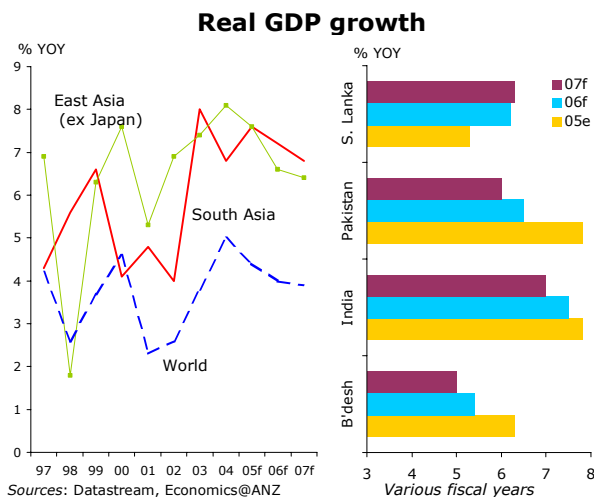


# South Asia Regional Report

## South Asia<sup>1</sup> : fastest growing region in 2006-07

- South Asia has grown at a strong pace over the past decade and is expected to be the fastest-growing region in 2006 and 2007
- Greater regional cooperation will help to lift long term growth prospects
- However, challenges ahead could limit the pace of economic advancement

Economic reform adopted over the past two decades, a gradual opening up of markets and a thawing of bilateral relations between India and Pakistan have helped to lift South Asia's economic performance. The region has experienced healthy growth over the past 15 years, averaging 5½% pa. between 1990-2005, ahead of world growth of 3½% pa. but lower than East Asian economic growth of 7½% pa. Widespread poverty persists and per capita income levels are still low but improving. Strong economic performance coupled with success in reducing population growth has helped to lift per capita income from around US\$385 in 1990 to US\$655 in 2004. The economic outlook is promising, with real GDP expected to post strong growth of around 7% pa. in 2006 and 2007, making it the fastest growing region.



Inflation remains a concern with food prices dependent on weather conditions. Shortage of food supplies exerted upward price pressures earlier in 2005 but this has since eased somewhat. High oil prices have also led to some reduction in fuel subsidies which have, in turn, lifted energy costs. Average annual inflation so far for 2005 has

ranged between 4% in India and 12% in Sri Lanka. Some easing is expected in 2006 as agriculture output returns to more normal levels, but further reductions in subsidies are likely to keep pressures firm. While administered prices on a range of products (eg. fuel, wheat and fertilizer) have helped to contain inflation, this has added pressures on the fiscal account.

Fiscal deficits persist and are unlikely to improve in 2006 with low government revenues relative to GDP, slow privatisation and expenditure expected to increase further. Government expenditure on subsidies, in particular, will continue to put pressure on finances as administered prices continue to be applied. In the case of Sri Lanka and Pakistan, reconstruction efforts are expected to drive increases in spending.

Current account deficits are forecast to widen in 2006. This partly reflects the effects of a high oil import bill as well as firm industrial activity leading to a surge in imports of intermediate inputs and capital equipment. The gradual liberalisation of trade has also lifted imports. Textiles and garments exports, which are major export items for the region, were less severely affected than feared earlier, following the expiration of the Multifibre Agreement (MFA) at the end of 2004 but import growth continues to outpace export expansion. Remittance flows have been strong but has not been sufficient to offset the merchandise trade shortfall.

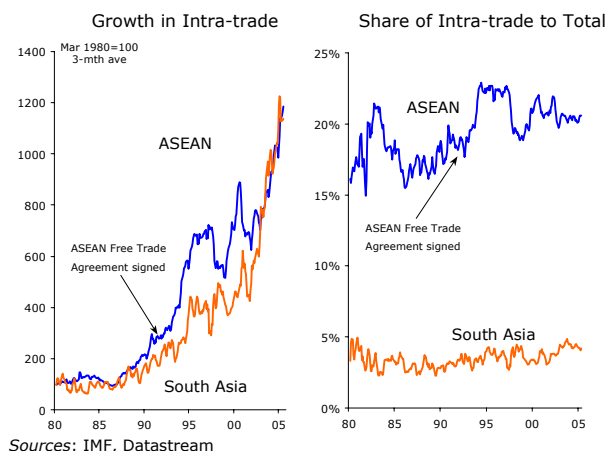
### Breaking down the barriers

In a significant move towards greater economic cooperation, a South Asian Free Trade Agreement was endorsed by India, Pakistan, Sri Lanka, Bangladesh, Bhutan, Nepal and the Maldives in November 2005. The group agreed to slash trade barriers from 1 January 2006 and aims to reduce tariffs to between 0-5% by 2016 (under the free trade accord, India, Pakistan and Sri Lanka have until the end of 2008 to reduce tariffs to that range). This agreement will be a major step towards boosting regional trade, which is currently very small. Intra-South Asian exports are less than 5% of the region's total exports compared with intra-ASEAN exports (20% of total). Breaking down the barriers is expected to lift intra-South

<sup>1</sup> South Asia: Bangladesh, India, Pakistan and Sri Lanka

Asian trade from around US\$5 bn annually to US\$14 bn per year within two years.

**Huge potential for Intra South Asian trade to accelerate**



The summit of the South Asian Association of Regional Cooperation also reinforced the commitment towards greater cooperation in disaster management. The tsunami, which hit Sri Lanka and the Maldives in December 2004, and the earthquake in Pakistan in October 2005 have underscored the urgent need to get processes in place to better mobilise regional relief efforts.

**Challenges to growth**

**Political landscape.** The difficult political environment with fragile coalitions and entrenched interests remains a key risk to the pace of economic reform. The uncertain security situation with ethnic and religious tensions also poses a concern to investors. Politics in Bangladesh is confrontational and the call for strikes has undermined growth prospects. A UN Development Programme report (March 2005) estimated that strikes, which have been used to influence policy, cost the economy between 3-4% of GDP annually in the 1990s. The pressures of coalition politics in India means that progress on economic reform is only likely to take place at a gradual pace. In Pakistan, the threat of violence and sectarian tensions are major concerns. In Sri Lanka, the peace process between the LTTE and the government will continue to dominate political affairs. This has been a significant drag on the economy's performance. An encouraging development, however, has been the marked improvement in relations between India and Pakistan and the efforts to build a more durable relationship.

**Climatic conditions.** While its share of GDP has declined over the years, agriculture (including forestry and fishing) remains a vital component of the region's economy accounting for around 20% of GDP and employing a sizeable share of the workforce. This compares with East Asia

(excluding Japan) where agriculture makes up around 10% of GDP. This sector, however, is vulnerable to adverse weather conditions. Efforts to build up the services sector will help to cushion the impact of volatility in agriculture output. The growth of the services sector is particularly evident in India, where the country has benefited greatly from the development of the IT sector and from multinationals moving towards outsourcing and offshoring.

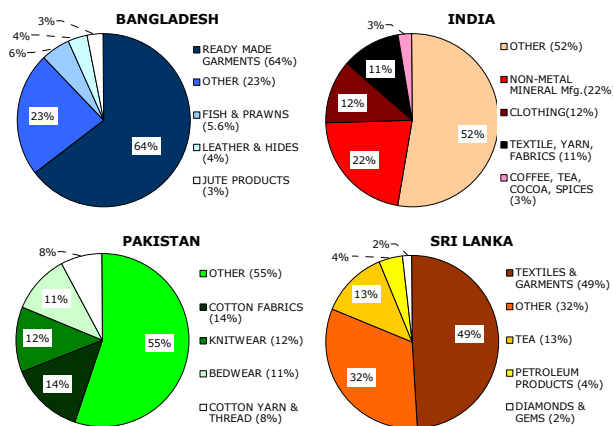
**Agriculture – an important component of the economy**

% of GDP 1990/2004	Agriculture 1990/2004	Industry 1990/2004	Services 1990/2004
Bangladesh	29.4/20.2	20.9/25.5	49.7/54.3
India	31.3/21.1	27.6/27.2	41.1/51.7
Pakistan	26.0/23.1	25.2/24.6	48.8/52.3
Sri Lanka	22.9/17.8	27.3/26.8	49.8/55.4

Source: Asian Development Bank

**Competitive pressures.** Textiles and garment exports are among the region's top 5 exports. The region has benefited from the quotas imposed on China by the US and EU. However, competitive pressures will intensify over the medium term as these "safeguard quotas" are eventually removed. This increases the urgency to improve infrastructure and production efficiencies in order to better compete in the global market.

**Textiles and garments – major export sectors**  
(% share of total exports – 2004)

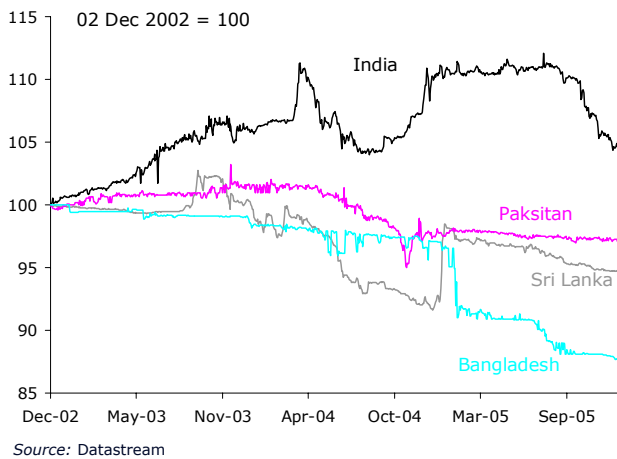


While there is broad consensus on reform, sustaining faster economic growth over the medium to long term will require further trade and investment liberalisation, infrastructure development and economic/industry diversification. Together with greater regional economic cooperation, this will enable serious inroads to be made in alleviating poverty and lifting per capita income levels in the region.

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# Financial Markets Update

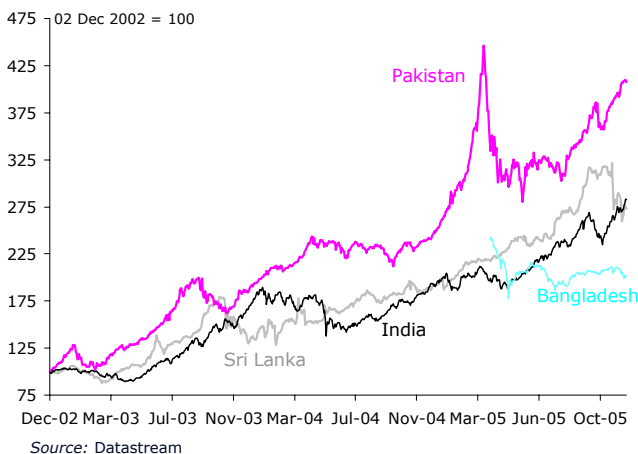
Exchange rates, US\$ per local currency unit, indexed



## Exchange rates

- The currencies of South Asia have all depreciated, to varying extents, throughout the course of 2005. Widening current account deficits, due primarily to a boom in imports across the region, have been largely responsible for this downward trend.
- The Indian rupee had been supported in the first half of 2005 by strong capital inflows. However, a marked softening in these flows, especially in October, combined with very high import growth has seen the rupee fall from highs reached in July.
- A stronger US dollar, strengthening on the back of continued increases in the Fed Funds rate has also put downward pressure on exchange rates across the region.

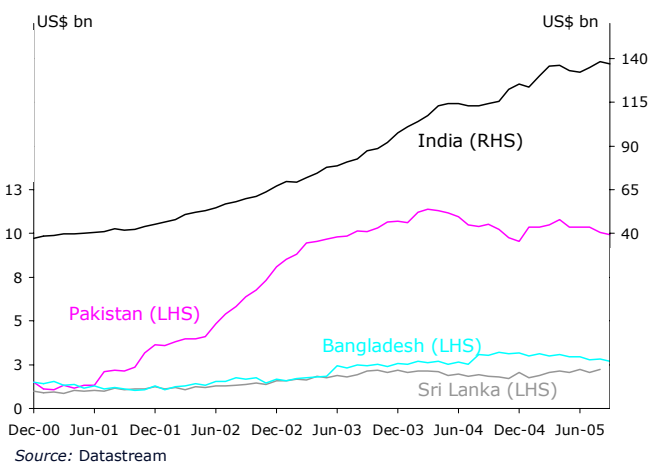
Share price indices



## Stockmarkets

- The Karachi stock index saw a sharp acceleration earlier this year due largely to inflows ahead of potential privatisations. However, the slow privatisation process led to a consequent correction. Since then, however, Pakistan's stockmarket has recovered strongly.
- India's stockmarket continues to make strong gains buoyed by solid domestic conditions.
- Sri Lanka's stockmarket has been resilient, climbing by 67% between January and October. Political uncertainty around the November elections has, however, resulted in some correction.
- Bangladesh's equity market is less developed with low market capitalisation.

International reserves

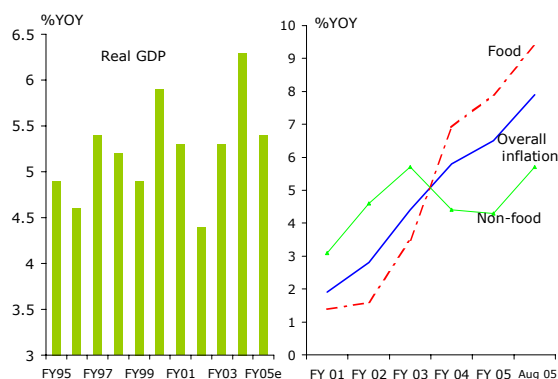


## International reserves

- International reserves have strengthened particularly in the case of India where reserves have risen rapidly in recent years. As at October 2005, India's reserves stood at US\$138. bn, equivalent to around 12 months of imports.
- Pakistan has also seen a rise in reserves due in part to grant inflows and a rise in remittances. Reserves have risen from just US\$1.5 bn in 2000 to US\$10 bn as at October 2005, sufficient for about 5 months of imports.
- Bangladesh and Sri Lanka have seen a marginal increase in reserves but import cover remains low at around 3 months

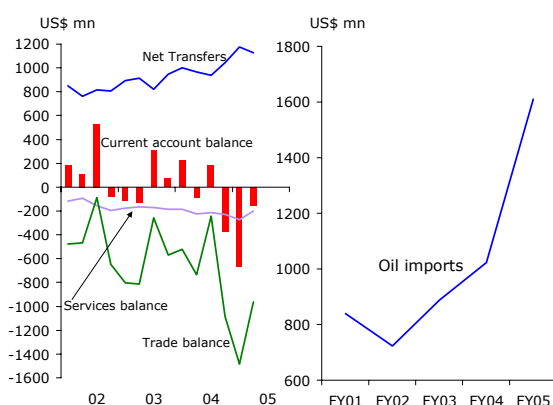
# Country Update Bangladesh

## GDP growth slows and inflation accelerates



Sources : Datastream, IMF, Bangladesh Bank

## Current Account deteriorates



Sources : Datastream, IMF, Bangladesh Bank

- Reforms adopted since the 1980s have helped to lift Bangladesh's economic performance over the past two decades. Real GDP, which averaged 4.9% in the 1990s, grew by a stronger 5.4% during 2000-2004. The economy is estimated to have recorded slower growth of around 5.4% in FY04/05 (year ending June 2005) from 6.3% in FY03/04. This still represented a respectable pace of growth given the adverse impact of crop damage due to severe flooding in July-August 2004. The outlook is for growth to ease marginally to around 5¼% in FY2005/06. While agricultural production is forecast to recover strongly, a moderation in major trading partner demand and competitive pressures in the garments sector from other garment producers such as India, China and Vietnam are likely to see growth in industrial production slow this fiscal year.
- Bangladesh is opening up to foreign investment notably in industries such as natural gas, power generation and textiles and this bodes well for the economy. FDI totalled US\$660.8 mn in 2004, up 49.7% from 2003.
- Rising fuel prices and higher food prices, due to the decline in agriculture production, have put pressure on consumer prices. Inflation reached 7.9% YOY in August 2005 from 5.5% in December 2004. Petrol prices were raised in September for the fourth time this year. Average annual inflation is likely to ease in 2006 as food inflation moderates but is likely to stay above 5% reflecting pressures from the non-food segment. Inflation averaged 3.3% in 2000-2004.
- The trade deficit widened significantly in FY2004/05 with a high import bill, due largely to the rapid increase in oil prices. However, current transfers helped to contain the current account deficit. This largely consists of remittances from Bangladeshis working abroad. The current account deficit, which was estimated at 0.9% of GDP for FY2004/05, is forecast to widen further as exports moderate reflecting the slowdown in global demand and oil prices stay high, keeping upward pressure on import costs.

Jasmine Robinson

## Economic data and debt statistics

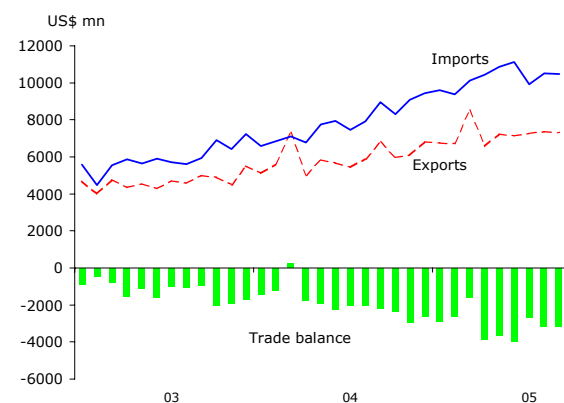
Bangladesh	2000	2001	2002	2003	2004	2005f	2006f
Real GDP growth* (%)	5.9	5.3	4.4	5.3	6.3	5.4	5.0
Nominal GDP* (US\$ bn)	47.1	47.0	47.6	51.9	56.0	58.7	60.4
CPI* (yr av, % YOY)	2.8	1.9	2.8	4.4	5.8	6.5	6.0
Exchange rate (eop, USD/TK)	54.0	57.0	57.9	58.8	59.2	66.1	75.0
Interest rate (Discount rate)	7.0	6.0	6.0	5.0	5.0	5.0	6.0
M1 (yr av, % YOY)	18.4	10.7	5.1	7.6	17.8	15.8	12.5
Public Sector balance* (% of GDP)	-6.2	-5.0	-4.6	-3.4	-3.2	-4.5	-4.5
Foreign currency debt (US\$ bn)	15.8	15.2	17.0	18.8	20.4	21.1	23.3
Foreign currency debt (% GDP)	33.4	32.4	35.8	36.2	36.5	36.2	38.2
Short term F.C. debt / reserves (%)	22.5	28.3	34.0	23.9	20.6	23.1	22.9
Current account balance* (% GDP)	-1.2	-2.5	0.2	0.2	0.3	-0.9	-1.7
International FX reserves (US\$ bn)	1.5	1.3	1.7	2.6	3.2	3.0	3.2
Import cover (months)	1.8	1.6	2.2	2.8	2.9	2.4	2.3

\*: Fiscal year ending June of year stated

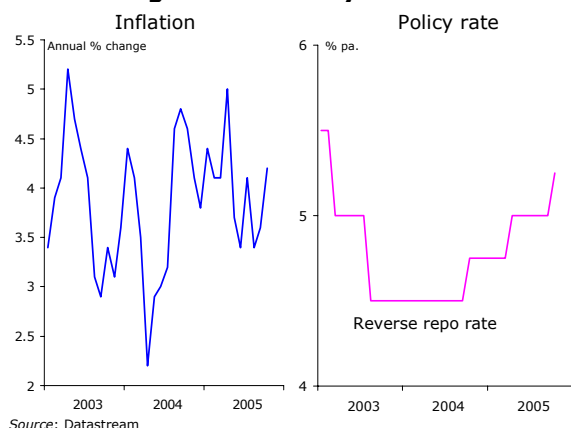
Sources: ADB, Bangladesh Bank, Datastream, EIU, ANZ Banking Group Ltd

# Country Update India

## Trade balance to deteriorate as imports soar



## Demand pressures fuel inflation and tighter monetary stance



- India's economy is powering ahead, with real GDP in the July-September quarter (ie. the second quarter of the fiscal year) exceeding market expectations and expanding by 8% YOY, matching the rate achieved in the first quarter of FY2005/06 (April-June). Growth has been underpinned by robust activity in both the industry and services sectors. India's growth outlook remains upbeat as private consumption stays strong and exports gain momentum. We expect the economy to expand by 7.8% in FY2005/06 compared with 6.9% in FY2004/05.
- The country's strong economic expansion and high oil prices have, however, led to a surge in imports and pushed the current account further into deficit despite strong export growth. The merchandise trade deficit was US\$23.8 bn during April-October. Exports were up by 28% YOY but imports surged by 38.6% YOY during the same period. The large trade shortfall has been partly offset by an invisibles surplus thanks to strong earnings from software exports and remittances but the current account deficit, which was recorded at US\$6.4 bn in FY2004/05, is forecast to widen this fiscal year as the trade deficit continues to deteriorate.
- Nevertheless, financing the current account is unlikely to pose a concern given the strong pace of capital inflows seen over the past two years. Foreign exchange reserves have risen significantly in recent years and stood at US\$125 bn at end-2004, equivalent to 12.6 months of imports of goods and services. Reserves were US\$138.7 bn as at October 2005, up 10% from end-2004.
- Inflation pressures are expected to intensify with the pass-through of higher oil prices and rapid credit growth. While still below the Reserve Bank of India's inflation range of 5-5.5%, growing concerns over price pressures prompted the RBI to lift the reverse repo rate by 25 bps to 5.25% on 25 October, the second rate hike this year. The central bank is likely to retain its gradual tightening stance.

Jasmine Robinson

## Economic data and debt statistics

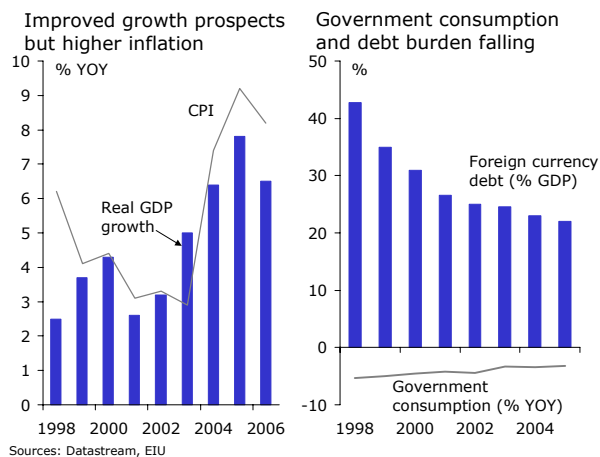
India	2000	2001	2002	2003	2004	2005f	2006f
Real GDP growth* (%)	3.9	5.2	4.1	8.6	6.9	7.8	7.5
Nominal GDP* (US\$ bn)	457.4	478.5	508.9	594.9	669.9	758.9	859.6
CPI* (yr av, % YOY)	4.0	3.8	4.3	3.8	3.8	4.6	5.2
Exchange rate (eop, USD/INR)	44.9	47.2	48.6	46.6	45.3	43.6	43.0
Interest rate (Policy rate)	8.0	6.5	5.5	4.5	4.75	5.25	5.5
M1 (yr av, % YOY)	10.6	10.0	12.5	16.2	20.7	11.0	12.5
Central govt balance* (% of GDP)	-5.2	-4.7	-6.0	-4.6	-4.4	-4.3	-4
Foreign currency debt (US\$ bn)	99.1	97.5	106.3	113.5	118.8	120.4	126.1
Foreign currency debt (% GDP)	21.7	20.4	20.9	19.1	17.7	15.9	14.7
Short term F.C. debt / reserves (%)	9.1	6.0	6.8	4.8	4.1	4.0	3.5
Current account balance* (% GDP)	-1.0	0.3	1.4	1.1	-0.1	-2.1	-2.6
International FX reserves (US\$ bn)	37.9	45.9	67.7	98.9	126.6	146.7	170.5
Import cover (months)	6.6	8.1	11.1	13.1	12.2	10.7	10.8

\*: Fiscal year beginning April of year stated

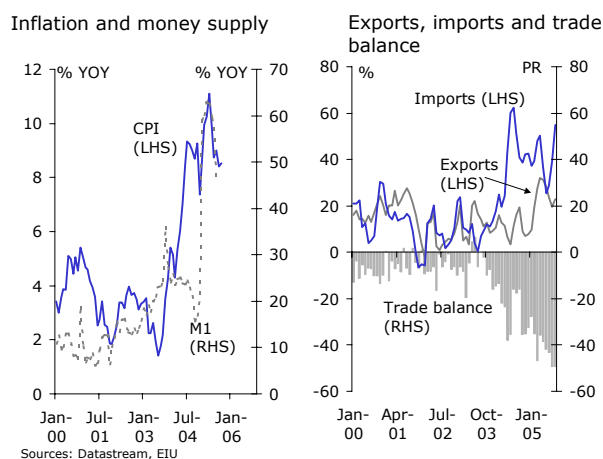
Sources: EIU, ANZ Banking Group Ltd

# Country Update Pakistan

## GDP growth has improved with declining debt burden but inflation ticking up



## Inflation rising and trade deficit worsening



- Improved macroeconomic stability following implementation of Pakistan's IMF program and Paris Club debt restructuring has led to a period of solid growth. Real GDP has risen at more than 5% since 2003, and is forecast to remain above 6% for 2005 and 2006. Growth has been driven by expansion of large-scale manufacturing and a recovery in the agricultural sector from the 2000-2002 drought. The agricultural sector employs 40% of the labour force and accounts for around 25% of GDP.
- Public sector debt has declined from 87% of GDP in 2001 to 70% of GDP currently. The government continues to achieve a primary surplus and use privatisation receipts to pay down debt. Nonetheless, about 25% of fiscal revenue is used for interest payments on domestic and foreign currency debt.
- Inflation has risen to around 8% from a low of 2.6% in 2001, and the money supply is rising rapidly. Interest rates will have to rise, or there is a risk that the economy will overheat and push inflation expectations even higher. Higher interest rates will push up the cost of debt service, with about 50% of government debt denominated in local currency.
- Further pressure could arise if Pakistan's external balances turn negative. Although much of the foreign currency debt is bilateral and/or concessional, any significant decline in foreign exchange reserves from current levels would worsen key liquidity ratios. Exports of textiles in particular are vulnerable to Chinese competition with the expiration of the Multi Fibre Agreement.
- Politics remain a key risk. The threat of violence is always present, with assassinations of President Musharraf and other senior leaders attempted in the past several months. Musharraf's consolidation of power has lowered short-term political uncertainty, but raised long-term questions regarding Pakistan's democratic future.

Amy Auster

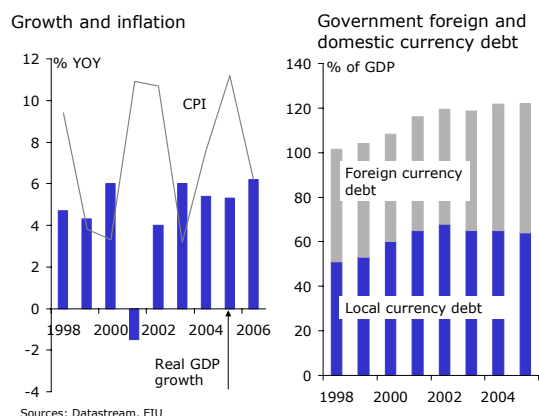
## Economic data and debt statistics

Pakistan	2000	2001	2002	2003	2004	2005f	2006f
Real GDP growth (%)	4.3	2.6	3.2	5	6.4	7.8	6.5
Nominal GDP (US\$ bn)	76.0	74.0	71.0	72.0	82.0	96.0	111.0
CPI (yr av, % YOY)	4.4	3.1	3.3	2.9	7.4	9.2	8.2
Exchange rate (eop, USD/PR)	57.6	59.9	58.3	57.4	59.4	59.8	60.5
Interest rate (Discount rate)	13	10	7.5	7.5	7.5	9.0	10.5
M1 (yr av, % YOY)	11.09	9.01	14.3	22.6	22.4	58.4	25.0
Gen. government balance (% of GDP)	-4.5	-4.0	-4.0	-2.9	-2.8	-3.3	-3.2
Foreign currency debt (US\$ bn)	32.8	31.7	33.7	36.4	35.8	39.9	42.6
Foreign currency debt (% GDP)	44.4	44.5	47.1	44.2	37.2	36.1	35.0
Short term F.C. debt / reserves (%)	100.5	36.0	19.1	11.4	14.8	24.0	26.6
Current account balance (% GDP)	-0.1	2.6	5.4	4.3	-0.8	-3.4	-3.8
International FX reserves (US\$ bn)	1.5	3.6	8.1	10.9	9.8	10.9	11.2
Import cover (months)	1.5	3.6	7.7	8.6	5.3	5.9	5.0

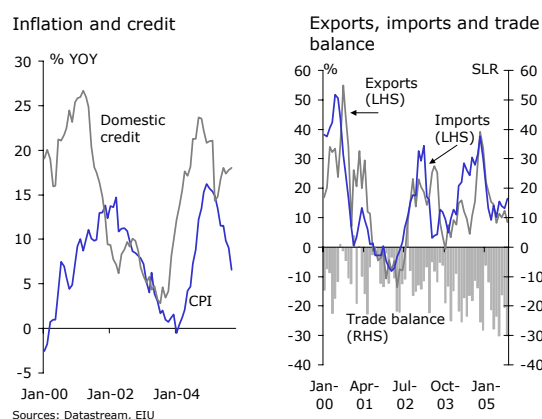
Sources: Datastream, EIU, ANZ Banking Group Ltd

# Country Update: Sri Lanka

## Growth strong, but prices volatile and debt burden remains high



## Inflation declining but domestic credit growth heading up; trade balance remains in slight deficit



- The results of the November 2005 presidential elections have cast uncertainty over Sri Lanka's political and economic outlook. Newly elected President Mahinda Rajapakse's campaign ran on a platform that including renegotiating the ceasefire with the Tamil Tigers (LTTE) and increasing agricultural subsidies. Although Rajapakse is from the Sri Lanka Freedom Party of outgoing President Kumaratunga, the former President as well as the business community supported the losing candidate from the opposition United National Party. In addition to uniting his party behind him, Rajapakse is also likely to have to govern in a coalition as he received only 50.3% of the popular vote. One of the key members of the coalition appears likely to be the Marxist nationalist Janatha Vemukthi Peramuna (JVP).
- From an economic perspective the most immediate concern is the fiscal deficit, which has been above 7% of GDP for more than five years. The rise in foreign currency debt has been limited, which lowers the pressure that could have otherwise risen on external balances. However, the majority of the deficit is being monetised by the central bank and has led to double-digit inflation. The seeming lack of political will to impose fiscal discipline – possibly on the rise with this new government – raises the risk that Sri Lanka will once again enter into another high deficit, high inflation spiral similar to the one that led to the recent IMF program.
- Aid disbursements to assist the victims of the December 2004 tsunami have been slow due to disruptions in the peace negotiations. The cost of reconstruction is being largely absorbed into the budget deficit. While the ceasefire has officially held, sporadic outbreaks of violence have killed up to 200 people in the past year. The LTTE boycotted the November election, and the newly appointed Prime Minister Ratnasiri Wickremanayake is a known hardliner on the LTTE issue. The outlook for longer term peace has certainly been clouded by the election results.
- Over the longer term, productivity increases will depend upon reducing the massive role of the state in the economy through the sale of SOEs, a step that remains controversial.

*Amy Auster*

## Economic data and debt statistics

Sri Lanka	2000	2001	2002	2003	2004	2005f	2006f
Real GDP growth (%)	4.3	6.0	-1.5	4.0	6.0	5.4	5.3
Nominal GDP (US\$ bn)	15.7	16.3	15.7	16.6	18.3	20.1	23.8
CPI (yr av, % YOY)	6.2	14.2	9.5	6.3	7.6	11.2	6.2
Exchange rate (eop, USD/SLR)	82.5	93.2	96.7	96.7	104.6	102.5	N/A
Interest rate (prime lending %)	21.5	21.5	14.3	8.9	10.2	11.8	N/A
M2 (% YOY)	26.5	11.0	15.5	13.0	16.1	19.2	N/A
Fiscal balance (% of GDP)	-9.5	-10.4	-8.3	-7.5	-7.6	-8.5	-9.0
Total government debt (% GDP)	108.3	116.6	119.2	118.7	121.7	123.0	N/A
Of which, local currency (% GDP)	60.1	65.5	67.7	65.0	65.0	66	N/A
Of which, foreign currency (% GDP)	48.2	51.1	51.5	53.8	56.7	57.0	N/A
Short term FC debt / reserves (%)	65.9	35.0	31.1	20.8	22.3	21.0	18.4
Current account balance (% GDP)	-6.4	-1.5	-1.6	-0.9	-3	-1.6	-3.7
International FX reserves (US\$ bn)	1.0	1.3	1.6	2.3	2.1	2.3	2.6
Import cover	1.5	2.2	2.8	3.5	2.9	2.7	2.8

Sources: ADB, Datastream, EIU, ANZ Banking Group Ltd.

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