

Media Release

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NEW ZEALAND LIMITED ANNUAL REPORT 2005

The ANZ National Bank issued its inaugural edition of the *New Zealand Limited Annual Report* which provides investors with valuable background information on the state of the New Zealand economy.

The report provides its insights in a form familiar to investors by viewing New Zealand as if it was one company. In this framework Helen Clark can be viewed as the CEO and Alan Bollard the CFO while the NZ dollar will reflect investors' confidence in New Zealand, making it akin to a share price.

Topics include:

- The performance of key sectors (or divisions) such as Rural, Consumer, and Government;
- The cash-flow (current account) position;
- Financial policy; and
- Investment recommendations.

Viewed in this light, New Zealand Limited is a quality asset for which medium-term prospects look favourable. However, after posting six straight years of very strong results this quality asset is no longer cheap.

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A large, stylized map of New Zealand is centered on the page. The map is composed of a grid of small green dots, creating a halftone effect. It shows the North and South Islands, along with the Chatham Islands to the east of the North Island.

New Zealand Limited (NZL) Annual Report 2005

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INTRODUCTION

An annual report is intended to give a snapshot of the state of a company at a particular point in time. It should enable an investment analyst to determine the strengths, weaknesses, outlook, and relative attraction of the company. An annual report may also provide some original insights into the progress the company has made over the previous year and highlight the prospects for the year ahead.

In some ways any country can be likened to an individual company – just as any company can be compared to a country. Notably, this has been done in the past with General Motors in its heyday of the seventies (perhaps unfortunately with the benefit of hindsight). At this time it was the largest company in the world and its size was often demonstrated by comparing it to whole countries.

The following report is ANZ National Bank Limited's look at New Zealand as one company. Similar exercises have been undertaken for a number of countries, most notably in the *International Bank Credit Analyst* for The USA Inc. In New Zealand Limited (NZL), Helen Clarke is the Chief Executive Officer (CEO), Alan Bollard is the Chief Financial Officer (CFO), Parliament is the board of directors, and Cabinet forms the executive management team.

In this report each of the major "divisions" of NZL is assessed, from the very important Rural Division through the Consumer Division and even People Capital.

This year may well prove to be an appropriate time to begin looking at New Zealand in this way. The last six years has seen NZL perform in a way that has not been seen since the 1960s – in both economic performance and in share market and currency performance.

After two years of delivering some of the best currency and share market returns in the world, along with the second-longest economic expansion in the post-war period, a key question for any investor is:

"Will these favourable trends continue or are things about to change?"

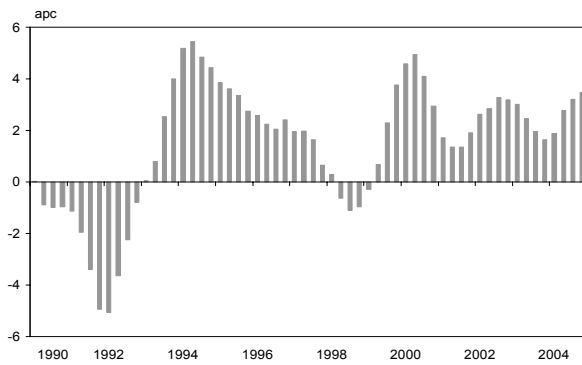
We hope that this inaugural edition of *New Zealand Limited Annual Report* provides investors with valuable background information and offers a slightly different perspective on the current position of NZL.

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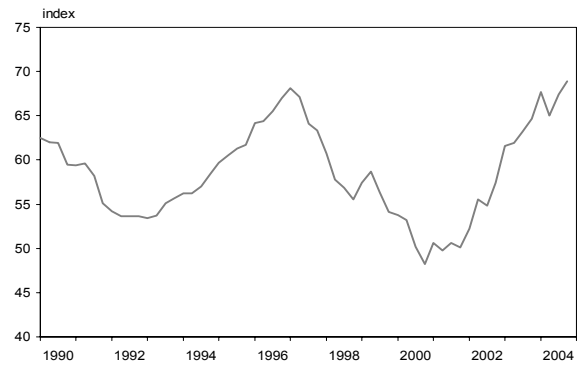
FINANCIAL HIGHLIGHTS

GDP Growth Per Capita



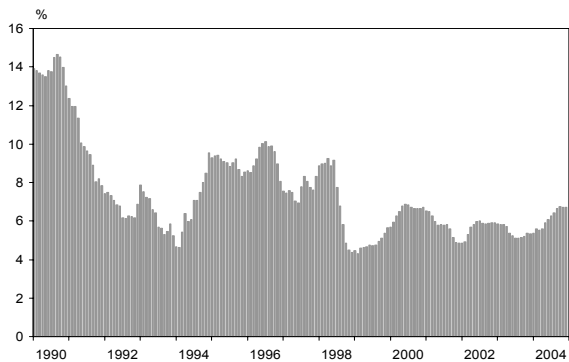
Source: Statistics NZ

Exchange Rate (Real Trade Weighted Index)



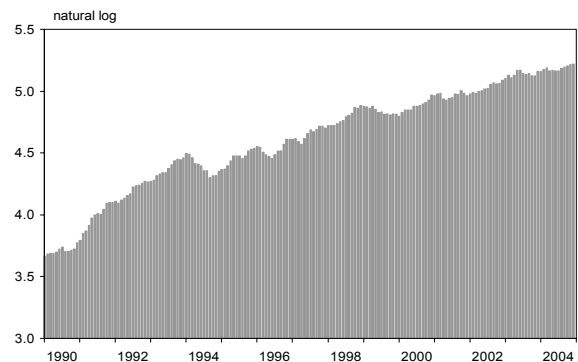
Source: Reserve Bank of New Zealand

90 Day Bank Bills



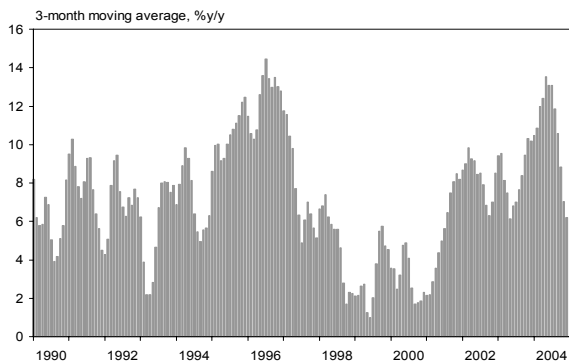
Source: Reserve Bank of New Zealand

Bond Market Performance (10-Yr Bond Total Return)



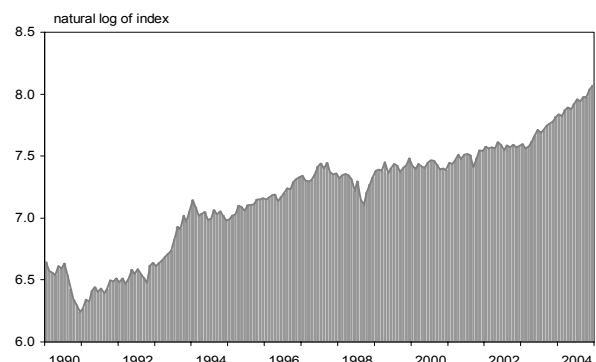
Sources: ANZ National; Reserve Bank of New Zealand

Money Supply (M3R ex-repos)



Source: Reserve Bank of New Zealand

New Zealand Stock Market (Total Return)



Source: Global Financial Data

ANALYST OVERVIEW

New Zealand Limited (NZL) is a quality asset that continues to perform well. NZL's current expansion phase is the second-longest in the post-war period – since 1999, growth in production averaged 4 percent a year. This rate of expansion compares favourably with the 2½ percent registered across its main competitors in the OCED group. The key drivers NZL's strong performance were the fortuitous rise in global commodity prices, prudent management of policies, and the benefits that are now accruing from the difficult restructure undertaken in the 1980s.

During the expansion phase, NZL has increased production potential substantially, by increasing its labour force nearly 20 percent and increasing capacity utilisation to an astonishing 93 percent – its highest level for at least 40 years. However, growing capacity constraints faced by NZL are causing inflation pressures to emerge. In fact, a culture of extravagance is creeping in. For example, over the past year non-tradable goods inflation sat above 4 percent and high oil prices caused tradable goods inflation to rise.

The CFO faces a difficult balancing act. He needs to adjust monetary policy to regain control of costs and ensure that inflation remains within the Policy Targets Agreement inflation target band of 1 to 3 percent over the business cycle. However, he needs to do this without aggravating the slowdown in production activity that is widely anticipated. In our view, the conduct of monetary policy has been appropriate to date.

The fiscal position is in very good shape. Past and current executive management teams have a strong track record of providing healthy operating surpluses allowing the government debt-to-GDP ratio to decline. However, the current executive management team will need to maintain this discipline in face of emerging long-term pressure from rising healthcare costs and superannuation commitments. Some of the parameters of NZL's defined benefit superannuation scheme will require changing in the near future in order to preserve the viability of the scheme. In the meantime, the partial pre-funding of the future pension liabilities is a welcomed starting-point.

In order that NZL continues to prosper, productivity enhancements are required. Key priorities include improving roading infrastructure, securing uninterrupted electricity supply, upgrading education, and meeting the training needs of the workforce.

Investors will be interested in recent discussions on the potential takeover of the Banking Supervision Division by Australia Limited. The outcome of these discussions is very unclear at this stage; nevertheless the executive management team will need to ensure adequate guarantees are in place in the event of future difficulties in this area.

The strength of NZL has resulted in a rapid appreciation of the NZ dollar (share price). On a real trade weighted (TWI) basis the exchange rate is trading around 18 percent above its post-float average. NZL is a quality asset but an expensive investment.

INTERNATIONAL DIVISION

New Zealand Limited (NZL) is a small open economy with fortunes that are closely tied to the health of the global economy. The slowdown in the global economy in the near-term will restrain export growth over 2005 but an anticipated revival in global growth during 2006 will help stimulate a lift in export performance thereafter. Over the medium-term, NZL's prosperity can be improved by increasing productivity (generating more output for any given inputs) or by improving its terms of trade (by persuading foreigners/customers to pay more for the generated output). Prospects for the latter look encouraging.

Global growth in 2004, at around 4 percent, was the strongest seen in decades. Most forecasters, including the OECD and IMF, do not expect this strength to be repeated in 2005 but anticipate growth of around 3 percent, with a revival to about 3½ percent in 2006.

Risk profile

Despite this relatively benign outlook, there remain various risks on the horizon. In particular, high oil prices have the potential to hinder global growth. Country-specific factors also confirm that the risk profile points down – for example, the burgeoning current account and fiscal deficits in the United

States and concerns over a lack of labour market flexibility in European markets.

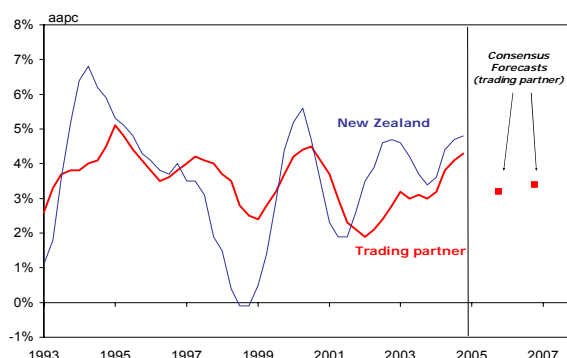
Terms of trade performance

Over the past eighteen months, world prices for New Zealand's commodity exports have been boosted by tight supplies from offshore competitors and strong demand for commodities generally as China becomes an important economic force.

Consequently, NZ dollar export returns have been solid, despite the NZ dollar's appreciation over the same period. In the medium-term, these supply-specific issues are expected to reverse but will be partially offset by a depreciating exchange rate. In contrast, imported goods prices have fallen as manufactured goods become the new 'commodity'. Jointly, this has lifted New Zealand's terms of trade to pre-1975 levels.

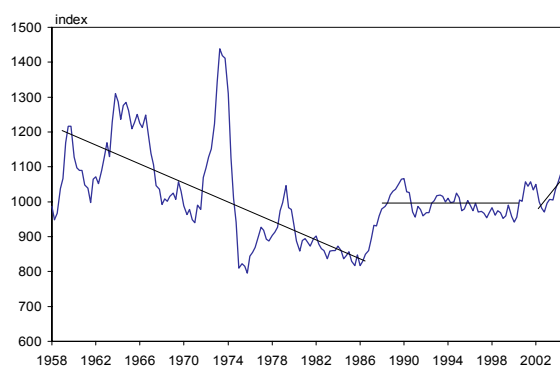
The terms of trade is expected to remain high by historical standards due to a secular decline in the price of manufactured goods. A higher term of trade raises New Zealand's purchasing power relative to the rest of the world and increases per capita income.

New Zealand's trading partner growth (12-country)



Sources: ANZ National; Statistics NZ; Consensus Forecasts Economics Inc

Terms of trade



Source: Statistics NZ

Trading Partner Growth

Annual average percent change, calendar year

	Actual		Forecast **	
	2003	2004	2005	2006
Australia	3.3	3.5 **	2.6	3.4
Japan	2.5	2.9 **	0.9	1.7
United States	3.0	4.4	3.7	3.4
Euro-zone	0.5	2.0	1.6	2.0
United Kingdom	2.2	3.1	2.6	2.4
12-Country Index *	3.0	4.0	3.1	3.4

* Export weighted index for Australia, Canada, China, Hong Kong, Japan, Malaysia, Singapore, South Korea, Taiwan, United Kingdom, United States, and Euro-zone. ** Consensus Forecasts Economics Inc, March 2005.

RURAL DIVISION

The Rural Division is the backbone of NZL, contributing around 17 percent of the economy (primary processing, downstream service providers, and if agriculture is included directly). Rising global commodity prices increased the earnings potential of this division.

The Rural Division had a mixed year. Production and profitability were good over most sectors but returns from venison and pip-fruit were disappointing. Productivity continues to improve. Another increase in the value of the underlying asset base and improved liquidity puts the overall division in reasonable financial shape.

Production in the first half of 2004 was good, following on from a favourable autumn and spring in 2003. The second half of the year was a different story. A prolonged cold wet spring dented milk production and live weight gains in lambs.

Prices were generally better than expected, given the strength of the NZ dollar. Dairy payouts benefited from both high international commodity prices and the forward exchange cover put in place by the three dairy companies. International sheep meat prices are steady and farm gate prices are similar to 2003. Heavier lambs helped to mitigate the moderate appreciation of the NZ dollar against the euro. Wool prices fell, particularly for finer wool. Crossbred wool prices held up well in US dollar terms, underpinned by underlying demand for carpet wool.

The prices received for New Zealand beef in the US made a remarkable recovery from a five-year low in June 2003 to a 12-year high by June 2004. Factors responsible include a slowly shrinking US cow herd, the continued lock out of Canadian manufacturing beef due to BSE in that country, and the Atkins diet encouraging consumers eating more meat protein.

Kiwifruit prices have held up well given the record harvest of 80 million trays, up 18 million from the previous year. The same cannot be said for pip-fruit or venison. Marketing and quality issues affected apples, while venison struggles with increased supply in a flat market. Profitability and liquidity of both sectors are under pressure. The viticulture sector also had a record production year taking in 166,000 tonnes, up 89,000 tonnes from a badly frosted harvest in 2003.

Physical productivity gains continue to be made in the division. Part of this is due to the favourable weather in 2003 and early 2004 but the underlying trend is also up as genetics, pasture species, and management techniques continue to be refined. More widespread and more efficient use of irrigation is also a contributing factor.

Demand for farmland remained buoyant. The rural land price index is estimated to have increased by an amount similar to the 20 percent increase in 2003. Farm businesses continue to grow in size. Land use change within the pastoral sector is slowing but viticulture continues to forge ahead and the supply/demand for lifestyle blocks moves further and further out from urban centres.

Confidence in the sector is high but some caution is apparent as the rate of expansion in debt almost halved, from 18 percent growth in 2003 to 11 percent (plus \$2 billion) in 2004. In addition, liquidity was improved by \$600 or 20 percent. Net bank debt at December 2004 was \$19.1 billion (compared with \$17.7 billion at December 2003).

The outlook for the division is like last year's result – mixed. The impact of the stronger NZ dollar, higher freight rates, and increasing input costs are likely to erode profitability but overall the division is in good heart.

Productivity Gains

Calendar year

	2000	Actual 2002	2004
Lambing (%)	115	117	120
Lamb Slaughter Weight (per kg)	16.4	16.8	17.3
Milk Solids per Cow (kgMS)	277	292	304
Kiwifruit (Zespri™, green trays per ha)	6,500	5,750	7,300

CONSUMER DIVISION

The Consumer Division has been a significant contributor to NZL's economic upswing. During the past three years consumer spending has contributed 75 percent of growth. However, much of this growth resulted in rising debt, limiting the future growth potential of this division.

Two notable drivers of higher consumption were increased household wealth caused by rising house prices, and employment growth raising incomes and its associated job security. Other factors included inward net migration and rising terms of trade.

Residential housing market

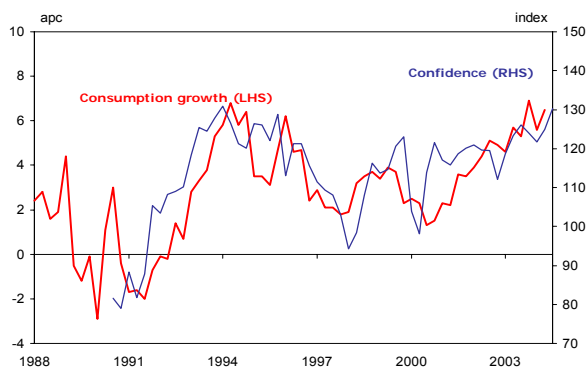
In recent years house prices and household debt levels have surged, although improving balance sheets mitigated some of the effect on homeowners. However, a lack of diversification into other asset classes means consumers have become more closely tied to housing's future prospects. The jury is still out whether (economy-wide) the housing market represents a speculative bubble but it is certainly overvalued by most measures. These factors point towards an increased vulnerability for this division.

Employment growth

Strong employment growth has also been a major impetus for increased spending. The labour force participation rate – in particular among women and part-time workers – is high at 67.6 percent and the country is benefiting from an unemployment rate at 3.9 percent, one of the lowest among OECD countries. Excess demand for labour, especially skilled labour, has boosted wage growth and household incomes. Strength in the labour market will provide support to the household sector in coming years.

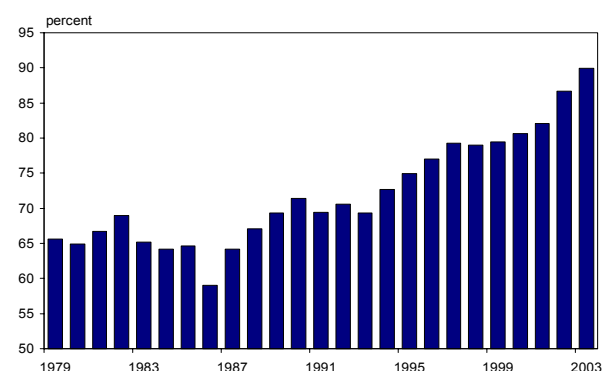
Over the longer-term, raising the labour market's productivity will be an important area for sustainable growth. Although higher wages will support spending in the household sector, the absence of an associated rise in productivity will produce the unwelcome marriage of pricing pressure and lower output. Labour market flexibility remains the key to avoiding this situation.

Consumer confidence drives consumption



Sources: ANZ National; Statistics NZ; Westpac McDermott Miller

Housing value as a percent of net wealth



Sources: ANZ National; RBNZ; Statistics NZ

Macroeconomic Forecasts

Annual percent change, calendar year

Employment
Unemployment Rate (%)
Real Private Consumption
Real Residential Investment
Household Debt to Disposable Income (%)
Consumer Price Inflation

* Estimate

	Actual		Forecast	
	2003	2004	2005	2006
Employment	2.6	4.4	$\frac{3}{4}$	$\frac{1}{4}$
Unemployment Rate (%)	4.6	3.6	$3\frac{3}{4}$	$4\frac{1}{2}$
Real Private Consumption	5.4	5.3	$3\frac{1}{2}$	$2\frac{1}{4}$
Real Residential Investment	13.2	-2.6	$-3\frac{3}{4}$	-13
Household Debt to Disposable Income (%)	127.4	$134\frac{1}{2}$ *	$138\frac{1}{2}$	140
Consumer Price Inflation	1.6	2.7	$2\frac{3}{4}$	$2\frac{3}{4}$

CORPORATE DIVISION

NZL's Corporate Division is in good health. Business investment has picked up strongly in response to capacity constraints and firms are taking advantage of the high currency when making investment decisions (which has reduced the cost of equipment investment relative to labour). The Corporate Division is taking a more medium-term approach to investment and decision-making as a high currency is typically not cashflow positive in the near-term. Liquidity remains strong and balance sheets are in good shape.

Total returns on New Zealand equities are up 25 percent on a year ago, and returns have been around 9 percent per annum over the past decade. The key factors underpinning this performance are:

- *A strong economic performance:* real economic growth has averaged 4 percent per year for the past five years, which has buoyed corporate profitability;
- *An elongated expansion phase:* NZL is now more than 6 years into the current expansion phase, which is reminiscent of pre-1974 business cycles;
- *Benefits of the 1980s restructuring to accrue to the economy:* improving supply capacity is a slow process and it has taken considerable time for the benefits of reform to diffuse through the economy;

- *An improvement in capital productivity:* capital productivity has averaged 0.6 percent for the past decade, well up on -0.5 percent average recorded in the preceding decade. The return on the capital stock has risen from around 4 percent in the early 1990's to above 7 percent currently; and
- *A result-orientated corporate culture:* while difficult to quantify, NZL's senior managers highlight a more medium-term approach to decision-making and focus on productivity.

Going forward, the Corporate Division faces challenges. The economy is in the mature stage of the economic cycle and margins are under pressure as firms are facing rising cost-push pressure across a range of non-labour costs (energy, rents, rates and constructions costs). The composition of growth is rotating from capital to labour, as wages pick-up in response to employee shortages.

Sectors most vulnerable at this stage in the economic cycle include forestry and horticulture (high currency but low commodity prices); pockets of manufacturing that are facing competition from Asia and elements of the construction sector that may be vulnerable to adverse developments in the housing market.

Corporate Sector Accounts

Annual percent change, calendar year

	1996	Actual 2000	2004
Capital Productivity	0.5	0.6	0.6
Return on Capital Stock	7.0	6.4	7.7
Business Investment (3-year average)	15.5	2.6	9.9
Gearing Ratio: debt to assets (%)	24.8	28.1	28.3 *
Equity Returns (3-year average)	9.0	8.6	17.0
Equity Returns (decade average)	4.3	11.0	9.1

* 2003

GOVERNMENT DIVISION

NZL has a strong fiscal position and fiscal surpluses are becoming the norm rather than the exception. This is in contrast to overseas nations, where the majority of OECD governments fail to balance their books. Successive surpluses have been recorded over the past decade and net debt has declined from 37 to 11 percent of GDP over the same period. The Government Division reported a \$7.4 billion surplus in the 2004 fiscal year, and looks set to achieve a result of similar magnitude in 2005. Moreover, such a strong fiscal position is being driven by structural (i.e. fiscal prudence) rather than cyclical factors such as growth, which can quickly reverse.

NZL's strong fiscal position is placing the Government in the enviable position of being able to increase priority spending, partially pre-fund future costs associated with an aging population through the Super Fund, invest in core infrastructure, and yet continue to present a strong fiscal position.

Alternative options

Of course there are merits in alternative options. Tax cuts could provide stimulus to growth and further targeted spending could deliver incremental social benefits. Excessive surpluses may be considered an excessive tax on productive capacity. But a weaker fiscal position may be untenable given the high current account deficit and huge stock of overseas debt. With gross debt now below 25 percent of GDP, the incremental benefit to New Zealand's risk premium of paying off more debt is probably small and market failure in some key areas such as energy suggest that there is an appropriate role for Government involvement and investment.

Crown Financial Statements

June years

Operating Balance NZ\$(million)
- as a % of GDP
Net Crown Debt NZ\$(million)
- as a % of GDP
Issue of Conventional Bonds

* Budget 2005

Actual 2004	Forecast			
	2005	2006	2007	2008
7,400	5,900	6,700	5,300	3,900
5.3	3.9	4.3	3.3	2.3
15,200	11,500	10,200	10,600	12,500
10.8	7.7	6.6	6.6	7.4
2,200	2,200	2,200	2,800	2,800

The Government's approach

The Government's core approach is built around trying to deliver a degree of balance, which covers off all quadrants.

But looking at the big picture, there are two key issues the Government faces:

- *Additional investment in infrastructure is required.* Infrastructure deficits exist in roading and energy and if not addressed will act as bottlenecks to medium-term growth. Progress is being made, but the process appears slow, cumbersome and prone to political manoeuvring; and
- *The level of intervention that is appropriate.* Market failure suggests there is a role for Government in the delivery of some key services. Unfortunately, economic and political tradeoffs involved are inevitable. Currently, there is a bias towards social rather than economic policy issues.

Ultimately society will determine, via the ballot box, where the relative merits lie. But with the Fiscal Responsibility Act and Public Finance Act residing at the heart of the Government decision-making process, economic and political considerations can not be completely divorced from each other.

PRICES

Inflation has remained within the Policy Targets Agreement inflation target band of 1 to 3 percent in the current expansion phase. However, inflationary pressures are emerging. Tradable goods prices are increasing as the effects of the appreciating currency moderates and oil prices rise. Moreover, unions have been increasingly pressing for higher wages, causing NZL some difficulties and likely to prompt the CFO to engage in more extensive cost-cutting exercises.

A period of strong growth, beyond what is considered the country's potential, has put significant pressure on resources. The result has been growing price pressures as the economy's recent strong performance exposes capacity constraints. Skill shortages abound in the labour market and a dwindling labour supply are key factors limiting businesses' ability to expand. Capital is also in short supply, as evidenced by capacity utilisation near historical highs. Moreover, the major driver in this business cycle is the services sector which relies on labour as its major productive input. This is limiting the ability of firms to substitute capital for labour in some of the areas where constraints are most intense.

Capacity constraints

Capacity constraints are placing strong pressure on internal price structures. These are coming from two sources:

- **Demand-pull pressures.** Excess demand has allowed some sectors to push up costs; this is particularly evident for the property sector. Housing related activity, where demand is strongest, continues to underpin non-tradable inflation; and
- **Cost-push pressures.** Rising costs associated with wages, energy, rents, and rates are putting the squeeze on firms' margins, some of which have been absorbed. But domestic pricing pressures threaten to remain sticky, particularly with wage pressures mounting.

Inflation Gauges

Annual percent change, calendar year

	1995	Current	Outlook
Inflation Expectations *	2.6	2.9	↑
Consumers Price Index (excl interest) *	2.4	2.7	↑
PPI Outputs	0.6	2.6	↑
GDE Deflator	2.6	4.5	↔
Capacity Utilisation *	0.91	0.92	↔

* Percent

Input costs (as measured by producer prices) have picked up over 2004, revealing a degree of margin compression in recent quarters. For some sectors, strong demand – in excess of the sector's ability to supply – has allowed cost pressures to be passed on. But other sectors (for example retailing, manufacturing, and forestry) face strong competition from within New Zealand and abroad, providing little scope to pass on cost increases.

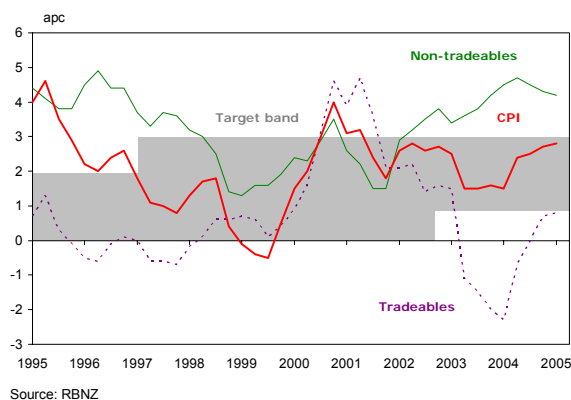
Wage pressures mounting

Wage demands have mounted in response to skill shortages and as employees seek to gain a greater share in the benefits of the economic expansion. But excessive wage settlements will come at a cost of lower employment growth and higher interest rates.

Currency influence

The strengthening New Zealand dollar has kept a lid on external price pressures, helping to contain headline inflation. However, domestic inflation is running above 4 percent. There is a risk that this becomes unmasked as the dampening influence of the currency's strength on tradeables inflation dissipates over 2005 and 2006.

Consumers price index



PEOPLE CAPITAL

People drive the success of NZL. Making New Zealand a great place to live and work will ensure the future prosperity of the company. NZL's standard of living has improved over the past half-a-century but at a slower pace than the workforce

of many of our competitors. The health of the workforce has improved as living standards rise and our roads have become somewhat safer. The lifestyle choices of the workforce have evolved over the last half-a-century.

Key Indicators of Social Conditions

<i>Economic Standard of Living</i>	1950	1960	1970	1980	1990	2000	Latest
Real Income per Capita (\$US)	17,028	19,598	19,730	19,797	13,798	12,620	21,634
OECD Ranking	3	7	14	19	19	20	21
Urbanisation Rate	73.2	76.7	81.5	83.8	85.5	85.7	85.8
Misery Index (Unemployment+CPI)	5.6	1.7	4.7	18.8	14.1	7.9	6.3
Population Density (Popn per km ²)	7.2	8.9	10.6	11.6	13.0	14.4	15.1
Number of Cars (per 1000 popn)	128	214	312	391	444	496	539
<i>Health</i>	1950	1960	1970	1980	1990	2000	Latest
Infant Mortality per 1000 Live Births	27.6	22.6	16.7	13.0	8.4	5.8	6.0
Life Expectancy (Male)	67.2	68.4	68.5	70.4	72.9	76.3	76.3
Life Expectancy (Female)	71.3	73.8	74.6	76.4	78.7	81.1	81.1
% of population aged 65+	9.2	8.6	8.5	9.6	11.0	11.8	12.0
Death Rate (per 1000 popn)	-	9.0	8.8	8.5	7.9	6.9	7.1
Suicide Rate (per 100,000)	7.5	8.6	9.2	10.8	13.1	11.9	12.3
No. of Doctors (per 1000 popn)	1.2	1.4	2.0	1.6	1.9	2.2	2.2
Smoking Rate (% of 15+ popn)	-	-	28.9	32.0	27.5	25.0	25.8
<i>Lifestyle</i>	1950	1960	1970	1980	1990	2000	Latest
Sex Ratio (males per 100 females)	100.9	101.0	99.9	99.2	97.3	96.3	96.8
Marriage Rate (per 1000 unmarried popn)	-	38.2	44.0	29.4	22.2	15.5	14.7
Voter Turnout %	89.1	89.8	88.9	91.4	85.2	84.8	77.0
Women Representation in Govt (%)	4	5	5	4	22	30	29
Divorce Rate	-	3.2	5.1	9.0	12.3	12.5	13.1
<i>Knowledge and Skills</i>	1950	1960	1970	1980	1990	2000	Latest
% Popn with a University Degree	-	-	-	-	8.0	12.5	14.8
<i>Safety</i>	1950	1960	1970	1980	1990	2000	Latest
Road Casualties (per 100,000 popn)	12.0	15.6	22.9	19.2	20.9	11.8	10.7
Murder Rate (per 100,000 popn)	-	-	1.2	1.3	1.6	1.5	1.2
Prisoners (per 1000 popn)	0.5	0.7	0.8	0.9	1.2	1.5	1.5

CASHFLOW STATEMENT

NZL's Achilles heel has been its lack of ability to fund required investments out of retained earnings and thus has a strong reliance on overseas funding. A current account deficit of \$9.4 billion (6.4 percent of GDP) was recorded in 2004. New Zealand has only recorded seven annual surpluses in the past half a century. Persistent current account deficits of around 5 percent of GDP have seen the ratio of net financial liabilities – the total debt burden – increase to 84.4 percent of GDP over the past decade.

NZL is reliant on global capital as it generates insufficient domestic savings to fund its investment. Offshore investors are typically happy to fund this savings shortfall provided they are adequately compensated – either through strong domestic growth or a high yield.

Current account deficits tend to register on global investors' radar screen only when they exceed 5 percent of GDP. Large deficits typically place downwards pressure on the currency because global investors demand higher yields to compensate for the additional risk. The former channel improves the performance of the export sector, while the latter moderates domestic spending and import demand. Eventually, balance is restored.

In some ways NZL's current account position is "special", particularly relative to the most often quoted other deficit - The USA Inc. In particular:

- *The size of inward flows.* Attracting US\$7 billion of capital each year for NZL is tiny compared to the US deficit, which requires in excess of US\$400 billion.

- *The stock of debt.* NZL's deficit largely reflects a high stock of debt. Typically, the net investment income deficit is around 5 percent of GDP and New Zealand records modest surpluses on the trade front as exports outpace imports. Ironically, when the economy performs well – and investors are receiving good returns (such as now) – the investment income deficit can increase, taking the current account deficit higher as well.
- *The fiscal position.* New Zealand's fiscal position is strong. There are frequent comments regarding The USA Inc.'s "twin deficits" as a major investment negative. In contrast, NZL's Government Division has been running persistent surpluses for 11 years, and this looks set to continue.

At what level the current account deficit will become a "funding" problem is an open debate. NZL does not seem to be there yet, although may soon be. The deficit is expected to approach 7 percent of GDP over the coming year as the high New Zealand dollar bites into the export sector, the domestic economy continues to underpin growth, and corporate profitability remains strong.

Eventually the current account deficit will necessitate a downward correction in the currency and investors will demand a higher risk premium. There is a limit to how long the economy can continue to borrow and spend its way to growth. With a high debt burden, eventually NZL will have to sell more to the rest of the world to avoid going bankrupt.

Balance of Payments

Percent of GDP, calendar year

	Actual		Forecast	
	2003	2004	2005	2006
Trade Balance	-0.5	-1.4	-1.5	-1.9
Services Balance	1.1	1.0	1.1	0.7
Net Investment Income Balance	-5.0	-6.1	-5.3	-5.3
Current Account Balance	-4.2	-6.4	-5.7	-6.4
Funded via Foreign Direct Investment *	4,211	3,683	-	-
Funded via Other *	2,822	12,584	-	-

* NZ\$(million) calendar year

BALANCE SHEET STRUCTURE

Household indebtedness has risen sharply in the past two decades increasing the sector's sensitivity to interest rate movements. Offsetting this vulnerability has been the improved quality of the Government, corporate, and rural balance sheets.

Credit growth remained strong in 2004 and into 2005. Private sector credit increased by 12.7 percent in the year to March: its strongest growth since October 1996.

Households' borrowing has been encouraged by the security offered by a strong labour market, the wealth effects associated with ongoing strength in the property market and under the influence of fixed rate mortgage discounting late last year. Intense competition in the mortgage market has encouraged a flurry of activity in NZL's residential property market, which has lingered through the first quarter of 2005. As such, a slowdown in household borrowing in the second half of 2004 was arrested in final quarter of 2004 and into 2005.

The household sector

Household borrowing has increased sharply over the past decade as individuals sought to take advantage of changes to the regulatory environment (which allowed greater access to credit). During this period, credit growth outstripped household income growth, leading to a steady increase in the household debt to income ratio – from below 60 percent in the early 1990's to around 135 percent by the close of 2004. A comparison with other developed countries indicates that deregulation of the finance sector has allowed New Zealand households a period of catch-up, but that debt-to-income levels are now at levels comparable to other developed countries.

This trend continued in 2004, encouraged by a very strong housing market. Household lending growth increased by 15.0 percent, similar to the rate recorded in 2003 (15.5 percent). From a fundamental perspective, a robust economy and strong labour market have encouraged households to continue borrowing. Household borrowing has also been accentuated by a number of other influences, including strong consumer confidence, historically

low interest rates, intense competition amongst lenders, banking product innovation, the wealth effect from a strong property market, and a greater take-up of relatively cheap funds secured against equity in a property. Residential property investment has been one of the drivers of mortgage growth, amidst rising expectations about capital gains, and apprehension towards other asset classes (including managed funds).

The net result is that credit growth once again outstripped nominal GDP (as a proxy for income) in 2004. However, there is a limit to how long this can continue both in terms of banks' lending limits and the servicing cost of higher debt levels – a lower interest rate environment notwithstanding.

Householders are heavily indebted

Much of the increase in household borrowing has been funded from abroad. During 2004, the banking sector's net international debt increased by \$10.8 billion to \$60.2 billion, to account for 63.7 percent of New Zealand's total net international debt.

The business sector

System-wide business lending picked-up as 2004 progressed in response to a pick-up in business investment. However, corporate balance sheets are not nearly as extended (or vulnerable) as the household sector.

Rural lending has increased sharply in recent years, but is set to slow as unique circumstances fade.

Credit growth anticipated to slow

Credit growth is expected to slow in 2005 and 2006 as interest rate increases gain traction. Many borrowers have been insulated from increases in interest rates as a result fixed-rate borrowing. At the close of 2004, 63 percent of mortgage lending was fixed for terms of up to two years. As fixed mortgages rates come up for renewal higher interest rates will start to bite into remaining disposable income.

Balance Sheets by Business Unit

Fiscal position

	Assessment
Government	Good
Rural	Sound
Corporate	Good
Household	Poor

RISK ASSESSMENT

NZL is a small open pastoral economy. Exports account for 32 percent of GDP and commodity exports account for 61 percent of total exports. Total imports and exports (a measure of openness) total 69 percent of GDP. Moreover, NZL has run a persistent current account deficit for the past thirty years. The nation's net stock of debt is 84.4 percent of GDP and total debt stands at 2.9 times exports.

Such a degree of openness gives New Zealand the benefits of globalisation (sourcing cheaper products) and specialisation associated with comparative advantage. Free-flowing capital has allowed consumers to optimise their balance sheets, albeit at heavily indebted levels. But this also makes NZL more vulnerable than most countries to adverse developments.

- New Zealand is heavily susceptible to adverse global growth developments and movements in commodity prices, particularly for pastoral related products.
- The nation is heavily reliant on offshore sentiment to fund both the flow (current account deficit) and existing stock of debt.

Assessment

Such indebtedness warrants an implicit risk premium in order to reward offshore investors for investing in a riskier asset. But the magnitude of this risk premium is not large relative to other nations. The spread between NZL's and The USA Inc.'s 10-year bond yields has averaged 1.3 percent for the past decade. The discount that New Zealand equities have traded

relative to offshore counterparts has closed. While a portion of this is cyclical, there also looks to be a structural component.

New Zealand's sovereign debt is rated high quality (AA+ with a stable outlook by Standard and Poor's and Aaa by Moody's). Rating agencies have repeatedly stressed the importance of prudent fiscal policy, a sound monetary framework, and free-floating capital markets in assessing the risk profile. On these three points, NZL scores highly.

Nonetheless, NZL is vulnerable to a potentially adverse external event or marked change in investor sentiment. A sharp turn in commodity prices – such as occurred during the Asian crisis – will materially dent growth prospects. The economy is susceptible to adverse oil price shifts. Geopolitical events could dampen growth of key trading partners. High levels of indebtedness and an extended housing market leave the household sector vulnerable to adverse interest rate developments. An outbreak of foot and mouth disease could undermine New Zealand's productive capacity, export performance, and growth. Moreover, NZL cannot continue to borrow and spend its way to growth indefinitely. The list of potential adverse events is ongoing and assigning a probability on any such event is problematic.

The key underlying message is that New Zealand's economic and institutional framework, which includes sound fiscal policy, a free-floating exchange rate with no capital controls, independent central bank, and flexible labour market represent mechanisms that will mitigate the consequences of any such event.

Risk Indicators

	2004
Exports (% of GDP)	29
Pastoral	8¼
Non-pastoral	13
Services	8
Net Financial Liabilities NZ\$(billion)	94.5
- % of GDP	64½
Serviceability (%) *	289
Household Debt NZ\$(billion)	114.2
- % of GDP	78
National Savings (% of GDP)	5½
Household saving	-5
Corporate saving	5½
Government Saving	5

*Net debt to exports

FINANCIAL POLICY

Measures to contain rising inflation pressures have been necessary following a prolonged period of strong growth that is placing increasing pressure on New Zealand's productive resources. The Official Cash Rate has been raised 175 basis points, to 6.75 percent, during the present monetary policy tightening phase in an effort to cool demand. "The current outlook offers little scope for an easing of policy in the foreseeable future." – Alan Bollard.

The CFO has responsibility to keep inflation within a 1 to 3 percent target band over the medium term. This medium term focus provides some flexibility to look through short-term fluctuations in inflation brought about by factors such as oil price shocks. Instead, the focus of monetary policy is more on the drivers of medium term inflationary pressure such as the output gap (the difference between the actual rate of growth and its potential) and on measures of capacity pressures.

Both of these factors have been brought into consideration following a prolonged period of growth beyond that which is considered New Zealand's potential (which sits around 3½ percent). Skill shortages abound and a limited labour supply is a key factor curtailing firms' ability to expand. Capacity utilisation is running near historical highs. Business

investment has picked up in response, but is taking time to filter through the economy. The OCR is at a moderately restrictive level, necessary to cool the economy sufficiently to give the supply side a chance to catch up with demand.

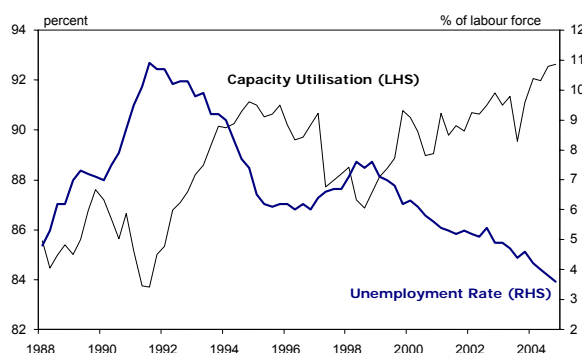
Assessment

Inflation is rising and looks set to remain at or above the top of the 1 to 3 percent policy band over the coming year as the economy continues to place pressure on capacity.

Inflation pressures dominate the outlook for the NZL. Excess demand pressures cannot continue indefinitely. This is sowing the seeds for a period of below-trend growth, which will allow the supply side of the economy to catch-up and alleviate capacity constraints.

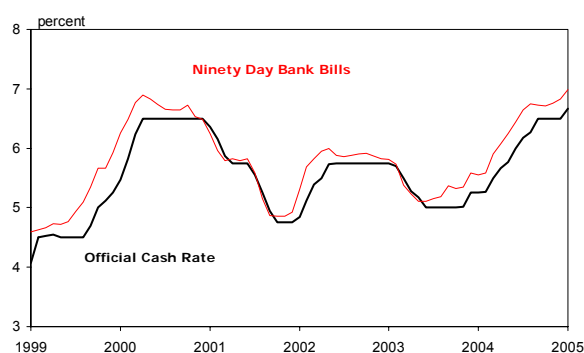
However, with the economy near a turning point, care needs to be taken to balance inflation risks against an economy at the mature stage of the business cycle.

Productive resources are feeling the squeeze



Source: Statistics New Zealand, NZIER

Interest rates are mildly restrictive



Source: Reuters

Backdrop for Firms' Accounts

Calendar year

	Actual		Estimate
	2003	2004	2005
Consumer Price Index (apc)	1.6	2.7	2.9
Ninety-Day Bank Bills (%)	5.3	6.7	6.9
Ten-year Bond Yield (%)	6.1	6.0	7.0
Private Sector Credit Growth (apc) *	9.2	12.6	8.5
Bank Tier 1 Capital Adequacy Ratio (apc) **	8.2	7.6	-

* Excluding Repurchase Agreements ** As at 31 March. Tier 1 comprises mainly shareholders' funds.

INVESTMENT RECOMMENDATIONS

It is probably fair to say that it is surprises, or the unexpected, that materially moves any market. Almost by definition whatever is broadly expected by most market participants is already priced in to the market. Over the past five years it is clear that there has been surprise after surprise in New Zealand on virtually every front and almost all of those surprises have been pleasant or positive surprises. It is remarkable how much things have changed in such a relatively short time.

In mid-2001 New Zealand was still suffering from a depressed currency and the share market had been largely tracking sideways since the Asian crisis several years earlier. In fact the gross index was still below where it had been prior to the Asian crisis. Since that low point the currency has surged 80 percent versus the US dollar and the share market has delivered about a 100 percent return. The key issues and questions for existing and prospective investors to understand and ask are: *“What has driven this remarkable turnaround and can it continue?”*

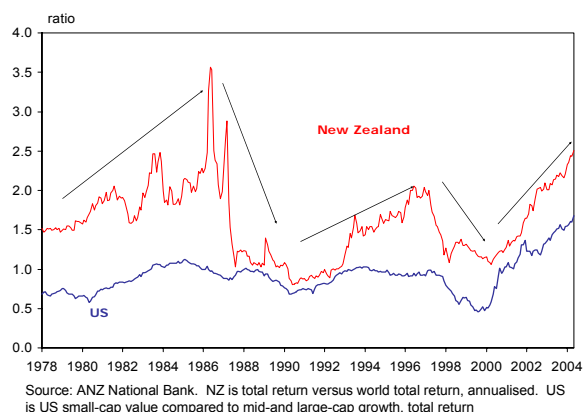
Key drivers

The apparent catalyst for this world beating performance appears to have been an almost ideal economic backdrop, as described earlier in this report. That has seen corporate profitability soar as capacity utilisation has risen, unemployment fall, confidence rise and inflation remain relatively subdued as the country has enjoyed its second longest post-war economic expansions. All this has been supported by what has been one of the most enduring commodity bull markets ever.

Both local and international investors have enjoyed the tail-wind provided by all these drivers. However, it is possible that a frequently overlooked characteristic of the New Zealand share market has also been augmenting these other drivers and that is the so-called “small cap” effect.

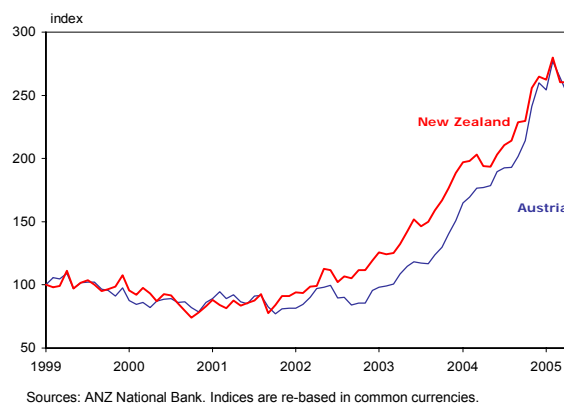
By any measure New Zealand is a small market and even its largest companies are small when global comparisons are made. It has been widely reported that international, particularly American, investors have sought out global opportunities over the past few years and one of the key characteristics that has been targeted has been size. Small cap was cheap a few years ago and international small cap was particularly cheap. Turning points for both New Zealand’s relative performance and the performance of smaller, “value” shares have been remarkably coincident.

The small-cap effect



An alternative “hint” is possibly provided by the truly remarkable correlation between the New Zealand gross index and the Austrian – **not Australian** – gross index over the last five years. Almost the only characteristic that these two markets share is size.

Austrian and New Zealand Total Returns



Current situation

As a result of the past few years’ performance New Zealand shares are now looking expensive on virtually any valuation metric, particularly when compared to their own history. It is possible that “it is different this time”, however, those five words are generally considered to be the most dangerous five words in investing.

New Zealand’s price earnings multiple (compared to the world, excluding Japan) is currently at historically high levels. Current levels have rarely been exceeded and have generally been followed by periods of stark underperformance.

As noted earlier this extreme position has been driven by an unusual confluence of positive surprises, corporate profitability and earnings. Unfortunately the element of surprise appears to be fading on this front as seen in the last quarter of 2004's results where downgrades have started to surpass upgrades. It is possible this "best of all possible worlds" has already been priced in and things will struggle to get even better!

Is there a property bubble?

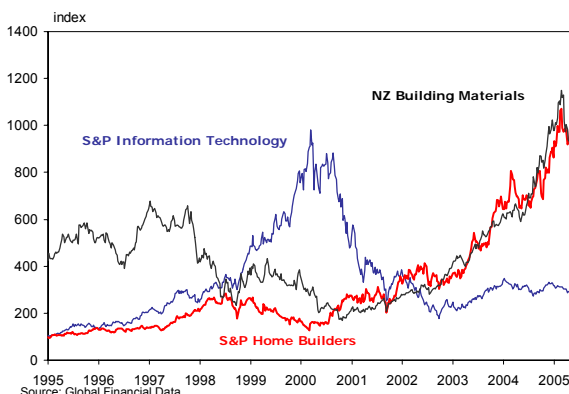
The only answer to this very broad question is "possibly, and only in some markets".

It is a gross over simplification to describe all property markets as teetering on the edge of collapse due to their recent appreciation. While it may well be true that some selected markets may be in this position, it is unlikely that property markets as a whole, globally or in New Zealand, are about to collapse.

Major bubbles of this nature, such as the tech wreck of the early 2000s, are thankfully quite rare. Unfortunately, since the world just witnessed the largest bubble ever, a cottage industry has sprung up looking for the next one and property is the easiest target.

However, the next bursting bubble may not be in property markets. It maybe in the much overlooked property related area of building and building related companies. The chart below shows the last ten years of US information technology stock price movements overlaid with the index of US home builders and New Zealand building materials index all on the same scale.

Wheres the next bubble coming from?



It is generally agreed that US information technology underwent an enormous bubble in the late nineties. Unfortunately for most participants, the "obvious" nature of this bubble only became apparent after it

burst. The magnitude of the last five years moves in the building and building materials indices bear an uncanny resemblance to what with hindsight was obviously a bubble. Property markets do not need to collapse for the underlying hopes (which have driven property related issues to such extremes) to be disappointed. Clearly this has implications both locally and globally.

Conclusions

No matter what hype may be presented after such a startling period of outstanding performance it must be remembered that NZL is still a small country that is heavily dependent upon commodity prices, and its share market is small, and it is made up of small companies. These characteristics have certainly helped drive the performance of the past few years.

Unfortunately, more positive surprises over the next few years for commodities, small cap stocks or the economy are likely to be less common. As such the current elevated position that the New Zealand share market enjoys, both in absolute terms and relative to international markets, is vulnerable.

From an international perspective the major cyclical opportunity is now largely, if not completely, passed. NZL may now be at the opposite extreme of where it was five years ago, having enjoyed the virtuous spiral of a rising share price (currency) and asset values.

These comments relate to the cyclical positioning of New Zealand where, in both shares and possibly property, the current cycle may be close to peaking. The longer-term, or secular, story may, however, be slightly different. Having already pointed out that considering things to be different this time is most dangerous there is a real possibility that one of the key drivers for New Zealand, commodity prices, may be just beginning a major secular reversal. For most of the last century prices for commodities have trended down versus those of manufactured goods, this most recent enduring bull market in commodities may be the start of this reversal. Nonetheless, even if a major new bull market has begun in commodities it will not travel up in a straight line.

Given this, the very long-term outlook for NZL may be better than many now consider, but over the shorter-term, with the possible exception of cash that now offers amongst the highest interest rates in the developed world, most investment assets in New Zealand appear close to fully valued.

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