

SUMMARY OF ECONOMIC FORECASTS

Calendar Years	Actual		Forecast				
	2005	2006	2007	2008	2009	2010	
Page 3	NZ Growth and Employment (annual average percent changes)						
	Real GDP	2.7	1.6	2.8	1.5	2.9	3.4
	Employment	2.8	2.1	1.8	0.7	0.8	1.4
	Unemployment Rate (Dec qtr)	3.6	3.7	3.8	4.2	4.3	4.4
Page 6	Global Growth (annual average percent changes)						
	US	3.1	2.9	2.0	2.6	3.2	3.3
	Australia	2.8	2.7	4.1	3.6	3.6	3.1
	Japan	1.9	2.2	1.6	1.2	2.1	1.9
	Trading Partners	3.3	3.7	3.7	3.4	3.5	3.4
Page 8	NZ Inflation (annual percent changes)						
	CPI Inflation	3.2	2.6	2.8	2.8	2.5	2.4
	Non-tradable Inflation	4.3	3.8	3.8	3.6	3.3	3.2
	Tradable Inflation	1.7	1.2	1.5	2.1	1.4	1.3
Page 9, 12	NZ Financial Markets (December quarter averages)						
	TWI	71.5	67.1	70.0	64.5	60.5	61.6
	NZD/USD	0.69	0.67	0.75	0.69	0.60	0.59
	NZD/AUD	0.93	0.87	0.85	0.76	0.78	0.81
	Official Cash Rate	7.0	7.3	8.3	7.7	6.8	6.8
	90-day bank bill rate	7.5	7.6	8.7	7.7	7.0	7.0
	10-year bond rate	5.9	5.8	6.4	6.7	6.7	6.0
	Other Information						
	Current Account Balance (\$m)	-13,300	-14,000	-13,500	-12,200	-12,800	-13,400
	as % of GDP	-8.6	-8.7	-7.9	-6.8	-6.8	-6.7
Page 7	Govt. Operating Balance (\$m)*	6,200	11,500	8,700	6,700	5,700	5,500
	as % of GDP	4.1	7.3	5.2	3.8	3.1	2.8

Forecasts and text finalised 19 October 2007

* June years

For all enquiries please contact:

Economics

ANZ Bank

P O Box 540

WELLINGTON 6140

Phone: +64-4-802 2212

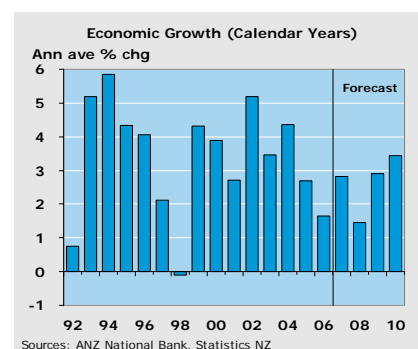
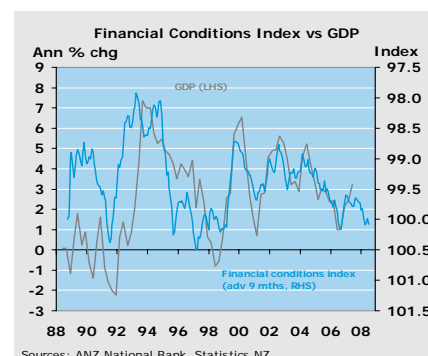
Fax: +64-4-496 8639

Internet: www.anz.com/nz

Email: ecnmcs@anz.com

SUMMARY

- **The economy remains resilient.** GDP growth expanded strongly at an annualised rate of 4 percent over the first half of this year, the labour market remains tight with the unemployment rate at record lows, and business and consumer confidence are holding at robust levels. The economy should continue to draw support from surging commodity prices and pending fiscal largesse over the next 12 months.
- **This is adding to already disconcerting inflationary pressures.** Capacity and resource pressures remain intense, with stronger growth over the first half of the year adding to inflation concerns. Cost-push inflation from a tight labour market, food price inflation and surging global oil prices pose additional upside risks.
- **But evidence is mounting that a slowdown is developing.** The four OCR hikes this year finally look to be gaining traction. The housing market has turned, consumer spending has slowed, and household borrowing has moderated. However, this moderation needs to broaden to the general economy for inflation pressure to subside. Financial conditions are now consistent with growth slowing towards 1½ percent.
- **We expect a more wide-spread deceleration over the next 12-18 months.** Inflationary pressures and imbalances necessitate a further period of sub-trend growth. Economic growth is forecast to ease from 2.8 percent in calendar 2007, to 1.5 percent in 2008 before rebounding thereafter. Strong growth is incompatible with current inflation pressure and the supply-side capacity of the economy.
- **The economic outlook is one of uncertainty and contrasting forces.** Some pockets remain vulnerable given the build up of leverage. Financial conditions are now extraordinarily tight. Yet, strong commodity prices are elongating the economic cycle. Our forecasts are for a relatively benign slowdown, but our bias is skewed towards a sharper (housing-led) correction.
- **In particular we remain concerned about how the credit cycle could play out given global uncertainty.** The New Zealand property market has been strongly correlated with global “credit conditions”, and New Zealand is very dependent upon offshore capital to fund a savings shortfall. Despite global credit concerns easing of late, residual concerns continue to linger and the US housing market retrenchment could spark another round of financial market turbulence.
- **The Reserve Bank faces some difficult challenges.** Inflationary pressures are prevalent, but potential vulnerabilities within some leveraged pockets suggest the cycle could unravel quickly. In the current environment, it is imperative that inflation expectations remain well anchored and wage setting behaviour is contained.
- **We expect interest rates to remain restrictive for some time.** While inflation risks remain, a further move up in rates cannot be ruled out. Conversely, the current level of uncertainty warrants caution, and the housing market is slowing, which we expect to dampen inflation. We expect interest rates to remain on hold until late 2008 before falling modestly. The underlying spirit is one of rates being high and restrictive for some time.
- **We have lifted the starting point for the NZD, but still look to a move lower in the kiwi.** We are not buying into the hype that fair value for the NZD/USD is now north of 70 cents. While a strong AUD and weak USD are likely to keep the NZD/USD strong for sometime, the rubber band is taut. Heightened global volatility points to continued wide swings from month-to-month. Divergent business cycles are pointing to continued weakening in the NZD/AUD.



ECONOMIC OUTLOOK – CONTRASTING FORCES

The economy is facing capacity constraints. Inflation pressure will keep financial conditions restrictive for some time. We struggle to see growth remaining strong in this environment. However, strong commodity prices and pending government spending will continue to provide a floor to growth as the housing slowdown diffuses through the wider economy.

The economy remains resilient. Economic growth expanded strongly over the first half of the year, growing at an annualised rate of 4 percent. A stronger than expected GDP print of 0.7 percent in the June quarter along with an upwardly revised 1.2 percent increase in the March quarter saw annual growth running at over 3 percent, after troughing at just 1.0 percent last year. This strength in activity is placing further pressure on resources in the economy, at a time when they are already stretched. The unemployment rate is currently at its equal lowest level at 3.6 percent, capacity utilisation continues to run at a high level and firms continue to report difficulty finding both skilled and unskilled labour.

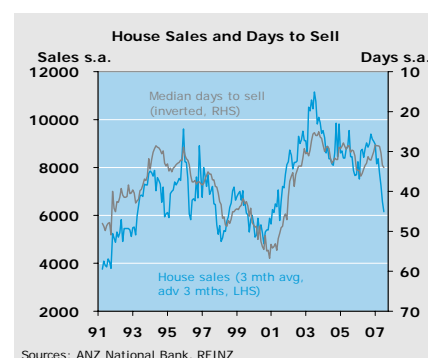
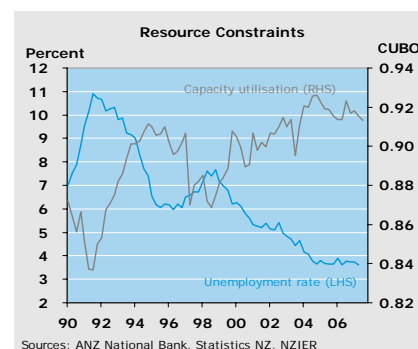
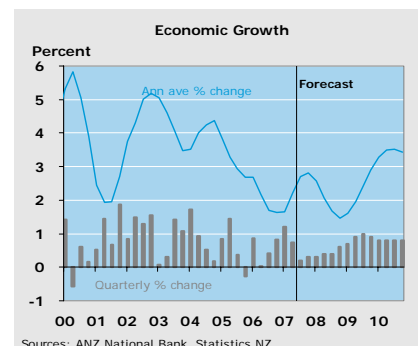
However, inflationary pressure is still a major concern. Stronger economic growth over the first half of this year will add further to inflation pressures in the economy. The tight labour market has the potential to cause more cost-push inflation, particularly in the services sector. In addition, food price inflation and surging global oil prices, both courtesy of the worldwide commodity boom, pose additional upside risks.

The economy is capacity constrained. Unemployment sits at a record low, migration gains are moderating with a notable pick-up in departures to Australia, and productivity growth has shown a substantial deterioration. Capital investment has been rather muted considering the traditional accelerator of past profit growth, capacity constraints and relative price signals. Potential growth estimates – the available supply side capacity of the real economy – of around 3 percent look decidedly lofty in such an environment.

In this environment, we struggle to see growth remaining strong, and have pencilled in a relatively benign soft landing for the economy over the coming year as growth slips below trend.

The more relevant aspect is how such a slowdown is shared. Strong growth is incompatible with current inflation pressure and the supply-side capacity of the economy. Additional fiscal largesse or stronger commodity prices will add to growth and thereby adding to inflation pressure, necessitating a growth sacrifice elsewhere as the Reserve Bank takes counter-balancing action. Conversely, altered global conditions and weakening commodity prices would alleviate the need for restrictive monetary policy. The game is zero sum, with the Reserve Bank attempting to achieve a fabled soft landing, but having the advantage of the final move. Regulators always win, and the end-game is slower growth to curb inflation pressure. A key judgment in our forecasts is that the 2008 *Budget* is expansionary, but not excessively beyond what has already been flagged. We have likewise pencilled in a modest easing in dairy prices over 2008 but expect the level to remain elevated.

The Reserve Bank is having success slowing domestic spending. House sales have fallen 30 percent in six months and house prices have barely budged in that time. The trend in retail sales is flat. Consumer borrowing has moderated. With the effective mortgage rate facing households expected to rise over the coming months as the pipeline interest rate effect fully manifests, housing market activity and consumer spending are expected to slow further over coming quarters. Income growth is solid, but is being eroded by spending on higher priced necessities such as food, energy, petrol, rents and also higher borrowing costs. An easing in net migration inflows will also contribute to the slowdown in domestic demand.



However, the wider economy looks to have found a good base.

Business and consumer confidence have eased since early 2007, and are pointing towards a more sedate – but respectable – pace of expansion. Considering the sizeable tightening in financial conditions that has occurred since the start of the year, confidence looks remarkably robust. It is difficult to go past the exuberance surrounding the forecast record dairy payout for this season (from NZ\$4.46 in 2006/07 to NZ\$6.40/kg milk solids in 2007/08, equivalent to an extra NZ\$2.3bn to rural incomes) to explain this. The rise in commodity prices over the past year has seen New Zealand's terms of trade rise to its highest level since the 1970s, which will underpin activity in the rural regions with some spillover into other areas. Certainly, the details in the consumer confidence surveys reveal a large divergence, with confidence the strongest in dairy intensive regions. Similarly, the agriculture sector is the most optimistic compared to other sectors in the business confidence survey.

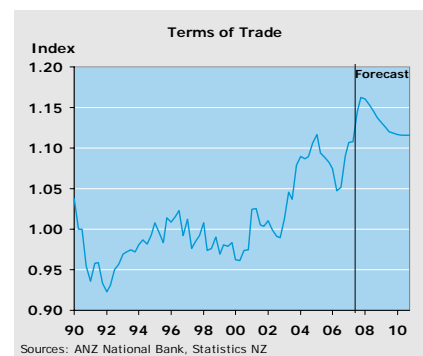
Tax cuts are pending. Non-residential and infrastructure-related investment is solid. A strong NZD/USD is curtailing export incomes. However, recent declines in the NZD/AUD are providing considerable support, particularly as Australia is New Zealand's major tourist market, and where roughly half of all non-commodity manufactured exports are destined.

A key judgement we are making is that the slowdown in housing diffuses through the rest of the economy. Fifty percent of employment growth in the past four years has been in the housing sensitive construction, finance and business services sectors of the economy. Wealth related spending and equity-withdrawals are expected to subside as house prices flatten by early 2008. A booming dairy industry in 2000 and 2001 did not stop house prices going backwards. The forward looking indicators for GDP growth that we monitor, based on components of our business confidence survey and the tightness of financial conditions, both point to a slowing in the annual pace of growth from the current 3.2 percent towards 1½ to 2 percent by mid-next year.

The credit cycle is a key area to watch. New Zealand is hugely reliant on offshore capital. The recent re-pricing of risk internationally and spillover from US subprime woes has delivered a further tightening in financial conditions via wider swap and credit spreads, at a time asset price growth was already flattening. Signs of liquidity stress domestically across non-bank financial institutions are merely an extension of the re-pricing of risk and change in risk appetites we are seeing around the globe. While such a turn in the credit cycle is a relatively healthy dynamic (returning appetites and conditions to traditional levels), it adds a layer of risk to heavily geared and speculative pockets of the economy.

Our economic forecasts have a relatively benign cycle. The economy continues on a gradual adjustment and rebalancing process with growth switching away from the domestic economy towards the external sector (particularly as the New Zealand dollar eventually recedes), and commodity prices stabilise at current levels before edging lower later next year (though remaining high by historical standards). Global conditions remain volatile for another few months but credit markets and risk appetites remain healthy. However, the combination of deteriorating productivity growth, inflation pressure and fragile credit sentiment leaves us wary of a less orderly adjustment, despite stimulus from booming commodity prices.

Despite a cyclical slowdown over the next 12-18 months, we still remain optimistic about the New Zealand economy over the longer term. Strong international soft commodity prices, natural resources (potentially oil, but more importantly water), and growing integration with Asia are presenting New Zealand with real opportunities and a chance to push our way up the OECD economic ladder. However, improving productivity growth is a prerequisite to a better sustained economic performance on average over the cycle. A period of soft growth expected over the next 12-18 months may just act as a positive elixir across businesses and policy-makers to get them focused on how productivity can be improved.



Key Assumptions

- Dubai oil prices remain between US\$80 and US\$75 per barrel in the near-term before declining towards US\$69 per barrel.
- Trading-partner growth returns to trend of 3½ percent over the next few years.
- Net migration remains subdued for another 18 months before increasing to around 10,000 over 2009.
- Current cyclical potential growth around 2 to 2½ percent, but longer term potential still around 3 percent.



THE NATIONAL ACCOUNTS

Annual average % change Calendar Years	Actual 2005	Actual 2006	Forecast			
			2007	2008	2009	2010
Total Consumption	4.7	2.7	4.0	1.9	2.1	2.5
Private Consumption	4.8	2.1	4.2	1.2	1.6	2.3
Public Consumption	4.4	4.9	3.4	4.5	3.6	3.4
Total Investment	3.3	-2.4	4.0	-0.8	4.4	6.2
Residential investment	-4.2	-2.7	4.8	-4.9	2.7	5.3
Other investment	5.6	-2.4	3.8	0.3	4.9	6.4
Stockbuilding¹	-0.2	-0.8	0.6	-0.1	0.0	0.0
Gross National Expenditure	4.1	0.7	4.7	1.2	2.6	3.4
Total Exports	-0.3	1.9	3.0	2.7	4.9	5.9
Goods	0.4	3.2	3.2	2.2	4.6	4.9
Services	-2.5	-1.7	2.8	3.3	5.8	8.9
Total Imports	5.4	-2.5	7.7	1.9	3.8	5.6
Goods	4.7	-1.7	7.2	1.8	5.0	6.1
Services	7.9	-5.0	8.4	1.7	-0.4	3.8
Expenditure on GDP	2.7	1.8	3.2	1.4	3.0	3.4
GDP (production based)	2.7	1.6	2.8	1.5	2.9	3.4

¹ Percentage point contribution to growth

GLOBAL OUTLOOK – HAS THE WORLD DECOUPLED FROM THE US?

Trading partner growth is expected to remain solid courtesy of robust growth in Australia and Asia. However, the outlook for the US is clouded, “challenges” have emerged and there is considerable debate whether the global economy has truly decoupled from the US consumer.

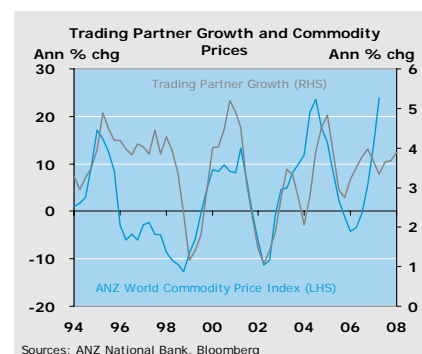
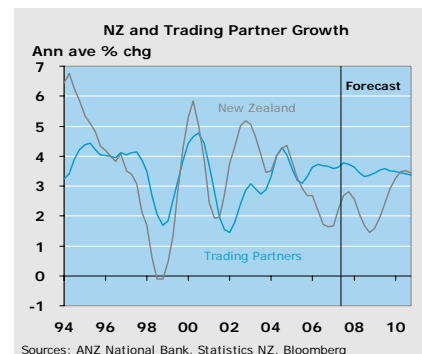
The global economy is facing “challenges”.

- The US economy is slowing courtesy of very weak conditions in the housing market. The US housing cycle is 70 percent correlated to the economic cycle, and house prices are in retreat, with expectations of a 10 percent fall.
- Global inflationary pressures are elevated by cost-push forces, notably low unemployment rates, high soft commodity prices, and recent rises in oil prices. It's an inflationary cocktail that has central banks on edge, particularly given memories of the 1970's.
- The credit cycle has turned, and the re-pricing of risk and general tightening in financial conditions via swap and credit spreads is creating considerable stress in certain leveraged pockets, particularly after years of exorbitant growth.

Against this backdrop, there are ample positives. Liquidity remains abundant. The Fed has been quick to restore confidence and ensure the financial “plumbing” is functioning by cutting interest rates by 50 basis points. Inflation expectations remain low across most nations. Reduced demand from the US will assist in the much needed rebalancing of global growth. Excluding the US, demand remains strong. The Asian region continues to be fuelled by phenomenal Chinese growth, which recorded its 5th successive year of 9+ percent growth. Such growth has reignited fears that the Chinese economy is overheating as inflation readings have increased sharply in recent months. However, increased administrative controls, higher interest rates and allowing the yuan to appreciate further, will ensure the Chinese economy grows at a more sustainable rate. Australia is also benefiting from the Chinese growth as its demand for hard commodities has seen Australia's terms of trade surge to an all-time high. This commodity boom is also providing support to the price of some of New Zealand's key exports, namely dairy.

On balance, trading partner growth is expected to remain solid.

Trading partner growth is expected to remain at 3.7 percent in 2007, following similar growth in 2006. A weaker outlook for the US economy is offset by stronger growth from Australia. Between 2008 and 2010, trading partner growth is expected to average around 3½ percent. However, the key risk to the outlook at present looks to be greater credit dislocation and the US consumer battening down the hatches in the face of falling house prices and rising energy costs. The weight of opinion at present is skewed towards the global economy remaining robust in the face of a deteriorating outlook in the US. We expect such a decoupling theme to be tested.



GLOBAL ECONOMIC GROWTH

Annual average % change Calendar Years	Actual	Actual	Forecast			
	2005	2006	2007	2008	2009	2010
United States	3.1	2.9	2.0	2.6	3.2	3.3
Australia	2.8	2.7	4.1	3.6	3.6	3.1
Japan	1.9	2.2	1.6	1.2	2.1	1.9
Euro Zone	1.6	2.9	2.6	2.2	2.1	2.0
China	10.4	10.7	11.3	10.3	9.0	8.8
Trading Partner Growth	3.3	3.7	3.7	3.4	3.5	3.4

FISCAL POLICY – ELECTION YEAR SPEND-UP?

Higher inflation and solid economic growth continue to fill the Government's coffers. A larger fiscal stimulus next year and personal income tax cuts are on the cards, which mean fiscal policy will remain high on the Reserve Bank's watch list.

A stronger nominal economy and departmental under-spends have increased the Government's operating balance. The Government recently announced an operating surplus of \$8.7 billion for 2006/07, which is \$2.1 billion higher than forecast in the 2007 *Budget*. Increased tax revenue courtesy of solid economic growth over the first half of the year, along with timing issues around expenditure items look to have contributed to the stronger than expected result.

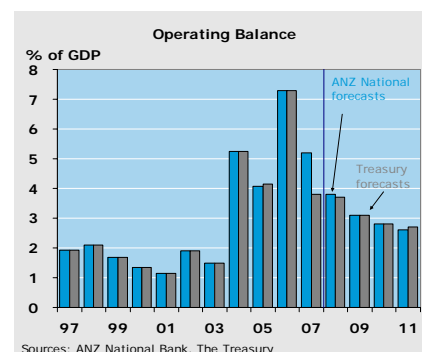
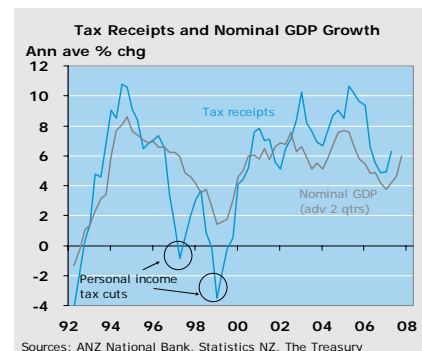
This has intensified the pressure on the Minister of Finance, who has already hinted at potential tax cuts. At the last *Budget* the Government announced the lowering of the corporate tax rate to 30 percent (effective from 1 April 2008) through the Business Tax Reform package. However, personal tax rates were left unchanged. Instead, the Government increased incentives for participation in KiwiSaver, which we think was an appropriate measure to take at the time. However, given the Government's increasing embarrassment of riches, calls have once again intensified for personal tax rates to be lowered and Dr Cullen has signalled that tax cuts may be in next year's *Budget*. The timing and size of any tax cut package will likely be revealed in the *Half-Year Update* in December.

An election year spend-up is on the cards. The Minister of Finance is well aware of the potential inflation ramifications of increased government spending at this point in the economic cycle. At present, a fiscal impulse of 1.9 percent of GDP has already been flagged for the current fiscal year, and 0.8 percent in 2008/09, so keep in mind that "initiatives" may not necessarily be new money. However, a stronger fiscal purse, and of course the election, means the risks on the fiscal impulse all look one way, potentially fuelling the inflationary fire. Strictly speaking we believe fiscal policy decisions should be set within the medium term context, and wealth enhancing policies should never be forsaken for cyclical considerations. However, given the level of inflationary pressure, and current composition to the impulse, the Reserve Bank will remain alert. Officials need to be careful about the timing of any new initiatives. We've been doing some research on the composition of recent spending – into the front-line or the back office. It's disconcerting reading, but more on that down the track.

Nevertheless, the Government accounts will remain strong. Despite the high probability of a loosening of the fiscal purse strings next year, the Government's accounts will remain solid. A higher terms of trade will deliver more tax revenue, which will allow the Government to spend more while maintaining strong surpluses. We expect the operating balance to ease to 3.8 percent of GDP in 2007/08, before levelling out at around 2¾ percent of GDP over the remainder of the forecast period.

BALANCING THE BOOKS

June Years	Actual	Actual	Forecast			
	2006	2007	2008	2009	2010	2011
Operating Balance (\$m)	11,500	8,700	6,700	5,700	5,500	5,400
- as % of GDP	7.3	5.2	3.8	3.1	2.8	2.6
Net Crown debt (\$m)	7,700	3,400	3,500	4,500	5,500	5,500
- as % of GDP	4.9	2.1	2.0	2.4	2.8	2.7
Bond Tender Programme (\$m)	2,400	2,300	2,500	2,500	2,500	2,500



INFLATION – STILL TROUBLESOME

An inflationary undercurrent remains despite the headline rate falling below 2 percent. Cost-push inflation, rising food and energy prices and emissions charges all portend of inflation remaining elevated for some time.

One-offs in the September quarter have provided some relief.

Annual headline inflation retreated below the mid-point of the Reserve Bank's target band in the September quarter for the first time since March 2004. Ironically, given the increasing pressure that government spending has been placing on monetary policy, it was increased government subsidies in health and early childhood education that pulled the headline rate lower.

But a worrying inflation undercurrent still lurks.

The current headline inflation rate, at 1.8 percent, understates the degree of inflationary pressure within the economy. Housing related inflation, particularly construction costs, continues to make large contributions, despite clear evidence that the housing market has turned. Services inflation, an indication of cost-push inflation, also remains elevated.

The CPI is expected to quickly re-accelerate towards the top of the Reserve Bank's target band by the end of this year.

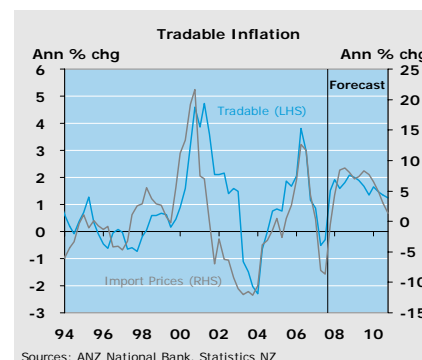
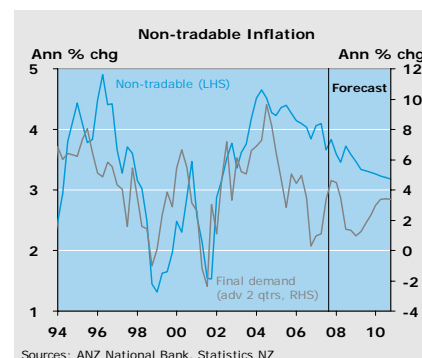
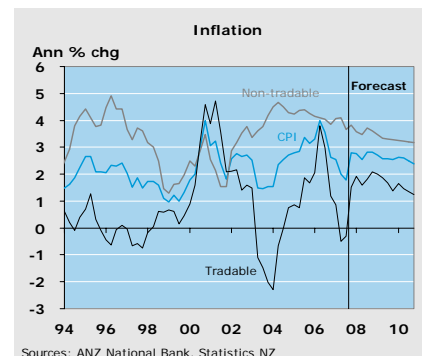
Although one-offs and the higher NZD (through lower tradable inflation) are helping to provide some offset, once the negative December 2006 figure drops out of the calculation, annual CPI growth is expected to increase to 2.8 percent by the end of the year and remain around that level for a further 12 months. Price increases appear to have become more broad-based and firms' pricing intentions remain elevated, pointing to near-term inflation pressure.

Inflationary risks appear skewed to the upside in the short-term.

Burgeoning food prices, surging global oil prices, potential cost-push inflation courtesy of a still tight labour market and increased demand pressures associated with a record high dairy payout and pending fiscal largesse, all suggest that inflation pressures will not abate any time soon. However, competitive forces, particularly in the retail sector, will help cap the extent of price pass-through from higher input costs onto the consumer.

Nevertheless, a slowing economy is expected to eventually weigh on demand pressures. Our forecasts critically assume that inflation expectations remain well contained and that potential food and energy price increases do not directly impact on further price and wage setting behaviour. Historically, housing market weakness has typically flowed through into reduced construction costs – a key source of recent housing inflation – and eventually resulted in less non-tradable inflation. This cycle is expected to be no different. However, given the more broad-based nature of the current inflation dynamic, any easing in inflation pressure will likely be a slow and drawn-out affair.

	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	0.5	2.5
Jun-07	1.0	2.0
Sep-07	0.5	1.8
Dec-07	0.8	2.8
Mar-08	0.5	2.8
Jun-08	0.8	2.5
Sep-08	0.8	2.8
Dec-08	0.8	2.8
Mar-09	0.4	2.7
Jun-09	0.7	2.6
Sep-09	0.7	2.6
Dec-09	0.7	2.5
Mar-10	0.5	2.6
Jun-10	0.6	2.6
Sep-10	0.6	2.5
Dec-10	0.6	2.4



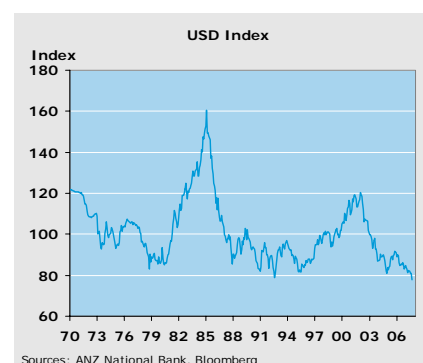
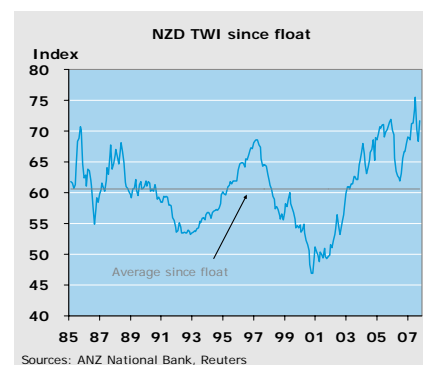
EXCHANGE RATE – USD WEAKNESS DOMINATING

We have lifted the starting point for the NZD, but still look to a move lower in the kiwi. We are not buying into the hype that fair value for the NZD/USD is now north of 70 cents. While a strong AUD and weak USD is likely to keep the NZD/USD strong for sometime, the rubber band is taut. Heightened global volatility points to continued wide swings from month to month. Divergent business cycles suggest a continued weakening in the NZD/AUD.

It is difficult to say anything with a great deal of certainty on the currency front at present. Wide confidence bands need to accompany the forecasts. The USD looks sick, equity markets and risk appetites are all over the place, and the NZD is moving both up and down – sometimes in the same night – at a rapid rate of knots. The NZD fell over 17 percent against the USD and 22 percent against the JPY in the space of three weeks in late July/August. The kiwi has since recovered as risk appetites have returned but sentiment remains fickle and is a day-by-day proposition.

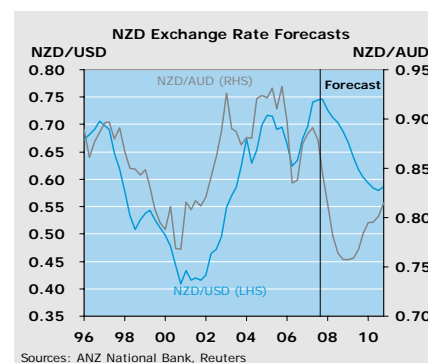
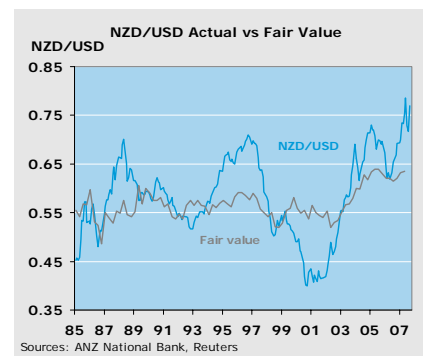
So what can we say with any degree of comfort?

- **There are still strong cyclical legs of support**, considering the wide yield differential (NZ-US 2 year swap differential +375 basis points), and expectations that New Zealand interest rates are set to remain high for some time. But equivalently it is the shape of the yield curve and interest rate expectations that matter. When the market gets a whiff of rate cuts, the currency market moves sharply. Just look at the US dollar! We expect the New Zealand interest rate market to become increasingly sensitive to weakening economic data, although the eventual monetary policy easing cycle will remain a way off.
- **Growth and housing are key directional barometers for the currency.** Our forecasts envisage a sustained period of sub-trend growth for the New Zealand economy and we struggle to see the NZD remaining elevated in such an environment. There is early evidence that this slowdown has begun, with the housing market turning and consumer spending moderating. However, the slowdown looks relatively narrowly based at this stage. When the market gets a sustained picture of slowing growth and consistent weakness across the partial indicators (not just the housing market), the NZD will be set for a move lower. To see this theme at work, just remember back to early 2006. GDP data was released showing the economy barely expanded at the end of 2005, and the NZD fell over 10 cents in three months. Our central forecasts have GDP growth relatively muted over the second half of this year.
- **Markets remain edgy and, therefore, volatility is likely to persist.** The past few days have been associated with a return of risk aversion on renewed fears that global credit concerns may linger for longer than expected. Another bout of risk aversion could see the NZD sold-off in similar fashion to that in July/August. However, it is far from clear whether this will in fact develop. With uncertainty at elevated levels, any potential currency forecasts must therefore be associated with a relatively large risk band. It is also a good time to emphasise the importance of sound hedging policies for businesses.
- **The USD is looking sick.** Housing market woes and expectations of further interest rate cuts from the Federal Reserve are weighing heavily on the USD and this is providing support to the kiwi by default. This theme is unlikely to abate in the near-term, particularly as a weaker USD could breed on itself as sovereign funds speed up diversification of their USD reserves to avoid further erosion of USD values.



- The rubber band is taut and the hoopla about fair value for the NZD/USD being north of 70 cents seems wrong to us.** Such estimates are based on cyclical as opposed to structural model inputs. Yes, commodity prices look likely to stay on a new higher plane, but productivity growth – a key structural determinant of an economy's and currency's prospects, and something that is often forgotten by market participants – is still wallowing. Over the longer-term we continue to expect the rubber band to become taut and drag the kiwi lower (just as it was dragged higher over 2002 to 2004). For those that question whether fair value for the NZD/USD does indeed have a six in front of it, cast your mind back to 2001. The consensus said that fair value had dropped below 50 cents, and the kiwi was never expected to reach 55 cents again. Hmm. Fair value estimates tend to miraculously “move” with the actual level of the currency as everyone gets caught tracking cyclical as opposed to structural forces. Eventually, it is the latter that dominate. Beware the hype.
- The NZD is riding in kanga's pouch.** Solid support for the AUD on expectations of further hikes from the Reserve Bank of Australia and strong commodity prices look set to carry across to the NZD against the majors. There is a growing chorus – subject to global conditions remaining strong – for the AUD to potentially test parity with the USD before receding. While this is not our house view, it is a sign of sentiment. The flipside of the ride-in-kanga's pouch effect against the majors is, of course, a weaker NZD/AUD. We expect the NZD/AUD to dip below 80 cents, given two economies that are on diverging growth paths.
- Historically the NZD does turn aggressively.** Just as we have with our growth forecasts, we have taken a gradual approach to our currency projections and have the currency slowly depreciating from current levels. However, history tells us that these adjustments are seldom gradual. But considering the uncertainties at present, and the immense difficulty in picking the exact turning point, we have taken what we feel is the safe, prudent approach.

When we roll all this together we have pencilled in a very gradual easing in the NZD/USD, but with the adjustment towards where we consider fair value (around 0.65 cents) not occurring until mid 2009. We are very comfortable calling the NZD/AUD to sub 80 cents.



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	0.89	83.1	0.36	0.53	68.8
Jun-07	0.74	0.89	89.5	0.37	0.55	72.0
Sep-07	0.74	0.88	87.9	0.37	0.54	71.4
Dec-07	0.75	0.85	86.2	0.37	0.52	70.0
Mar-08	0.73	0.81	83.8	0.36	0.51	67.9
Jun-08	0.71	0.78	81.1	0.36	0.50	66.5
Sep-08	0.70	0.76	79.0	0.36	0.51	65.8
Dec-08	0.69	0.76	76.0	0.35	0.50	64.5
Mar-09	0.67	0.76	73.3	0.34	0.50	63.2
Jun-09	0.64	0.76	71.3	0.33	0.49	61.8
Sep-09	0.62	0.77	69.9	0.33	0.48	60.7
Dec-09	0.60	0.78	69.6	0.32	0.48	60.5
Mar-10	0.59	0.79	69.6	0.32	0.49	60.5
Jun-10	0.58	0.80	69.6	0.32	0.50	60.5
Sep-10	0.58	0.80	69.6	0.33	0.50	60.7
Dec-10	0.59	0.81	70.4	0.33	0.51	61.6

INTEREST RATES – CHALLENGING TIMES FOR MONETARY POLICY

With credit markets improving and inflation pressure still intense, monetary policy is likely to remain restrictive for some time. Looking forward, we remain very wary of the credit cycle in certain leveraged pockets of the economy. But the Reserve Bank will not respond until it sees clear evidence that slowing growth is dampening inflation pressure.

Given the heightened uncertainty surrounding the economic outlook, the Reserve Bank moved to a more neutral stance at their September Monetary Policy Statement. Inflationary pressure remains intense. However, global credit market turmoil, liquidity difficulties across some non-bank financial institutions and signs that the housing market was finally turning provided some balance.

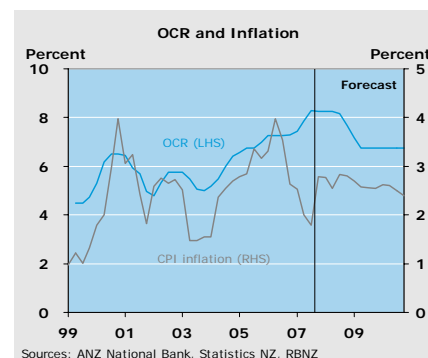
Nevertheless, the hawkish undertones in the Statement were still clearly present. The Reserve Bank's forecasts highlight the lack of inflation headroom. GDP growth forecasts run broadly in line with the economy's growth potential (just under 3 percent for the next three years), the output gap remains positive for the entire forecast horizon, the unemployment rate remains low, the 90-day rate is elevated until 2010, and inflation pressure is more broad-based than in the June MPS. In the absence of a flat-lined TWI (which is a departure from previous practices of assuming the TWI returns to its equilibrium level), their headline inflation forecasts would likely breach 3 percent.

The Statement contained two scenarios that were very diverse in terms of the trajectory for the OCR. This highlights the uncertainty regarding the future policy outlook. The upside scenario assumes additional inflation courtesy of more persistent wage pressure and more pervasive food price inflation – resulting in further policy tightening. The downside scenario was an extension of global unease and further difficulties across the local non-bank financial institution sector. The downside scenario laid the ground for early rate cuts despite inflation remaining close to 3 percent.

Rather scarily, both scenarios could well end up unfolding. Inflationary pressures continue to intensify. Capacity pressures are more intense, food related inflation is stronger and the recent rise in oil (petrol) prices is doing the Reserve Bank no favours. At the same time, global conditions remain uncertain. While global credit conditions have improved slightly, US housing woes continue to extend and certain pockets of the New Zealand economy remain caught in the rip of risk being re-priced and liquidity pressure. In reality, the Phillips curve in New Zealand (a relationship between growth and inflation) is reasonably stable, so the two extreme scenarios are unlikely to unfold together (i.e. no stagflation). However, recent developments give credence to both, although the inflationary pressure scenario looks to have the greater probability at present.

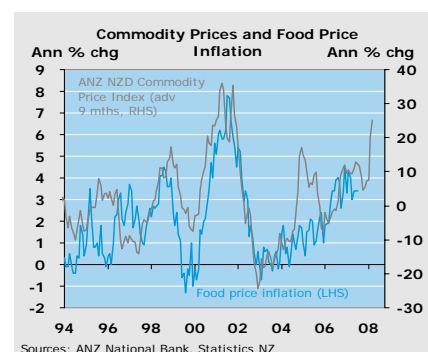
We have pencilled in an easing cycle from late 2008, but the underlying message is monetary policy remaining restrictive for a considerable period. The front-end of the New Zealand curve is expected (needed) to remain elevated for a while yet to ensure the Reserve Bank's pipeline tightening. Moreover, when we consider the "neutral" 90 day interest rate (where monetary policy neither has the foot on the accelerator nor the brake) we have also taken a conservative stance, settling around 6.5 to 7 percent, as opposed to the standard estimates of around 6 percent. This reflects some likely persistence of inflation pressure, a higher terms of trade, and a structural lift higher in the level of credit (cash) within the economy.

Looking forward, we see a fundamental test of the monetary policy framework. Considerable cost-push pressure is prevalent at a time



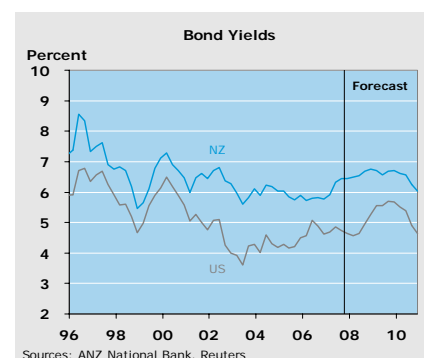
Assumptions for policy

- The neutral real interest rate is expected to be higher than in the past at slightly over 4 percent.
- Inflation expectations remain well anchored.
- Longer-term potential growth of the economy remains at around 3 percent.



demand-pull inflation from the domestic economy is starting to wane. The monetary policy framework is built around the latter dominating, provided inflation expectations are well anchored. At present inflation expectations are anchored, although we would still characterise them as being uncomfortably high. How wage and price setting behaviour responds to significant cost pressure and a higher inflation rate in the near-term will be critical.

Looking around the globe, we have pencilled in one further cut from the US Federal Reserve in response to housing woes, the European Central Bank to remain on hold, but successive hikes from the Reserve Bank of Australia. The latter is looking eerily like the Reserve Bank of New Zealand in early 2007 with inflation pressures escalating. Globally, we see inflation remaining as a key focus given cost-push forces, despite unease across credit markets. Longer-dated NZ yields are expected to remain largely range-bound.



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	7.4	7.8	7.7	7.4	5.9	4.7	5.8
Jun-07	7.9	8.1	8.1	7.8	6.3	4.8	6.0
Sep-07	8.3	8.7	8.3	7.9	6.5	4.7	6.0
Dec-07	8.3	8.7	8.4	8.0	6.4	4.6	6.2
Mar-08	8.3	8.6	8.2	7.8	6.5	4.6	6.0
Jun-08	8.3	8.6	8.1	7.8	6.6	4.7	5.9
Sep-08	8.2	8.2	7.9	7.7	6.7	5.0	6.1
Dec-08	7.7	7.7	7.6	7.6	6.7	5.3	6.2
Mar-09	7.2	7.2	7.3	7.5	6.7	5.6	6.4
Jun-09	6.8	7.0	7.1	7.3	6.6	5.6	6.3
Sep-09	6.8	7.0	7.1	7.4	6.7	5.7	6.4
Dec-09	6.8	7.0	7.1	7.4	6.7	5.7	6.4
Mar-10	6.8	7.0	7.1	7.4	6.6	5.5	6.4
Jun-10	6.8	7.0	7.1	7.3	6.6	5.4	6.6
Sep-10	6.8	7.0	7.0	7.1	6.3	4.9	6.3
Dec-10	6.8	7.0	7.0	7.0	6.0	4.6	6.0

ANZ ECONOMIC FORECASTS

	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09
Real Gross Domestic Product												
Total GDP, QPC	0.4	0.8	1.2	0.7	0.2	0.3	0.3	0.4	0.4	0.6	0.7	0.9
Total GDP, APC	1.0	2.1	2.5	3.2	3.0	2.5	1.5	1.2	1.4	1.7	2.1	2.6
Total GDP, AAPC	1.7	1.6	1.7	2.2	2.7	2.8	2.6	2.1	1.7	1.5	1.6	2.0
Real GDP Components												
Private Consumption, QPC	0.6	1.4	2.1	0.6	0.2	0.2	0.3	0.3	0.3	0.3	0.4	0.5
Private Consumption, AAPC	2.7	2.1	2.5	3.3	3.9	4.2	3.4	2.5	1.7	1.2	1.2	1.3
Public Consumption, QPC	0.9	0.4	0.5	1.2	1.0	1.2	1.2	1.1	1.0	0.9	0.9	0.9
Public Consumption, AAPC	5.3	4.9	4.4	3.9	3.4	3.4	3.7	4.1	4.4	4.5	4.3	4.1
Residential Investment, QPC	3.6	1.9	-0.3	3.8	2.0	-2.0	-2.5	-2.5	-2.0	0.0	1.5	1.8
Residential Investment, AAPC	-3.4	-2.7	-2.1	2.2	4.1	4.8	5.2	1.7	-2.4	-4.9	-5.9	-4.4
Other Investment, QPC	0.8	1.0	4.7	-2.2	1.6	-0.2	-0.3	0.3	0.3	0.7	1.4	1.6
Other Investment, AAPC	0.7	-2.4	-3.1	-0.9	1.6	3.8	3.0	2.3	1.0	0.3	1.3	2.0
Gross National Expenditure, QPC	0.6	2.6	1.4	1.5	0.3	0.1	0.1	0.3	0.3	0.5	0.7	0.8
Gross National Expenditure, AAPC	0.7	0.7	0.7	2.7	4.5	4.7	4.4	3.0	1.8	1.2	1.2	1.6
Exports, QPC	2.6	-2.4	1.9	0.5	1.0	0.5	0.5	0.7	0.7	1.0	1.3	1.5
Exports, AAPC	1.5	1.9	3.0	3.3	2.3	3.0	2.5	2.5	2.9	2.7	3.0	3.5
Imports, QPC	1.0	1.6	3.7	2.5	1.1	0.3	0.0	0.3	0.5	0.5	1.2	1.2
Imports, AAPC	-2.3	-2.5	-1.3	2.1	5.7	7.7	7.4	5.5	3.5	1.9	1.6	2.0
Prices												
Headline CPI, QPC	0.7	-0.2	0.5	1.0	0.5	0.8	0.5	0.8	0.8	0.8	0.4	0.7
Headline CPI, APC	3.5	2.6	2.5	2.0	1.8	2.8	2.8	2.5	2.8	2.8	2.7	2.6
Non-tradable CPI, QPC	1.0	0.8	1.2	1.1	0.6	1.0	0.9	0.9	0.8	0.8	0.8	0.8
Non-tradable CPI, APC	4.0	3.8	4.1	4.1	3.7	3.8	3.6	3.5	3.7	3.6	3.5	3.3
Tradable CPI, QPC	0.3	-1.3	-0.4	0.9	0.5	0.5	0.0	0.6	0.7	0.8	-0.1	0.5
Tradable CPI, APC	3.0	1.2	0.9	-0.5	-0.3	1.5	1.9	1.6	1.8	2.1	2.0	1.9
External Accounts												
Annual Balance on Goods, % of GDP	-2.0	-1.9	-1.7	-1.8	-1.8	-1.6	-1.3	-0.8	-0.7	-0.8	-0.9	-1.0
Annual Balance on Services, % of GDP	0.2	0.3	0.3	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3
Annual Balance on Invisibles, % of GDP	-7.1	-7.1	-6.8	-6.7	-6.8	-6.7	-6.5	-6.4	-6.3	-6.3	-6.2	-6.1
Annual Current Account Balance, % of GDP	-8.8	-8.7	-8.3	-8.2	-8.2	-7.9	-7.4	-6.9	-6.8	-6.8	-6.8	-6.8
Net International Invnt Position, % of GDP	-85.7	-88.5	-87.5	-89.1	-92.0	-94.4	-95.7	-97.1	-100.4	-102.9	-104.2	-105.6
Terms of Trade (SNA basis)												
Export Prices, QPC	0.1	-0.1	0.2	-3.1	4.1	3.9	3.1	1.5	0.6	1.1	1.4	1.8
Export Prices, APC	8.1	6.3	3.6	-2.9	1.0	5.1	8.1	13.2	9.4	6.5	4.8	5.1
Import Prices, QPC	-0.2	-3.7	-1.3	-3.2	0.8	2.4	3.3	2.1	1.3	1.8	2.0	2.4
Import Prices, APC	11.9	5.5	0.6	-8.2	-7.2	-1.4	3.2	8.8	9.3	8.8	7.4	7.7
Terms of Trade, QPC	0.4	3.7	1.5	0.1	3.3	1.5	-0.2	-0.6	-0.7	-0.7	-0.5	-0.6
Terms of Trade, APC	-3.4	0.8	3.0	5.8	8.9	6.5	4.8	4.1	0.1	-2.1	-2.4	-2.4
Labour Market												
Employment, QPC	-0.4	0.1	1.2	0.7	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2
Employment, APC	1.5	1.4	1.7	1.5	2.0	2.0	1.0	0.6	0.6	0.7	0.7	0.7
Labour Force, QPC	-0.2	0.0	1.2	0.5	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.2
Labour Force, APC	1.6	1.6	1.6	1.5	2.0	2.1	1.2	0.9	1.0	1.2	1.1	1.1
Unemployment Rate, sa	3.8	3.7	3.7	3.6	3.7	3.8	3.9	4.0	4.1	4.2	4.3	4.3
Participation Rate, sa	68.2	68.1	68.6	68.8	68.8	68.8	68.8	68.8	68.7	68.7	68.7	68.6
Private Sector Wages (apc)	5.4	5.5	5.5	4.2	4.1	4.5	4.9	4.9	4.3	4.6	4.6	4.6
Public Sector Wages (apc)	3.2	4.1	1.9	4.6	5.6	4.2	2.3	4.8	4.5	5.1	4.8	4.5

Forecast in bold

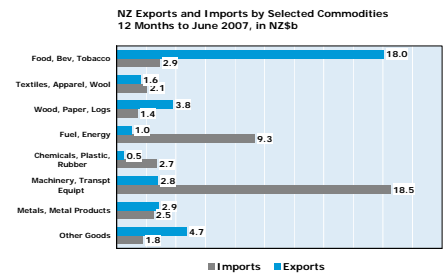
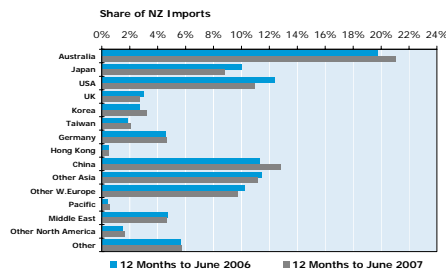
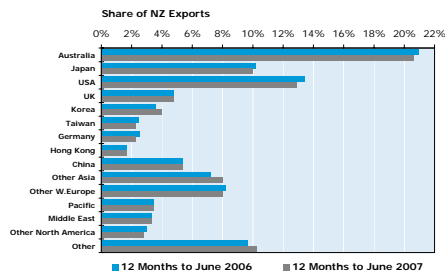
QPC - quarterly percent change

APC - annual percent change

AAPC - annual average percent change

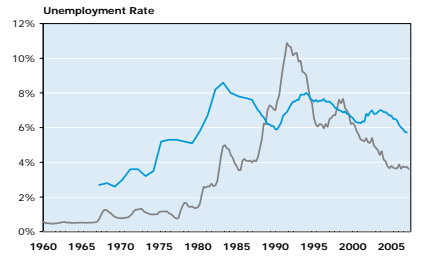
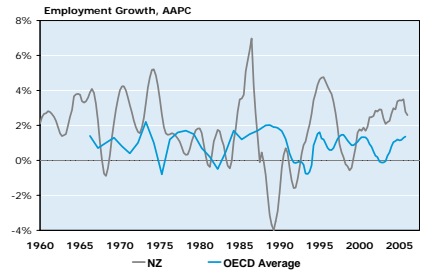
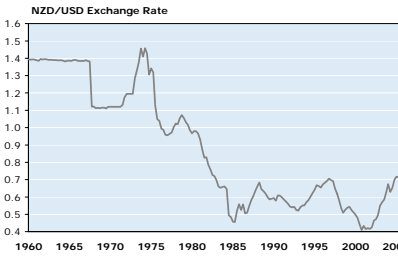
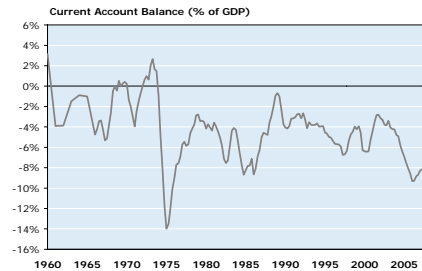
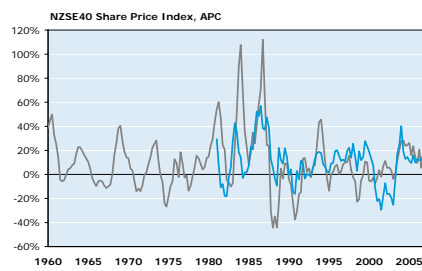
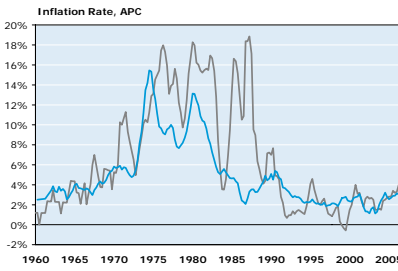
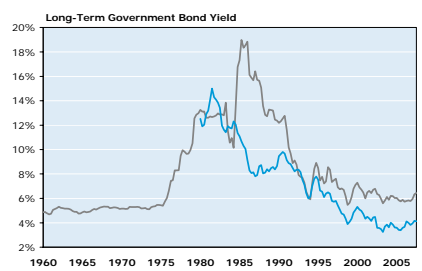
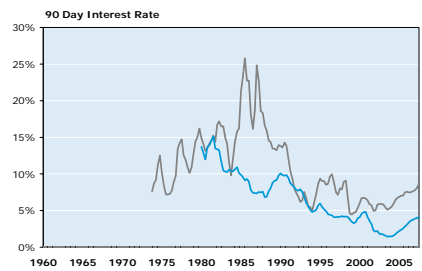
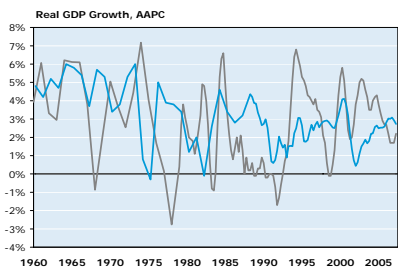
sa - seasonally adjusted

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	20.4	301.1	127.4	60.8	1321.8	82.4	49.0	22.9	24.8	6.9	4.6	234.7
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	32.1	337.2	249.1	138.2	231.0	531.5	636.1	75.2	6900.0	4600.0	123.2
GDP, in billion NZ\$	161.1	1122.6	18177.2	6144.1	3439.4	2773.8	4361.0	1224.9	431.1	198.6	252.0	179.1	430.0
Change in real terms (%)	2.2	4.3	1.9	1.6	3.1	11.9	2.5	5.0	5.1	5.7	6.9	8.6	6.3
Nominal GDP per capita in NZ\$	39,653	55,031	60,369	48,227	56,569	2,099	52,925	24,998	18,827	8,009	36,523	38,939	1,832
NZ exports to ..., in million NZ\$ (FOB)	n/a	7210	4522	3506	1682	1878	797	1405	796	584	578	514	652
Share of NZ Exports (%)	n/a	20.6	12.9	10.0	4.8	5.4	2.3	4.0	2.3	1.7	1.7	1.5	1.9
NZ imports to ..., in million NZ\$ (VFD)	n/a	8136	4239	3393	1042	4940	1793	1241	793	895	192	1831	600
Share of NZ Imports (%)	n/a	21.0	11.0	8.8	2.7	12.8	4.6	3.2	2.1	2.3	0.5	4.7	1.6
Current Account balance as a % of GDP	-8.2	-5.7	-6.1	4.4	-3.5	12.6	6.1	0.8	9.2	18.2	14.0	32.4	3.6



Disclaimer

This document has been prepared by ANZ National Bank Limited (the "Bank"), is provided for informational purposes only and does not constitute an offer to sell or solicitation to buy any security or other financial instrument. No part of this document can be reproduced, altered, transmitted to, copied to or distributed to any other person without the prior express permission of the Bank.

This document is a necessarily brief and general summary of the subjects covered and does not constitute advice. You should obtain professional advice before acting on the basis of any opinions or information contained in it. The information contained in this document is given in good faith, has been derived from sources perceived by it to be reliable and accurate and the Bank shall not be obliged to update any such information after the date of this document. Neither the Bank nor any other person involved in the preparation of this document accepts any liability for any opinions or information (including the accuracy or completeness thereof) contained in it, or for any consequences flowing from its use.

ANZ, Level 7, 1 Victoria Street, Wellington 6011, New Zealand Phone 64-4-802 2000 Fax 64-4-496 8639
<http://www.anz.com/nz> e-mail ecnmcs@anz.com