be tight.
- **While forward indicators have improved, notably in the housing market, the improvement will not be sustained.** Financial conditions have tightened via the rise in the New Zealand dollar. The Reserve Bank is set to hike rates. Imbalances are strong forces curtailing the ability of the economy to regain momentum from the soft landing trough. Economic growth is forecast to remain at 1.6 percent in 2007, before rising to 2.3 percent in 2008.
- **The currency will be a key dampening transmission mechanism over 2007**, and notably through the rural sector. The rural land price cycle has peaked, and we expect this to progressively filter through to the residential sector.
- **The corporate sector's main focus over the coming 12 to 18 months will be on costs.** Margins and profits are under pressure with businesses bearing the brunt of the slowdown to date. We expect a strong focus on costs to emerge, with this eventually filtering through to labour demand.
- **The economic slowdown will eventually shift through to households**, via a turn in the labour market. Though the unemployment rate will still remain low by historical standards, we expect the household sector to become more interest rate sensitive given the higher leverage they have taken on over the past few years.
- **Inflation pressures will remain sticky for a while.** Lower petrol prices will see headline inflation fall below 2 percent in mid-2007. Yet capacity constraints will see non-tradable inflation and core inflation remain elevated and uncomfortably high.
- **We expect the Reserve Bank to hike interest rates in March as a late cycle insurance policy, and signal the possibility of a follow-up move.** The Bank's frustration at renewed momentum in the housing market, continued concern over medium term inflation pressure, and discomfort over accelerating wage inflation suggest their patience has run out. Our central forecast incorporates only one hike in March given the tightness in financial conditions and our expectation that recent momentum will not be sustained. But if rebuilding economic momentum broadens further, interest rates will almost certainly move up again.
- **The late cycle hike will be withdrawn in late 2007 / early 2008**, but concerns over medium-term inflation pressure and stimulatory fiscal policy in the 2008 *Budget* will limit the scope for further moves back to a neutral setting. An aggressive easing cycle over 2009 will take the OCR to 5.50 percent by September 2009.
- **The NZD will remain well supported early in 2007 by yield chasers, but is set for a downward move in the middle of the year.** Softening economic momentum is expected to weigh, and perception towards the carry trade will unwind as global interest rates move up. Tactically, we expect an aggressive 10 cent move mid-year.



ECONOMIC OUTLOOK – THE GOLDILOCKS ECONOMY?

While partial indicators suggest the economy is accelerating, imbalances, a higher New Zealand dollar and higher interest rates will cap the potential for recent renewed momentum to be sustained. We expect growth performance in 2007 to mirror 2006.

The New Zealand economy has achieved the fabled soft landing.

Annual GDP growth slowed from 4.4 percent in 2004 to 1.6 percent in 2006. This can be regarded as a good growth performance given tight financial conditions in the form of a high exchange rate and a prolonged period of restrictive monetary policy settings, not to mention the worst oil shock since the late 1970s.

Recent indicators suggest growth might be reaccelerating. Business confidence took a step up late last year, and the housing market looks to be gaining a third wind. Lower petrol prices, improving migrations trends, and fiscal spending are providing considerable economic impetus. Certainly, economic activity might surprise on the upside early this year.

This reflation theme will not continue for too long.

- The Reserve Bank is set to hike rates given inflation concerns.
- Imbalances and capacity constraints are curtailing the economy's supply-side capacity.
- The currency and financial conditions have tightened sharply of late, and notably with the NZD/USD pushing through 0.70.

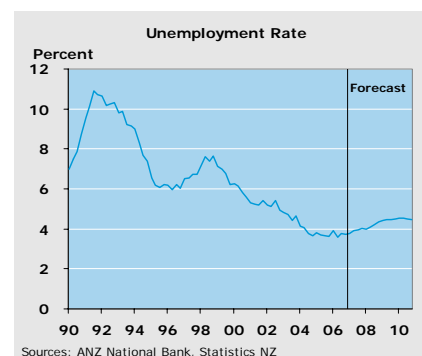
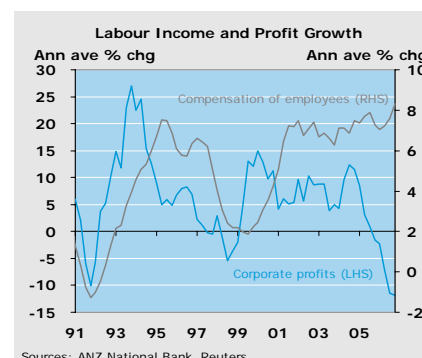
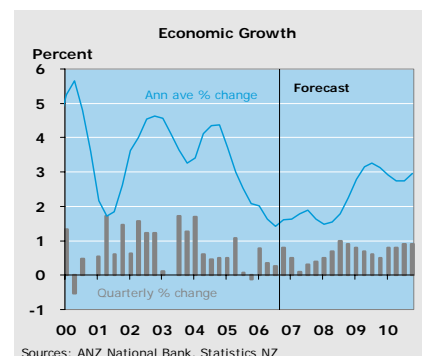
Concern is growing in the rural community. High commodity prices mask differing fortunes within the sector. Although international dairy prices have risen sharply, lamb prices are down considerably. Rising costs are eroding profitability further. Rural land prices have peaked, with a record number of properties on the market, and a sizeable gap opening between the listing and selling price. The rural chequebook remains firmly shut, and this is expected to progressively filter through into the urban centres and the residential housing market.

The business sector is similarly feeling the pinch. Business profits, going by our estimates, are down over 10 percent on a year ago, although this comes following four years of record profits. The manufacturing sector has effectively been in recession for the past two years, and export competitiveness continues to be eroded by the high exchange rate. The resurgence in the NZD over the second half of last year and early this year will hit exporters especially hard, given that most of their hedging would have run out. While some commodity exporters have the benefit of high commodity prices to offset the rising NZD, non-commodity exporters have no such luxury.

But the pinch is not yet a squeeze. The tradable sector has generally held up well in the face of a higher currency. Profits are down, but not of sufficient magnitude to require a "response". Employment intentions remain healthy and a strong labour market continues to underpin spending.

The household sector has been insulated to date with the 2005 and 2006 slowdown unevenly shared. Labour hoarding by firms means households continue to enjoy the best job market in a generation, helping to keep consumer spending and the housing market buoyant. Labour's share of income has risen to a 15 year high. The Government's coffers are also awash with cash resulting in a record operating balance of 7.3 percent of GDP for the 2006 fiscal year, and tax cuts look to be around the corner.

Corporate profits will continue to decline over the coming year. The economic environment remains earnings unfriendly given a modest growth and sticky inflation backdrop. Margins have fallen by as much as 3 percent



in the past year. A tight labour market environment and poor labour productivity performance over the past two years have hampered the corporate sector's ability to contain rising wage costs, and a strong competitive environment has not allowed them to pass on cost increases. Tighter financial conditions through higher interest rates will deliver collateral damage via the business community as opposed to the housing market directly. Expect business investment to remain sluggish in 2007 as firms shelve investment plans and focus on cost containment. The million dollar question is when this cost containment shifts to the labour arena.

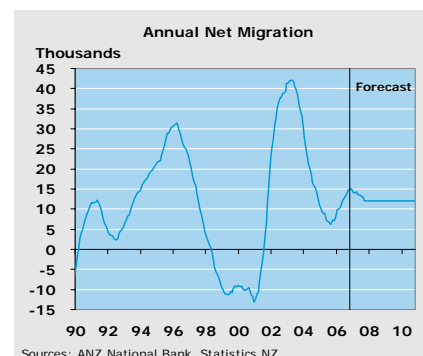
We expect the slowdown to be progressively shared over 2007. A strong corporate sector focus on costs will see less demand for labour. This, in turn, will see the unemployment rate rise over the next two years albeit still remaining low by historical standards. With less job security than they have been used to, households will be more interest rate sensitive given the additional leverage they have taken on over the past few years, and have less of an appetite for more debt. As the pipeline interest rate effect fully works its way through over this year, consumer spending will slow further. Residential investment will continue to find support from net migration, but the easing labour market will provide less support to house prices.

The housing market will ease, but avoid a rout. Given stable net migration above 10,000 per annum, it is difficult to envisage a material downturn in the housing market. The outright declines in nominal house prices of previous cycles coincided with a net outflow of migrants and economic distress, both of which are absent in our central forecasts. Although current house price valuation indicates that the market is stretched, a gradual easing towards fair value is expected, rather than an abrupt adjustment. However, recent downturns in the Australian and US housing markets suggest the risk profile resides towards a more disorderly adjustment.

Modest growth in 2007 will represent the third year of soft performance. Provided this soft performance dampens inflation pressure, an upswing from this juncture will be at hand as day inevitably follows night. The economic recovery will be a late 2008 story, and crucially depends on the NZD giving ground in 2007. Monetary policy will provide no relief until late 2008. The export sector needs a lower NZD in order to recover, and given where the currency is at the moment, it will not be until 2008 and 2009 before the export rebound occurs. Consumer spending will no longer be turbo-charged by debt to the same extent as in previous years, especially with the wealth effect from house prices waning. A period of household consolidation is expected. Government spending, while capable of stepping up several gears, will remain low key in 2007, leaving the big spend-up for next year, which is an election year. All these suggest no big engine to drive growth for 2007 and early 2008, but the stage will be set for a recovery in late 2008 and 2009.

Imbalances curtail the ability of the economy to regain momentum. Imbalances abound in the form of an unsustainable current account deficit (9.1 percent of GDP), persistent non-tradable inflation (3.8 percent) and record household debt levels (158 percent of income). Below-trend growth is the prescription needed to purge the economy of these imbalances. The economy has already been slowing for the past two years. This suggests the scene is set for another year or two of below-trend growth. Any reacceleration in economic momentum from this point will simply worsen imbalances and risk a much sharper slowdown down the track. The Reserve Bank is also poised to hike interest rates further if necessary to ensure that any reacceleration in growth does not take hold, for fear of exacerbating inflation pressure.

The persistence of such imbalances and particularly inflation is raising questions about the economy's growth potential. Multifactor productivity growth has averaged 1.1 percent per annum since 2000 – roughly half the rate of the preceding decade. Such performance, given a backdrop of continued capacity constraints yet easing growth over 2005 and 2006, raises questions about the economy's growth potential. Indeed it is



Key Assumptions

- Oil prices remain stable at between US\$55 to US\$60 per barrel.
- Trading-partner growth returns to trend of 3¼ to 3½ percent over the next few years.
- Net migration remains at current levels of 12,000 per annum.
- Potential growth of the economy remains at around 3 percent, with labour productivity improving from 2008.

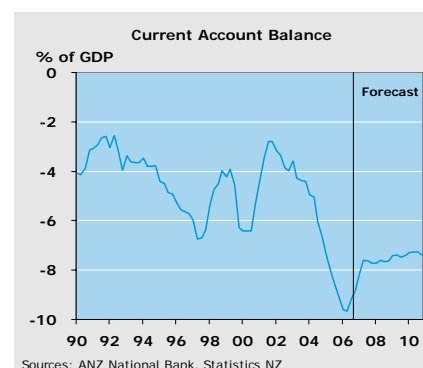


the average rate of growth over the cycle as opposed to the cycle that ultimately determines our living standards. A key judgement that underpins our forecast is that the economy's real potential growth rate resides around 3 percent and the recent deterioration in productivity performance is strongly cyclical. However, it is a judgement that we are becoming increasingly queasy about. A lower potential growth rate implies an even more elongated period of tighter financial conditions to purge inflation pressure, lower asset valuations, and slower improvements in living standards.

While the economic cycle we are forecasting is a benign one, the imbalances leave the economy vulnerable to shocks. Historically, global conditions have typically been the adverse trigger that has fostered the dreaded hard landing. The US economy looks in the midst of a soft landing and growth in the Australian economy remains brisk. China continues to surprise. Yet against this backdrop, global asset prices look inflated, risk indicators unsustainably low, and imbalances rife.

However, there is considerable scope for both fiscal and monetary policy to respond to unexpected developments – provided inflation pressure remains well contained. In this regard, the economy will likely avoid a hard landing scenario in the absence of a major catastrophe. With an abundance of liquidity both domestically and globally, it is difficult to be overly bearish on growth. An effective floor to growth is being provided by government spending, infrastructure investment, reasonable net migration inflows and high commodity prices.

A more aggressive turn in the housing market and contagion effects look to be the key downside risk to our forecasts, particularly with the Reserve Bank running out of patience and poised to increase interest rates. With a household debt servicing ratio above 13 percent of income, one of the highest in the developed world, there is a material risk that higher interest rates act as a "tipping point" and contagion develops.



THE NATIONAL ACCOUNTS

Annual average % change Calendar Years	Actual 2005	Estimate 2006	Forecast			
			2007	2008	2009	2010
Total Consumption	4.8	2.3	2.0	1.5	2.1	2.8
Private Consumption	4.9	1.8	1.3	0.6	1.6	2.7
Public Consumption	4.1	4.3	4.4	4.4	3.6	3.1
Total Investment	4.7	-2.2	1.2	2.7	6.0	5.7
Residential investment	-4.5	-2.6	3.2	1.3	2.9	3.2
Other investment	7.4	-2.0	0.7	3.1	6.8	6.3
Stockbuilding¹	-0.2	-1.0	0.6	0.0	0.0	0.0
Gross National Expenditure	4.5	0.0	2.5	1.8	3.1	3.5
Total Exports	-0.4	3.0	2.3	3.8	6.7	5.4
Goods	0.0	4.3	2.8	2.9	5.6	5.4
Services	-2.1	-1.2	2.1	6.7	10.0	5.4
Total Imports	6.3	-1.6	4.2	2.2	5.8	6.3
Goods	5.7	-0.7	5.0	2.7	6.4	6.5
Services	8.1	-4.7	0.2	0.5	3.7	5.5
Expenditure on GDP	2.0	1.6	1.8	2.3	3.2	3.1
GDP (production based)	2.1	1.6	1.6	2.3	3.1	3.0

¹ Percentage point contribution to growth

GLOBAL OUTLOOK – REASONABLE BUT NOT SPECTACULAR

The US economy will avoid a recession, and prospects for Asia remain sound. We are still in a global interest rate tightening cycle, as central banks around the world remain vigilant towards inflation risks. Inflation risks and global imbalances will continue to weigh on the global outlook.

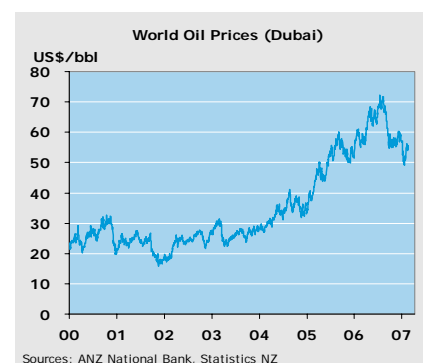
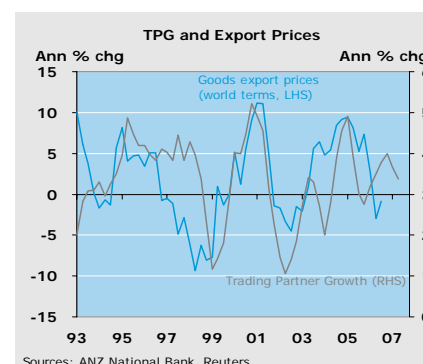
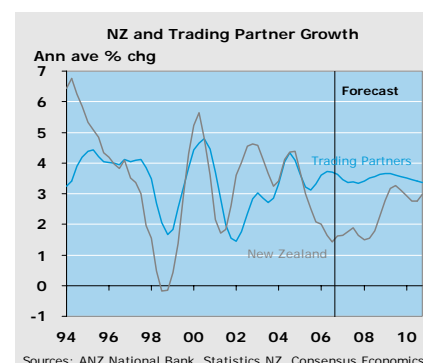
After a strong showing in 2006, trading partner growth is expected to slow to 3.2 percent in 2007. A slowdown in the US economy on the back of a housing market correction and sub-trend growth in Australia due to drought conditions are offset somewhat by still strong growth performances expected from the Asian economies.

The US economy does not look to be headed for recession. The housing market slump has been worse than many had expected and some flow-through into consumer spending will occur. But the US equity market is bullish and the wealth effect channel from there will help offset the waning housing wealth effects. In addition, the unemployment rate remains low and other sectors of the US economy outside of housing – in particular the services sector – continue to post modest growth. The Federal Reserve is certainly not buying into the recession scenario, expecting growth to be at or slightly below trend and maintaining a firm tightening bias. We expect New Zealand's experience over 2006 (growth surprising on the upside when the unemployment rate is low and liquidity is ample) to be repeated in other developed countries over 2007.

Asian economic growth is expected to remain strong, particularly in China, which continues to benefit from industrialisation. While concerns remain that the Chinese economy is overheating, it is difficult to assign a high probability that growth will derail, at least in the near term. Gradual adjustments by Chinese authorities to make the Yuan more flexible and curb over-investment suggest further strong performances can be expected.

The outlook is positive for New Zealand's commodity prices over time. While the first derivative of China's growth boom to date has been surging hard commodity prices (which has been more beneficial to Australia), the second derivative via rising incomes will be positive for New Zealand's soft commodity basket. However we see this as a rising trend over time as opposed to a near-term cyclical force over the coming years.

Inflation risks and global imbalances continue to weigh. Central banks around the world remain vigilant towards inflation, with many still on a tightening interest rate cycle. Against a backdrop of asset price exuberance, rising interest rates represent a key risk. Global risk indicators including the S&P VIX index, credit and emerging market spreads sit at historically low levels. If there is a global surprise to be had over 2007, it may follow from New Zealand's inflation experience – sticky and elevated inflation necessitating higher interest rates. Such an outcome would present some major challenges to asset valuations, and the global economy.



GLOBAL ECONOMIC GROWTH

Annual average % change Calendar Years	Actual	Estimate	Forecast			
	2005	2006	2007	2008	2009	2010
United States	3.2	3.4	2.5	3.0	3.2	3.2
Australia	2.8	2.4	2.7	4.0	3.3	2.7
Japan	1.9	2.2	2.3	2.0	2.1	1.9
Euro Zone	1.5	2.8	2.2	1.9	2.0	2.1
China	10.2	10.7	10.0	9.6	9.0	8.5
Trading Partner Growth	3.3	3.6	3.3	3.6	3.6	3.4

FISCAL POLICY – PRUDENT BUT FOR HOW LONG?

The Government has wisely abstained from putting more pressure on monetary policy in 2007, but the stage is set for an even larger fiscal stimulus in the 2008 election year Budget. The overall fiscal position will remain sound and help mitigate the risk to New Zealand's sovereign credit rating stemming from a large current account deficit. But the growing size of government in the economy risks lowering its long term growth potential.

The Government's coffers continue to overflow with an embarrassment of riches. The government sector is faring even better than the household sector during the current economic slowdown. The operating balance has improved with a surplus equivalent to 7.3 percent of GDP recorded in the 2006 fiscal year. Surpluses in the vicinity of 3 to 4 percent of GDP are expected over the next few years.

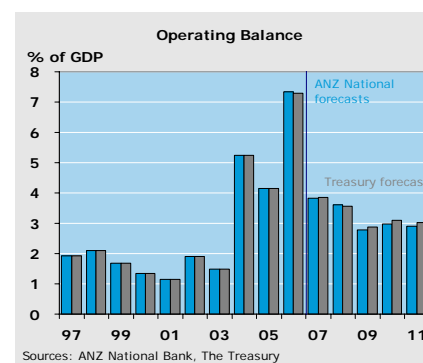
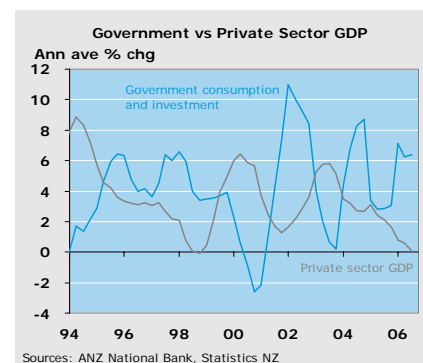
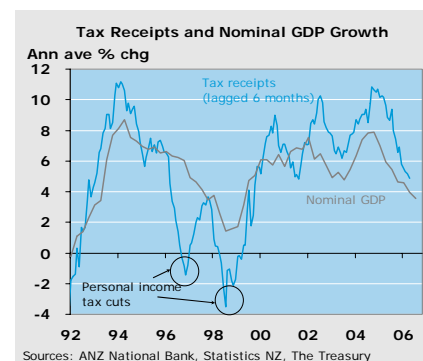
To their credit, the Government has proven to be a prudent fiscal manager. There is scope to increase spending in the near term given the upside surprises to tax revenue over the past year and the low level of debt. But the Government acknowledges the pressure that monetary policy faces at the current juncture of the economic cycle, and is doing its best to ensure that fiscal policy does not add further weight to inflation pressure in 2007.

However, political reality suggests that a further fiscal loosening will occur at some stage given the massive surpluses being flagged.

The \$1 billion *Business Tax Package* to be announced in the 2008 Budget will help spur much needed business investment. But we suspect the Government is hoarding a war chest to be unleashed at the 2008 election year Budget to ensure a fourth term in government. History suggests that at election time, prudence takes a back seat when you are behind in the polls.

Even with additional fiscal expenditure, the overall fiscal position is expected to remain sound. The resilience of the economy has delivered stronger than expected tax revenue growth. Slippages in fiscal discipline are unlikely to see the fiscal position deteriorate substantially. The Government is well aware that the strength of the fiscal position is New Zealand's saving grace from a credit rating downgrade. This naturally puts a cap on the extent of any fiscal loosening.

Interactions between monetary policy and fiscal policy pose the greatest risk to the inflation and interest rate outlook. While fiscal policy is largely out of the equation for 2007, it will loom large in 2008, particularly when inflation is expected to creep back up towards 3 percent courtesy of a lower exchange rate. Further stimulus to the economy then will serve to add upward pressure on inflation and hence, monetary policy. In addition, the continual expansion of the public sector risks the private sector being crowded out and lowering the economy's long-term growth potential. This will have further implications for the economy's ability to expand without generating more inflation pressure. For now, prudence is the best virtue for fiscal policy. But watch out for the long awaited tax cuts in 2008.



BALANCING THE BOOKS

June Years	Actual			Forecast		
	2006	2007	2008	2009	2010	2011
Operating Balance (\$m)	11,500	6,300	6,200	5,000	5,600	5,800
- as % of GDP	7.3	3.8	3.6	2.8	3.0	2.9
Net Crown debt (\$m)	7,700	6,600	5,900	6,900	7,100	6,600
- as % of GDP	4.9	4.0	3.5	3.8	3.8	3.3
Bond Tender Programme (\$m)	2,400	2,500	2,900	3,000	3,000	3,000

INFLATION – THE ROLLER COASTER RIDE

Short-term inflation relief in the form of lower petrol prices and a higher currency see headline CPI inflation temporarily ease over the first half of 2007. However, while core inflation measures are easing, they remain elevated. A further period of sub-trend growth will see non-tradable inflation continue to ease, though gradually. A decline in the currency from the second half of this year will see headline inflation rise towards the top of the band, before easing again towards 2¼ percent.

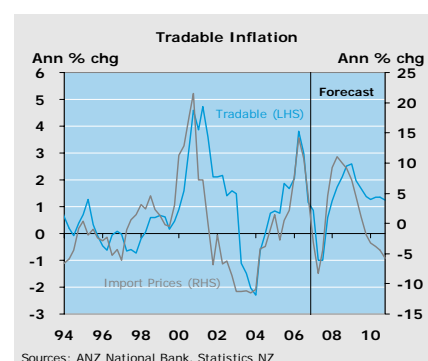
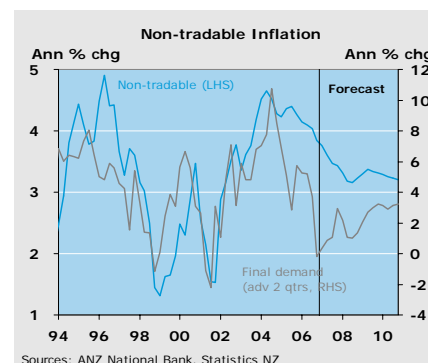
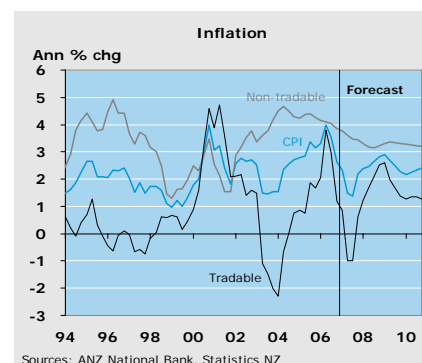
Some near-term inflation relief is at hand, courtesy of lower world oil prices and a higher currency. Lower domestic pump prices sent the annual headline inflation rate to 2.6 percent, the first time it has been below the top of the target band since June 2005. Petrol price discounting, together with further price pass-through from the higher currency, will see inflation head towards 1½ percent in the middle of this year.

Non-tradable and core measures have eased but they remain stubbornly elevated. Non-tradable inflation has eased from a peak of 4.4 percent to 3.8 percent, testament to easing growth over 2005 and 2006. Yet the backdrop remains elevated, and capacity constraints remain rife in some sectors, notably construction. Inflation across the service sector continues to be pressured by rising unit labour costs. Firms' margins have absorbed a huge amount of cost-push inflation to date, and are seeking to recover where competitive forces are absent.

There is still little inflation headroom for the Reserve Bank. Short term inflation softness will be greeted with relief by the Reserve Bank. A lower headline rate will dampen inflation expectations – a key element of any monetary policy framework. Yet, elevated domestic inflation, recovering economic momentum and a likely depreciation in the exchange rate over the second half of this year will push headline inflation towards 3 percent by the end of 2008.

The key judgement is whether the current growth momentum is sustained. Our expectation that the recent fillip is transitory should progressively dampen core inflation pressure as 2007 progresses. However, if the momentum proves to be sustained and the housing market accelerates, there is a risk that non-tradable inflation remains more elevated or even accelerates. In the near-term we see a lower headline rate and easing inflation expectations as a key mechanism dampening pressure on the medium term inflation outlook.

However, the risk to the medium-term inflation outlook is to the upside, in the form of a larger than expected fiscal stimulus in 2008. Inflation outcomes over the coming years look set to be volatile given a higher weight in the new CPI regime given to petrol prices (5.38 percent versus 3.12 percent previously) and volatility in oil and currency markets.



	Quarterly	Annual
Dec-03	0.7	1.6
Dec-04	0.9	2.7
Dec-05	0.7	3.2
Mar-06	0.6	3.3
Jun-06	1.5	4.0
Sep-06	0.7	3.5
Dec-06	-0.2	2.6
Mar-07	0.3	2.3
Jun-07	0.7	1.5
Sep-07	0.6	1.4
Dec-07	0.6	2.2
Mar-08	0.5	2.4
Jun-08	0.8	2.5
Sep-08	0.8	2.6
Dec-08	0.8	2.8
Mar-09	0.6	2.9
Jun-09	0.6	2.7
Sep-09	0.6	2.5
Dec-09	0.6	2.3
Mar-10	0.5	2.2
Jun-10	0.6	2.2
Sep-10	0.6	2.3
Dec-10	0.6	2.4

EXCHANGE RATE – WHEN WILL THE YIELD YIELD?

The NZD will remain well supported by yield chasers in early 2007, but is set for a downward move in the middle of the year. Softening economic momentum is expected to weigh, and perception towards the carry trade to unwind as global interest rates move up. Tactically, we expect an aggressive 10 cent move mid-year similar to 2004 and 2006.

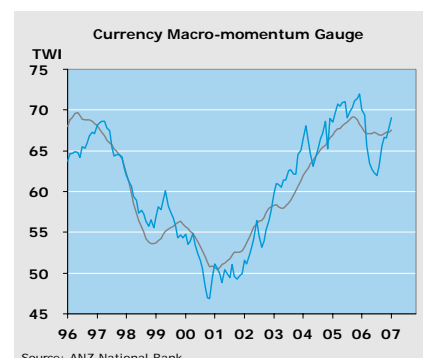
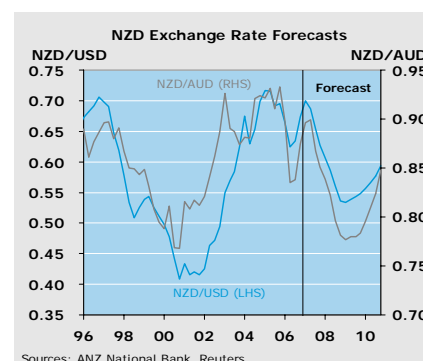
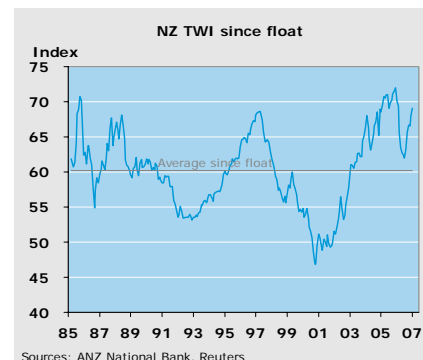
Yield remains king in the currency market at the moment. Interest rate differentials are still the main driver of the NZD, and expectations of higher New Zealand interest rates and lower US rates have seen a solid bid under the NZD.

Given hawkish overtures from the Reserve Bank we have once again softened and pushed out the easing trajectory for the kiwi. The New Zealand interest rate market is currently ascribing an 80 percent chance of a hike by the Reserve Bank in March and a full hike by April. The currency will remain supported courtesy of yield in such an environment. Such support is likely to be noticeable vis-à-vis the AUD, with a sharp fall in Australian yields, courtesy of a lower CPI and the RBA's assessment that inflation pressures will alleviate. The Reserve Bank looks in play and the RBA not. While a follow-up hike after March from the Reserve Bank is not our central track, the market will remain attuned to the risk.

Global forces are expected to cap the kiwi's upside potential at present across the majors. Although yields on US Treasuries have been volatile, the Fed remains on a tightening bias and any further rises in global yields has the potential to strongly influence risk appetites, particularly with key risk gauges at historically low levels. The USD on a TWI basis is currently sitting on key resistance and stronger data will open up the door to further moves higher. Global interest rates are still moving up. The BoJ hiked in February, and signalled it will adjust interest rates gradually. The BoE has now surprised with 2 hikes in response to inflation pressure, and the market is expecting one more to come. The ECB continues to warn of inflation risks and looks set to hike in March. As a broad theme we believe New Zealand's experience of sticky inflation and capacity constraints will end up being repeated around the globe.

Looking over the coming year, five broad themes shape our currency view.

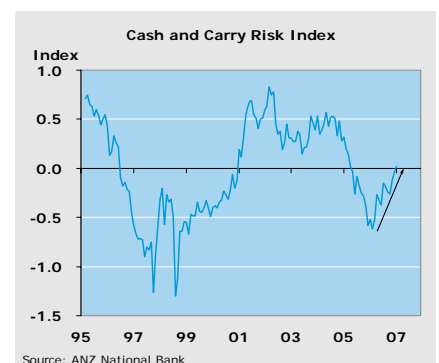
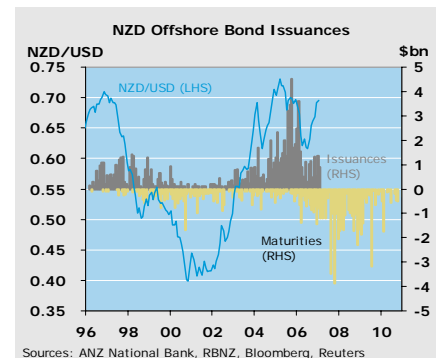
- **The New Zealand economy will slow whether the Reserve Bank hikes or not.** Speculation of 2 percent plus growth over 2007 does not wash given the material imbalances in the economy and the desire of the central bank. Either financial conditions are tight enough to foster the slowdown or the Reserve Bank is prepared to do more. We know from our macro-momentum gauge that ultimately it is growth as opposed to yield that matters for the NZD. The NZD is typically in a declining trajectory when growth is moderating. The Reserve Bank will not let the economy reflate at this juncture and the danger is that late cycle hike(s) act as a tipping point for the housing market. We know from recent US experience how quickly things (housing) can turn and the currency (USD) with it.
- **The economy has the potential to turn sharply, and the NZD with it, particularly if the Reserve Bank does hike.** The New Zealand economy tends to turn very aggressively in response to late cycle rate moves. The economy contracted in June 2000 and December 2005. The "lag" between hikes and the economy was generally contemporaneous in both instances. We suspect the economy will likely be on a recessionary knife-edge if 50 basis points of hikes eventuate at this juncture of the cycle. With a household debt servicing ratio above 13 percent, the housing market is exceptionally vulnerable, even in a low unemployment rate environment. The NZD/USD has had two 10 cent moves over three months in the past three years. If the Reserve



Bank does hike rates twice, we will pencil in a negative GDP outturn for the June quarter (in a similar fashion to the call we made in late 2005 for the December 2005 quarter), which will manifest in partial indicators around July, August and September. While we are now centred on Q3 for the timing of an aggressive turn in the NZD, Q2 looks equally likely.

- **We see the timing of pending Uridashi maturities** as being a significant factor around Q3 as they will likely coincide with flagging perception towards the economy in a similar fashion to early 2006. August and October this year are monster months with \$3.5 billion and \$3.9 billion of maturities pending respectively. A large portion may in fact be rolled. Yet the speculative market will find it difficult to ignore the sheer size of the potential flow.
- **We are strongly biased towards the New Zealand economic resilience story repeating elsewhere, which will eventually necessitate a closing yield differential.** A low unemployment rate and an abundance of liquidity have been the mainstays of New Zealand's resilience, and economic resilience has transferred to currency buoyancy. When we look at the US and Australia we see similar characteristics, and remain strongly biased (although not our central track) towards the surprise of 2007 being how far global interest rate settings in the other nations move up. Commodity prices have played a role for New Zealand as well, but more so in Australia given the 40 percent surge in their terms of trade since 2000. While migration has been a differentiating factor in New Zealand's case, we see that as more than being compensated for by a materially higher household debt servicing burden and tighter financial conditions.
- **We remain very wary of the global perception towards the carry trade.** Although the BoJ indicated that interest rates will remain low for some time, which will help underpin the carry trade in the near term, sentiment tends to be fickle and can change quickly. Our cash-and carry risk index has been negative for 20 months (although it has moved back to broadly neutral territory). Low levels of risk aversion remain a key supporting factor although we wonder how long this will continue, particularly if stronger than expected US data see US yields testing 5 percent. If there is a lesson from recent action in the oil market, it is how easily perception can change.

The end-game for the NZ economy is slower growth and the NZD will not sustain current levels under such a circumstance. We expect "global forces" including interest rates and perceptions towards risk to turn progressively NZD negative over the coming months. While we have softened our easing profile for the NZD over the coming months, tactically we remain attuned to a major move around mid-year.



NEW ZEALAND DOLLAR EXCHANGE RATE FORECASTS (average for the quarter)

	NZD/USD	NZD/AUD	NZD/JPY	NZD/GBP	NZD/EUR	NZ TWI
Dec-03	0.62	0.87	68.0	0.37	0.53	63.9
Dec-04	0.70	0.92	74.0	0.38	0.54	67.6
Dec-05	0.69	0.93	81.4	0.40	0.58	71.5
Mar-06	0.66	0.90	77.6	0.38	0.55	68.2
Jun-06	0.62	0.84	71.3	0.34	0.50	62.8
Sep-06	0.63	0.84	73.7	0.34	0.50	63.5
Dec-06	0.67	0.87	79.2	0.35	0.52	67.1
Mar-07	0.70	0.90	83.1	0.35	0.53	68.9
Jun-07	0.69	0.90	81.0	0.36	0.53	68.5
Sep-07	0.65	0.87	74.7	0.34	0.51	65.1
Dec-07	0.63	0.85	69.6	0.33	0.49	62.4
Mar-08	0.61	0.84	65.9	0.32	0.48	60.5
Jun-08	0.59	0.82	62.6	0.31	0.47	58.7
Sep-08	0.56	0.80	60.1	0.30	0.45	56.5
Dec-08	0.54	0.78	58.7	0.29	0.44	54.8
Mar-09	0.53	0.78	58.7	0.30	0.44	54.6
Jun-09	0.54	0.78	59.2	0.30	0.45	55.1
Sep-09	0.54	0.78	59.8	0.30	0.45	55.6
Dec-09	0.55	0.78	60.3	0.30	0.46	56.0
Mar-10	0.56	0.80	61.2	0.31	0.46	56.9
Jun-10	0.57	0.81	62.3	0.31	0.47	57.9
Sep-10	0.58	0.82	63.4	0.32	0.48	58.9
Dec-10	0.59	0.85	65.3	0.33	0.49	60.6

INTEREST RATES – LATE CYCLE INSURANCE POLICY

Our latest interest rate profile includes a rate hike in March as a late cycle insurance policy. We do not envisage a follow-up hike, but given the Reserve Bank's concern about medium-term inflation pressure and the spectre of a large fiscal stimulus in 2008, policy normalisation is a long way off. Expect upward pressure on New Zealand's longer dated yields to be maintained by global forces.

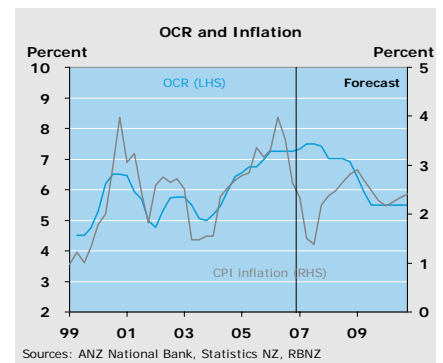
A March rate hike as a late cycle insurance policy is on the cards. A clear message from the Governor at his January OCR *Review* was that further policy tightening is likely if the housing market and domestic demand does not moderate. Given the continued tightness in the labour market, accelerating wage inflation and strong labour income growth (up almost 9 percent from a year ago), the Reserve Bank will view these as evidence that the moderation they are seeking will not eventuate in the near-term. A failure to hike will put into question the Reserve Bank's credibility given the continued escalation of their hawkish rhetoric since late last year.

While March is locked and loaded, the real question is whether it will be followed up by a further hike. The case for a follow-up move is well grounded. If the Reserve Bank feels that it is so far away from its optimal policy setting, then there is no point in hiking only once. If growth momentum is rebuilding, the housing market, which has been a source of frustration for the Reserve Bank, is unlikely to turn with a 25 basis point hike. The Reserve Bank will also be wary that job security and strong wage growth, whilst both classic late cycle phenomena, will continue to feed into the robust housing market, consumer spending growth, and medium-term inflation pressure.

The March *Monetary Policy Statement* will certainly be hawkish and flag the possibility of a further hike. The jawboning and talk will remain tough, with the March *Monetary Policy Statement* to possibly incorporate a second move within the interest rate projections – and the market moving to price it in accordingly. A likely strong Q4 GDP result released at the end of March – while historical – will certainly keep the market attuned to a follow-up hike.

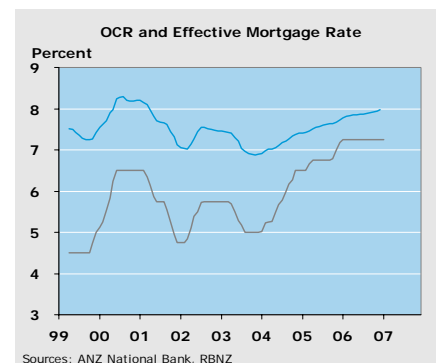
However, at this stage we envisage only one move by the Reserve Bank:

- **We find it difficult to go past the material tightening in financial conditions that has occurred**, and the close relationship this bears with the economic cycle. We remain very wary about extrapolating Q4's rebounding growth signals into 2007. The rural chequebook remains firmly shut, and there are signs that the rural property market has slowed. Business profits are easing and the focus on labour costs, the missing ingredient to a slowdown in the housing market, will be a major theme over the next 12 to 18 months.
- **Late cycle hikes are inherently risky moves, particularly when the economy is at a vulnerable stage in the economic cycle.** Policy settings have been in a contractionary stance for over two years, and economic growth has slowed accordingly. As noted in the Reserve Bank's Financial Stability Report, the New Zealand economy, and housing market in particular is very vulnerable to a change in sentiment.
- **The mortgage curve is finally working in the Reserve Bank's favour.** Low global interest rates and margin discounting by large local retail banks saw longer term mortgage rates fall last year, which worked against the Reserve Bank's efforts to slow the housing market and consumer spending. With global interest rates now higher and the local swaps market anticipating higher official interest rates for longer, the



Assumptions for policy

- Neutral real interest rate of between 3.75 and 4 percent.
- Inflation expectations remain well anchored.
- Potential growth of the economy remains at around 3 percent.



mortgage curve is now above the psychological 8 percent mark in the 1 to 4 year space, effectively doing the Reserve Bank's work. This will see a faster rise in the effective mortgage rate over 2007 compared to last year.

- **There is time to wait and assess the impact of a March hike.** While the Governor's patience towards the housing market is likely to have run out, leading to a March hike, there is sufficient inflation headroom in the near-term to wait and assess the impact.

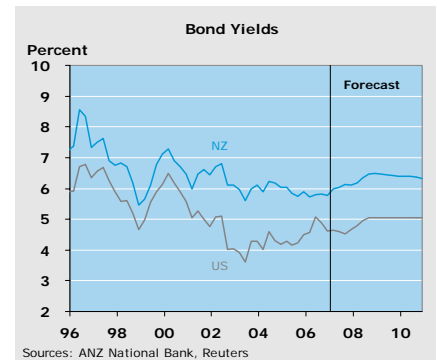
This leaves us erring towards "a spoonful of medicine" approach, where a hike in March is followed by a period of monitoring to assess the impact. If rebuilding economic momentum does not show signs of moderating following a March move – and key here will be forward gauges and the monthly REINZ housing market reports - interest rates will almost certainly move up again.

We have pencilled in two cuts in late 2007 and early 2008. We see these as being the removal of the late cycle insurance policy set to be taken out in March. But concerns over medium-term inflation pressure and a stimulatory fiscal policy in the 2008 *Budget* will limit the scope for further moves back to a neutral setting.

Fiscal policy clearly complicates the timing of a substantial easing profile. The *Business Tax Package* has already been ear-marked, and will have been factored into the Reserve Bank's decision making. But the Reserve Bank will be wary of growing pressure on the Government to deliver personal tax cuts during the 2008 election year. There is a possibility that any tax cuts could be delivered into taxpayers' Kiwisaver accounts as a way to dampen the inflationary impact. But any concrete policy proposals will not be announced until late this year at the earliest.

The long road to policy normalisation is not expected to occur until late 2008. At that stage a long period of below trend growth will be sufficient to alleviate the Reserve Bank's medium-term inflation concerns. The housing market and consumer spending will have slowed enough for the Reserve Bank to take the foot off the brake. We have forecast an aggressive easing cycle starting in late 2008 which, while sizeable in magnitude, is largely one of policy normalisation.

On the international front, our core house view is for rates in the US and Australia to remain on hold through most of 2007, then ease at the end of the year. Underpinning this view is core inflation in those economies moderating with economic growth broadly growing at trend. However, this is a view that contains more upside risk than down. We see the risk profile for global rates as being skewed sharply higher, with New Zealand's experience over 2006 of sticky inflation likely to repeat in other economies over 2007. Expect upward pressure on New Zealand's longer dated yields to be maintained from global forces.



INTEREST RATE FORECASTS (average for the quarter)

	OCR	90-day	2-year swap	5-year swap	10-year bond	US 10-year bond	AU 10-year bond
Dec-03	5.0	5.3	6.1	6.5	6.1	4.3	5.8
Dec-04	6.4	6.7	6.6	6.6	6.0	4.2	5.4
Dec-05	7.0	7.5	7.2	6.9	5.9	4.5	5.4
Mar-06	7.3	7.6	7.0	6.7	5.7	4.6	5.3
Jun-06	7.3	7.5	7.0	6.7	5.8	5.1	5.7
Sep-06	7.3	7.5	7.3	6.9	5.8	4.9	5.7
Dec-06	7.3	7.6	7.5	7.1	5.8	4.6	5.7
Mar-07	7.3	7.7	7.7	7.3	6.0	4.6	5.8
Jun-07	7.5	7.8	7.5	7.1	6.0	4.6	5.8
Sep-07	7.5	7.7	7.3	7.0	6.1	4.5	5.8
Dec-07	7.4	7.4	7.1	6.9	6.1	4.7	5.7
Mar-08	7.0	7.2	6.9	6.8	6.2	4.8	5.9
Jun-08	7.0	7.2	6.8	6.8	6.4	5.0	6.0
Sep-08	7.0	7.1	6.5	6.7	6.5	5.1	6.0
Dec-08	6.9	6.9	6.2	6.5	6.5	5.1	5.9
Mar-09	6.4	6.4	6.0	6.5	6.5	5.1	6.1
Jun-09	5.9	5.9	6.0	6.6	6.4	5.1	6.2
Sep-09	5.5	5.6	6.0	6.6	6.4	5.1	6.4
Dec-09	5.5	5.6	6.0	6.6	6.4	5.1	6.5
Mar-10	5.5	5.6	6.0	6.6	6.4	5.1	6.3
Jun-10	5.5	5.6	6.0	6.6	6.4	5.1	6.2
Sep-10	5.5	5.6	6.0	6.6	6.4	5.1	6.0
Dec-10	5.5	5.6	6.0	6.5	6.3	5.1	6.0

ANZ ECONOMIC FORECASTS

	Mar-06	Jun-06	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08
Real Gross Domestic Product												
Total GDP, QPC	0.8	0.4	0.3	0.8	0.5	0.1	0.3	0.4	0.5	0.7	1.0	0.9
Total GDP, APC	1.8	1.1	1.3	2.2	1.9	1.7	1.7	1.3	1.3	1.9	2.6	3.1
Total GDP, AAPC	2.0	1.6	1.4	1.6	1.6	1.8	1.9	1.6	1.5	1.6	1.8	2.3
Real GDP Components												
Private Consumption, QPC	0.8	-0.4	0.2	1.0	0.3	0.2	0.2	0.1	0.1	0.1	0.3	0.3
Private Consumption, AAPC	4.6	3.4	2.5	1.8	1.2	1.3	1.5	1.3	1.2	0.9	0.6	0.6
Public Consumption, QPC	0.6	1.6	0.9	1.0	1.1	1.1	1.1	1.1	1.1	1.1	1.0	0.9
Public Consumption, AAPC	4.8	4.2	4.3	4.3	4.3	4.5	4.4	4.4	4.4	4.4	4.4	4.4
Residential Investment, QPC	0.6	-6.3	3.8	2.3	0.8	0.5	0.0	0.0	0.4	0.4	0.6	0.6
Residential Investment, AAPC	-4.9	-4.8	-3.1	-2.6	-1.9	2.1	2.9	3.2	3.3	1.6	1.1	1.3
Other Investment, QPC	-1.6	-6.1	2.3	2.2	0.3	-0.4	-0.9	0.0	0.7	1.7	2.3	2.3
Other Investment, AAPC	9.1	5.3	1.2	-2.0	-3.8	-1.5	0.1	0.7	0.9	0.2	1.1	3.1
Gross National Expenditure, QPC	0.6	-1.4	-0.2	2.6	0.8	0.0	0.1	0.3	0.4	0.6	0.9	0.8
Gross National Expenditure, AAPC	4.4	2.3	0.3	0.0	-0.3	1.0	2.5	2.5	2.2	1.8	1.4	1.8
Exports, QPC	-1.8	3.9	3.3	-2.1	0.6	0.5	0.4	0.6	0.9	1.4	1.4	1.7
Exports, AAPC	-0.1	1.0	2.0	3.0	4.5	4.4	2.5	2.3	1.5	1.7	3.0	3.8
Imports, QPC	-1.0	-1.3	1.4	2.8	1.5	0.3	-0.1	0.4	0.4	0.9	0.9	1.4
Imports, AAPC	5.0	1.6	-1.5	-1.6	-0.6	2.0	4.2	4.2	3.4	2.3	1.8	2.2
Prices												
Headline CPI, QPC	0.6	1.5	0.7	-0.2	0.3	0.7	0.6	0.6	0.5	0.8	0.8	0.8
Headline CPI, APC	3.3	4.0	3.5	2.6	2.3	1.5	1.4	2.2	2.4	2.5	2.6	2.8
Non-tradable CPI, QPC	1.0	1.0	1.0	0.8	0.9	0.9	0.9	0.8	0.8	0.8	0.8	0.8
Non-tradable CPI, APC	4.1	4.1	4.0	3.8	3.8	3.6	3.5	3.4	3.3	3.2	3.2	3.2
Tradable CPI, QPC	-0.1	2.3	0.3	-1.3	-0.4	0.4	0.3	0.3	0.2	0.9	0.7	0.7
Tradable CPI, APC	2.1	3.8	3.0	1.2	0.9	-1.0	-1.0	0.6	1.2	1.7	2.1	2.5
External Accounts												
Annual Balance on Goods, % of GDP	-2.7	-2.6	-2.1	-2.0	-1.8	-1.8	-1.9	-2.0	-2.0	-1.8	-1.8	-1.7
Annual Balance on Services, % of GDP	0.0	0.0	-0.1	-0.1	0.1	0.2	0.2	0.2	0.2	0.0	-0.1	-0.1
Annual Balance on Invisibles, % of GDP	-6.9	-7.1	-7.0	-6.8	-6.4	-6.0	-6.0	-6.0	-5.9	-5.8	-5.8	-5.9
Annual Current Account Balance, % of GDP	-9.6	-9.7	-9.1	-8.9	-8.1	-7.6	-7.6	-7.7	-7.7	-7.6	-7.7	-7.6
Net International Invt Position, % of GDP	-83.6	-84.1	-86.9	-88.6	-88.4	-87.9	-89.7	-91.7	-92.0	-92.3	-94.3	-95.3
Terms of Trade (SNA basis)												
Export Prices, QPC	3.7	2.5	-0.1	-0.3	-2.3	-0.8	3.1	2.8	2.1	2.3	3.1	2.5
Export Prices, APC	4.0	8.1	6.8	5.9	-0.3	-3.5	-0.3	2.7	7.4	10.7	10.7	10.4
Import Prices, QPC	4.7	5.5	0.1	-5.1	-3.5	0.5	4.1	3.4	2.2	2.2	2.8	2.3
Import Prices, APC	7.2	13.5	11.0	4.9	-3.3	-7.9	-4.2	4.3	10.5	12.3	10.9	9.8
Terms of Trade, QPC	-0.9	-2.8	-0.3	5.1	1.2	-1.2	-1.0	-0.5	-0.1	0.1	0.3	0.2
Terms of Trade, APC	-3.0	-4.8	-3.7	0.9	3.1	4.8	4.0	-1.5	-2.8	-1.5	-0.2	0.5
Labour Market												
Employment, QPC	1.1	0.9	-0.5	-0.1	0.3	-0.1	0.1	0.1	0.2	0.2	0.2	0.2
Employment, APC	2.6	3.1	1.5	1.4	0.6	-0.4	0.2	0.4	0.3	0.6	0.7	0.8
Labour Force, QPC	1.4	0.5	-0.3	-0.1	0.3	0.0	0.1	0.2	0.1	0.3	0.3	0.3
Labour Force, APC	2.8	2.9	1.6	1.6	0.4	0.0	0.4	0.6	0.5	0.8	1.0	1.1
Unemployment Rate, sa	3.9	3.6	3.8	3.7	3.8	3.9	3.9	4.0	4.0	4.1	4.2	4.3
Participation Rate, sa	68.6	68.7	68.2	67.9	67.9	67.7	67.6	67.5	67.4	67.4	67.4	67.4
Private Sector Wages (apc)	4.6	4.9	5.4	5.5	5.5	4.0	2.7	2.7	2.7	2.6	3.0	3.4
Public Sector Wages (apc)	7.8	2.0	3.2	4.1	0.1	5.3	5.8	5.0	4.7	4.0	4.1	4.0

Forecast in bold

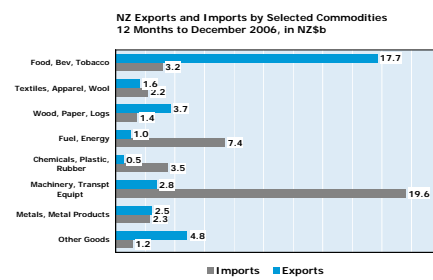
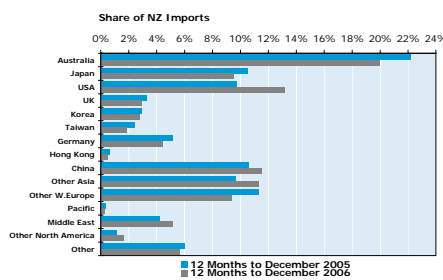
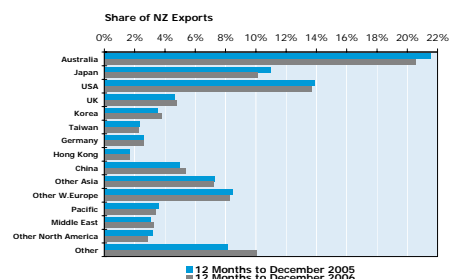
QPC - quarterly percent change

APC - annual percent change

AAPC - annual average percent change

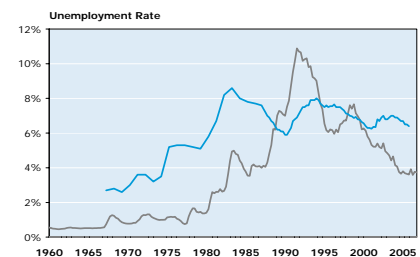
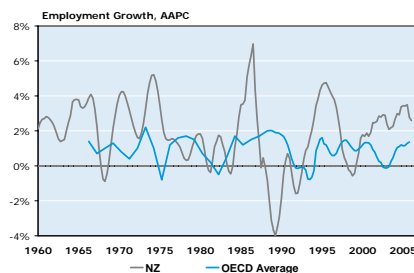
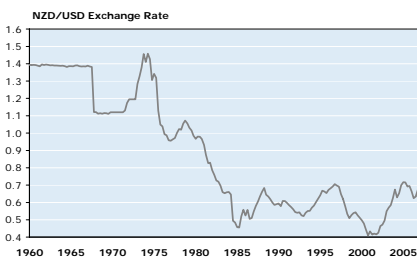
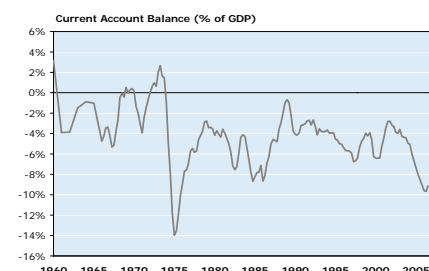
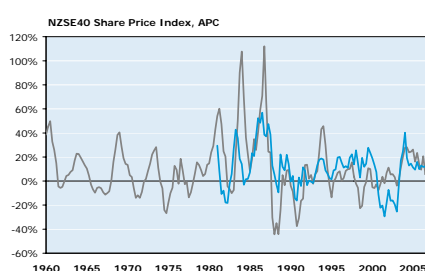
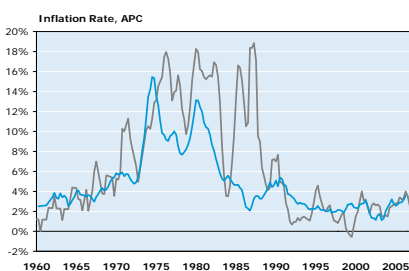
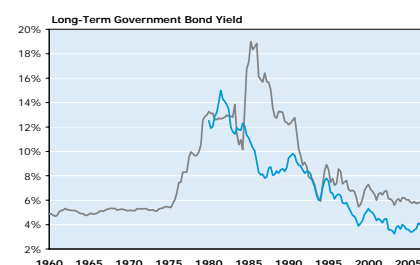
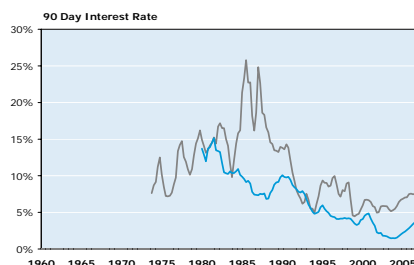
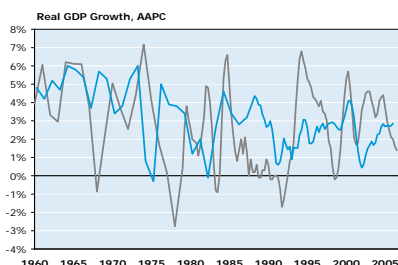
sa - seasonally adjusted

NEW ZEALAND KEY ECONOMIC INDICATORS



New Zealand Compared to Main Trading Partners (latest available figures)

	NZ	Aust	USA	Japan	UK	China	G/many	SKorea	Taiwan	Malaysia	H/kong	S/pore	Indonesia
Population, in millions	4.1	20.1	296.0	127.7	60.4	1306.3	82.5	47.7	22.6	25.6	7.1	4.3	219.9
Area in 1,000 km ²	271	7713	9373	378	244	9561	357	92	36	330	1	1	1905
Inhabitants per km ²	15.0	2.6	31.6	337.9	247.4	136.6	231.2	517.4	627.8	77.6	7100.0	4300.0	115.4
GDP, in billion NZ\$	157.8	1044.1	18751.1	6592.6	3152.0	2653.8	3981.1	1160.4	468.3	189.5	260.4	168.2	426.9
Change in real terms (%)	1.4	2.2	3.4	2.1	3.0	10.4	3.7	4.0	4.0	5.9	6.8	6.6	5.5
Nominal GDP per capita in NZ\$	38,846	51,946	63,348	51,646	52,185	2,032	48,268	24,328	20,723	7,402	36,675	39,118	1,941
NZ exports to ..., in million NZ\$ (FOB)	n/a	6972	4635	3445	1621	1821	885	1278	778	477	568	497	580
Share of NZ Exports (%)	n/a	20.6	13.7	10.2	4.8	5.4	2.6	3.8	2.3	1.4	1.7	1.5	1.7
NZ imports to ..., in million NZ\$ (VFD)	n/a	7501	4950	3580	1088	4325	1668	1052	699	1161	183	1571	600
Share of NZ Imports (%)	n/a	20.0	13.2	9.5	2.9	11.5	4.4	2.8	1.9	3.1	0.5	4.2	1.6
Current Account balance as a % of GDP	-9.1	-4.8	-6.8	3.7	-3.2	8.7	4.7	0.8	8.1	16.9	10.6	33.3	2.4



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