



New Zealand Economic Update

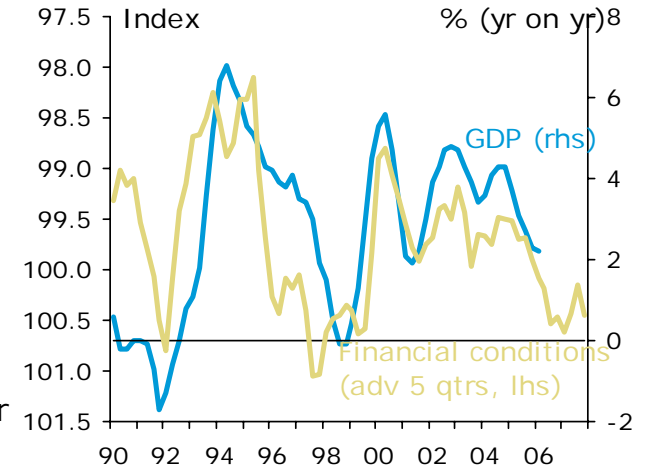
Executive Summary – New Zealand

- > **Partial indicators have surprised on the upside.** Employment growth surged in the June quarter with the unemployment rate falling back to 3.6 percent. While retail sales were soft in June, they still beat expectations of a modest decline.
- > **However, the composition of retail sales highlights the squeeze being placed on households.** Discretionary spending is now clearly the weakest component of retail spending, which we take as evidence of the belt-tightening being undertaken by households in response to rising costs, which are eroding purchasing power. There is also some evidence in trade data that the slowdown in domestic demand is filtering through to imports.
- > **Corporate earnings are under pressure** and this is forcing a strong focus on costs, which we eventually expect to extend into the labour market in 2007.
- > **We remain comfortable with our core economic view** that the economy is set for a period of sombre growth. The trough in the economic cycle is still looking elongated and pronounced, with subdued growth over the coming 2 years.
- > **We remain bullish on medium-term prospects and trend growth.**
- > **Inflation will remain the dominant theme for a while yet.** Cost-push pressures remain prevalent with the tight labour market accentuating pressure on unit labour costs. Tightness in the labour market implies it will take a sustained period of soft growth to alleviate capacity constraints.
- > **We have shifted our expectations for the easing cycle to start in June 2007.** The prolonged strength of recent data will accentuate the Reserve Bank's view that a material period of slower economic growth is required to keep inflation in check.
- > **We stand by our view that the easing cycle, when it comes, will be aggressive.** With the perceived neutral OCR residing around 5.75-6 percent, even a modest easing cycle implies NZ 2 and 3 year swaps offer value. However, given the Reserve Bank's desire to see policy traction across the swathe of fixed mortgages rolling off over the coming 6 months, a sizeable rally in rates is looking like an early 2007 story.
- > **The NZD is being supported, although we are not losing track of the big picture.** Low volatility, the perceived end to the Fed cycle, inversion of the US yield curve, and stronger domestic data is buoying the NZD courtesy of yield. These factors are a short-term phenomena. Global interest rates are rising. Our 12 month targets for the NZD/USD and NZD/AUD remain 0.53 and 0.75.

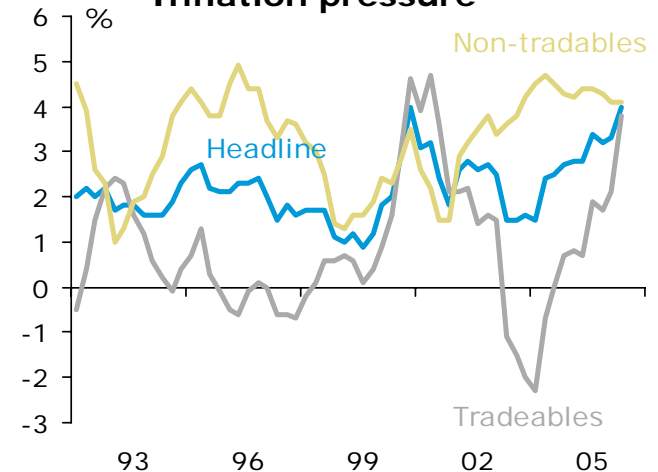
New Zealand Economy

- > **The growth outlook remains sombre.** Our economic forecasts incorporate a protracted period of subdued growth over the coming 2 years, as the mantle of growth passes from the domestic economy to the export sector.
- > **While partial indicators have surprised on the upside, the outlook is being counter-balanced** by tighter financial conditions, rising input costs (which are placing a squeeze on profits), and firm evidence consumers are cutting back on discretionary related spending.
- > **Consumer spending is set to continue moderating as imbalances in the economy are purged.** There has already been a marked slowdown in spending on consumer durables which is set to extend further as monetary policy continues to gain traction. Forty one percent of fixed-rate mortgage debt is set to roll-off in the coming twelve months, exposing a sizeable portion of borrowers to close to a 100 basis point jump in interest rates.
- > **The labour market is now key.** While the labour market is currently supporting incomes, the combination of slower growth, squeezed margins and unwinding of labour hoarding is expected to see the unemployment rate rise gradually over 2007.
- > **We are expecting growth to average 1½ percent in the coming 2 years.** Momentum is expected to recover from 2008 on the back of an export led recovery.
- > **While our growth prognosis is sombre, it is difficult to see a recession in NZ** given the strength of corporate balance sheets and solid global growth.
- > **We remain bullish towards medium-term prospects** with (real) potential growth marginally above 3 percent.

Financial conditions and GDP



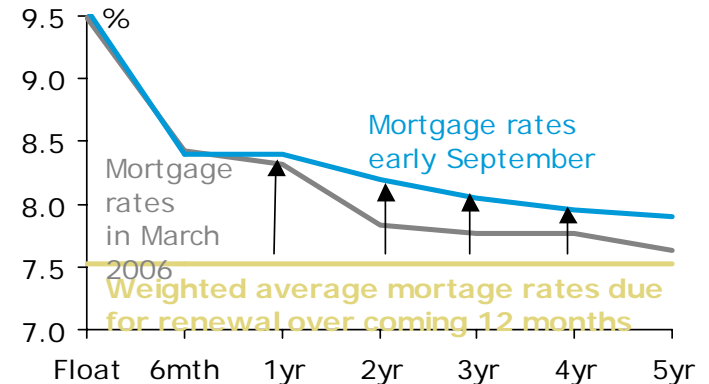
Inflation pressure



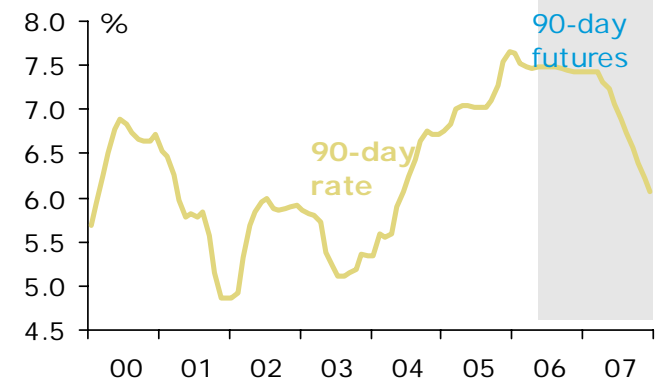
New Zealand Interest Rates

- > **Strong inflation pressure is putting the Reserve Bank in a bind.** Core inflation pressures remain persistent, and inflation expectations are on the rise. Recent declines in petrol prices should provide some relief, taking some of the heat out of headline inflation and helping to moderate inflation expectations.
- > **The Reserve Bank continues to place faith in the policy framework.** The Reserve Bank left the OCR unchanged at 7.25 percent at the July *Review* as expected, noting that they did not expect to have to hike rates further, and equally noting that *"it will be some time before an easing in the OCR can be considered"*.
- > **Key for the Reserve Bank is that the yield curve is now working in its favour,** with expectations for the easing cycle pushed out.
- > **We expect the Reserve Bank to maintain a steady course** in their September *Monetary Policy Statement*. A 21 c/litre fall in petrol pump prices in recent weeks should provide comfort to the Reserve Bank that the recent uptick in inflation expectations will be contained.
- > **Nonetheless, we have shifted our expectations for the easing cycle to begin in June 2007,** in light of persistent inflation pressures.
- > **Our core interest rate view is below the forward curve.** Our core strategic view remains that, once underway, the easing cycle will be aggressive with successive 25 bps cuts taking the OCR to 6 percent by December 2007.

Interest rate increases are in the pipeline



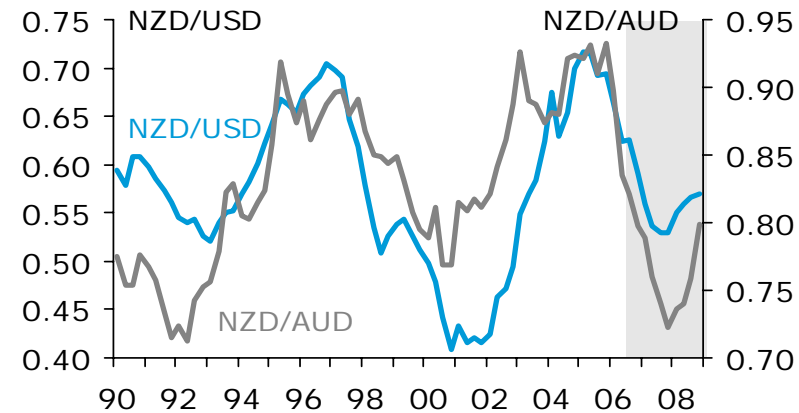
90-day rate vs futures



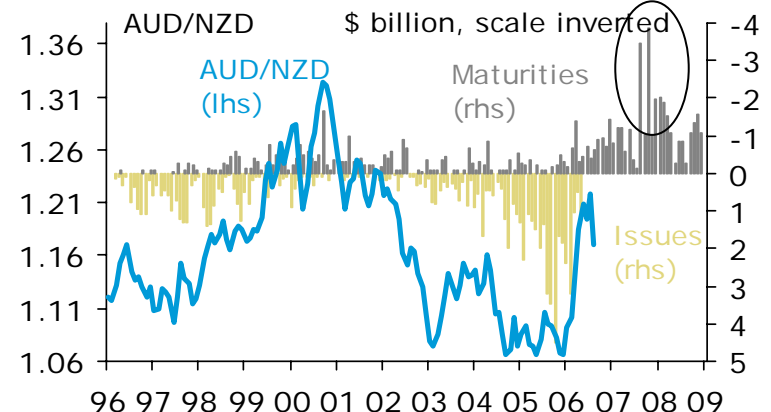
New Zealand Currency

- > **The NZD has found support**, courtesy of low volatility (which favours carry trades), a perceived end to the Fed tightening cycle, a rally in Japanese Government Bonds, and stronger than expected domestic data. This has brought New Zealand's yield attractiveness back into favour, particularly with the NZ-Aus 2 year swap back over 100 basis points.
- > **Yield support will not last indefinitely.** Volatility looks unsustainably low, and there is a large Eurokiwi and Uridashi maturity profile pending in 2007.
- > **At the time of writing, the NZ dollar was already reversing recent gains**, as some short-term support factors dissipated, and concern over NZ's massive current account deficit emerged.
- > **The big picture portends of pushes lower for the New Zealand dollar.** Statistically, the NZD is more strongly correlated with growth than yield, as such, signs of economic moderation are expected to continue to weigh on the NZ dollar. Yield is expected to continue to offer support, although there is a limit to how high NZ yields are likely to remain if we see a sustained run of soft data in a similar fashion to early 2006. We expect the bond / swaps market to rally in Q4, as soft data weighs, and the NZD to test lower over this timeframe. There is a swathe of Uridashi maturities from Q4 2006 and into 2007. Historically, the NZD has shown a strong tendency to both overshoot and undershoot, and we see this cycle as being no different.

NZD Exchange Rates



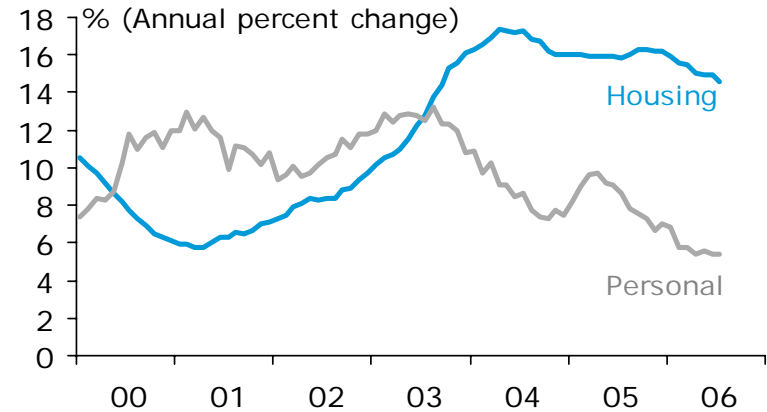
AUD/NZD and NZ Uridashi/Eurokiwi redemption profile



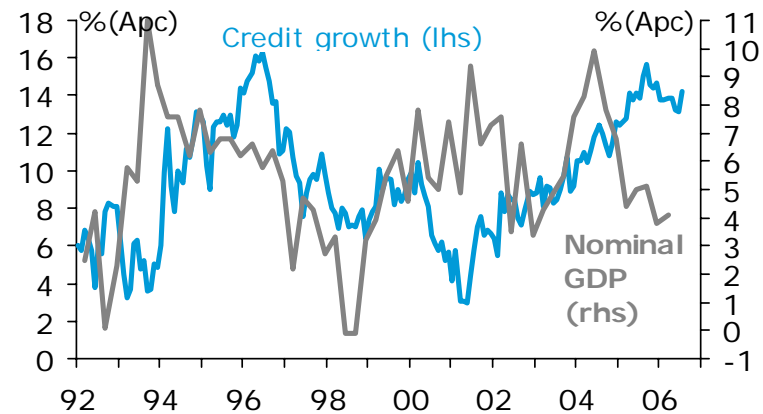
New Zealand Credit

- > **Credit growth remains buoyant.** Mortgage growth of 14.6 percent was recorded in the year to July. Personal borrowing is easing, as consumers consolidate outstanding debt. Business lending growth has come off its highs as investment slows, although the overall level of business lending growth remains strong at 12.5 percent for the year to July. A focus on business costs foreshadows further moderation. Rising farm values continue to drive strong rural lending of 15.4 percent for the year to July.
- > **We expect a more marked moderation in credit growth moving into the next bank financial year.** Slowing growth within the economy is expected to dampen appetites for debt. Consumer spending in particular is expected to consolidate. Household budgets are under pressure and affordability for first home-buyers has deteriorated. There has already been a marked slowdown in spending on consumer durables which is set to extend further as monetary policy continues to gain traction. Businesses are under margin pressure, which is eroding profitability. However, history (and the Australian experience over 2005) shows that credit growth can remain respectable in a slow growth environment.
- > **Non-bank financial institution growth** has been strong since 2001, although this has the potential to slow sharply given distress across various finance companies. At this stage we see no signs of systemic risk, and finance company difficulties look micro based.

Household credit growth

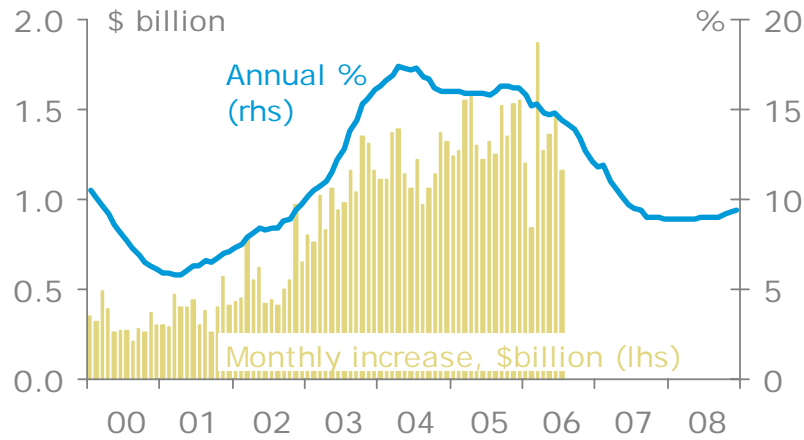


Credit growth and nominal GDP growth

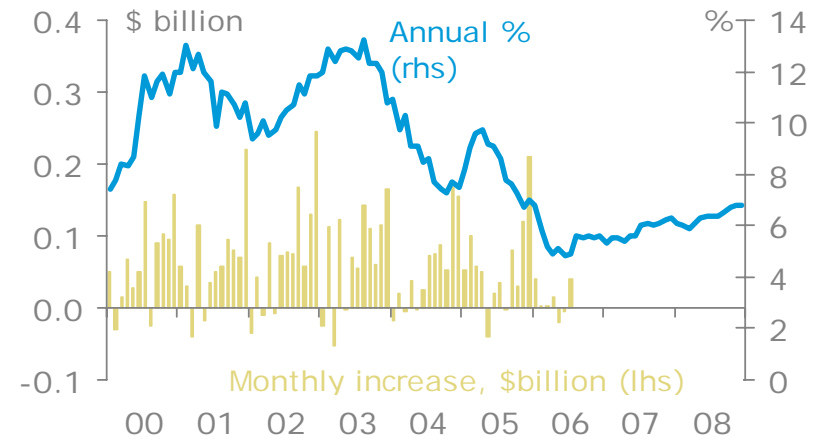


New Zealand Credit Charts

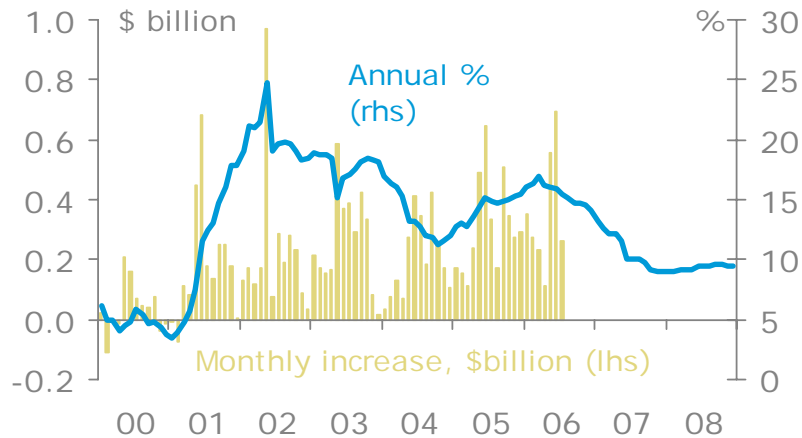
Housing credit



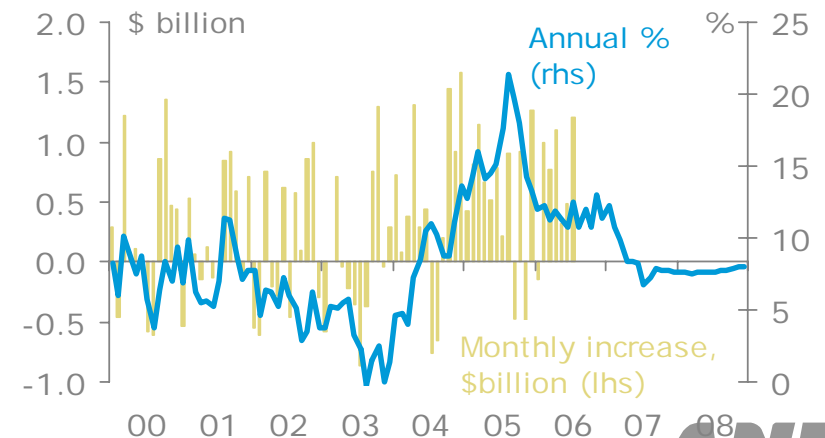
Personal credit



Rural credit



Business credit



Summary of Forecasts – New Zealand

September Years	2005	2006	2007	2008
GDP	2.7	1.7	1.3	2.6
Inflation	3.4	4.0	3.0	1.8
Unemployment (Sept qtr, s.a.)	3.7	3.7	4.3	4.7
Current Account (% GDP)	-8.5	-9.8	-8.7	-7.2
90 day bank bill (Sept month)	7.1	7.5	6.6	5.6
10 year bond rate (Sept month)	5.7	6.2	6.1	6.3
NZD/USD (Sept month)	0.69	0.61	0.53	0.57
NZD/AUD (Sept month)	0.91	0.80	0.74	0.77
AUD/NZD (Sept month)	1.10	1.25	1.36	1.30
Credit Growth	16.3	13.1	8.7	8.7
- Housing	16.1	13.9	9.0	9.0
- Business	18.0	12.9	8.5	8.4
- Other	7.4	5.5	6.0	6.5

Summary of Forecasts – Australia

September Years	2005	2006	2007	2008
GDP	2.3	2.9	2.8	2.9
Inflation	2.6	3.3	2.9	2.6
Unemployment	5.1	4.9	5.0	4.8
Cash rate	5.50	6.00	6.25	6.25
10 year bonds	5.4	6.0	6.3	6.1
A\$/US\$	0.76	0.76	0.72	0.74
Credit	13.4	14.5	11.9	10.0
- Housing	13.4	14.2	12.5	11.1
- Business	13.7	16.2	11.1	8.8
- Other	12.8	9.5	9.9	7.1

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