

AUSTRALIAN ECONOMICS

AUSTRALIAN FEDERAL BUDGET REPORT 2011-12

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A SMALL STEP IN THE RIGHT DIRECTION

SUMMARY

- The **underlying cash balance for 2011-12 has deteriorated** to \$22.6bn (1.5%) of GDP. This reflects the unfavourable combination of natural disasters and weaker economic growth.
- Despite this short-term deterioration, **the Government has preserved its planned return to surplus in 2012-13**. This has partly been achieved through automatic stabilisers (i.e. better economic growth). But discreet policy changes, via both cuts to spending and increased savings (largely tax increases) have played an important role.
- There are a number of positives in budget. There is a broad commitment to sound fiscal discipline and the economic assumptions seem reasonable.
- There is a focus on microeconomic reform, with the Government targeting the supply side of the economy via initiatives in education, skills training, infrastructure and participation. This is welcome. But, **apart from the increase in skilled labour, most programs that aim to raise labour supply are too small and too slow!**
- Budget surpluses of under 0.5% of GDP in the projection period are also disappointing. **There was nothing of note done to improve Australia's structural budget deficit**. The challenge over coming years will be to continue to improve the structural budget position in case the terms of trade weakens substantially.
- Overall, our assessment is that the Budget is not adding to demand in the economy, but nor is it doing enough to prevent inflationary pressures from rising. **We therefore do not think the stance of the Budget is sufficient to dissuade the RBA from further interest rate hikes in the months ahead.**
- The larger deficits in the short-term mean that **net debt is now expected to peak at 7.2% of GDP in 2011-12**. The Government maintained a commitment to keep the Commonwealth Government Securities market at around 12 to 14% of GDP.

FIGURE 1. KEY BUDGET AGGREGATES

	2010-11 (e)	2011-12 (f)	2012-13 (f)	2013-14 (f)	2014-15 (f)
Underlying cash balance					
AUD bn	-49.4	-22.6	3.5	3.7	5.8
% of GDP	-3.6	-1.5	0.2	0.2	0.3

Source: Budget Papers 2011-12

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ASSESSMENT

The Budget has many elements within it that should be commended and are, in our view, entirely appropriate measures and policies for the current economic environment. However, the Government has failed to undertake any truly significant economic reform. Given the opportunity that the first budget in a new parliament represents for 'politically difficult' decisions, we see this as a missed opportunity. The Australian Government budget will remain highly vulnerable to a downturn in the global economy and commodity prices, and meaningful progress on tax and welfare reform will have to wait for another parliament.

There are a number of positives in the budget.

- The Gillard Government has continued successive Australian Governments' **broad commitment to sound fiscal discipline**: the Government has remained true to a return to surplus in 2012-13 even with weaker than expected revenue growth and significant extra spending associated with recent natural disasters in the near term;
- A raft of **new spending measures worth about \$20bn over the projection period has almost entirely been offset by spending cuts**. Real spending growth is projected to average around 1% over the next five years, the lowest in four decades in any given five year period. That said, real spending jumped 12.7% in 2008-09 in response to the GFC, so some discipline on spending is a must.
- **The economic assumptions for 2011-12 appear reasonable**: growth rebounds from natural disaster related weakness in 2010-11 to 4% (though the farm sector assumption appears conservative); the economy continues to benefit from the terms of trade broadly remaining at exceptionally high levels; employment growth continues, pushing the unemployment rate slowly lower (the risk appears to be that unemployment could fall more quickly than forecast); and the inflation rate rises toward the top of the RBA's 2-3% target band, with wages growth 4-4.25% per annum. Investment spending dominates growth, driving a significant increase in imports and a widening in the current account deficit;
- **What distinguishes this budget is the extent of focus on microeconomic matters**. The Government is targeting the supply side of the economy with initiatives in education, skills training, infrastructure and participation. Some of these policies are likely to be more successful than others. Given an investment boom related surge in labour demand is getting underway right now we fear many of these participation measures will be too small and too slow. That said the increase in the skilled migration intake is a direct and immediate way to lift the effective labour force. The skilled migration intake will lift by 16,500 a year taking total skilled migration to just over 120,000 and we expect net migration number back towards 250,000 by 2011-12. This is still well below the pre-GFC peak of 315,000 but is up from the 2010 low of around 185,000.
- There has been some attempt to **tighten up on 'untargeted welfare'** through more stringent criteria for receiving benefits for some groups and increased means-testing on certain programs.

Some of the less favourable elements of the Budget.

- The markets and analysts will likely be **disappointed by the very small size of projected budget surpluses in the years beyond 2012-13**. Any minor disappointment on the economic assumptions and there will be no surplus whatsoever. With such small surpluses through the out years there is no prospect of building a meaningful net asset position for the Government over the medium-term without further policy change.
- The challenge over coming years will be to continue to **improve the structural position of Australia's fiscal accounts** in case the terms of trade weakens more substantially. Nothing of note was done on this and our early estimate has the structural budget deficit still at around \$35bn in 2012-13. The structural position was substantially weakened between 2004-05 and 2007-08, principally as the main benefits of the once in 150 year surge in the terms of trade were returned to the electorate in the form of tax cuts and middle-class welfare. This budget takes some useful steps in the right direction in spite of the Government's minority status, but is likely to be criticised for not going far enough. The fact remains that the Budget will remain vulnerable to a downturn in commodity prices for the foreseeable future;
- As noted, the programs aimed at raising labour supply in the economy, with the exception of the skilled migrant intake increase, are likely to be ineffective, essentially **too small and too slow!** The participation rate has increased significantly over the past two decades and in our view the next leg up will only come with meaningful reform of the tax/welfare system: something absent in this Budget and likely to be off the agenda for another term of Government.

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THE PATH BACK TO SURPLUS

At the outset, **it is worth noting that the Government's budget projections are only as good as the economic assumptions underpinning them.** Indeed, such slender projected surpluses from 2012-13 (of under 0.5% of GDP) could easily be wiped out/pushed up by changes in the underlying economic parameters; not just GDP, employment and inflation but also the A\$ and the terms of trade. Indeed, given the large relative price shifts currently occurring, it is the terms of trade, more than policy slippage/blow outs, that potentially pose the biggest risk to the budget bottom line over the next couple of years. **The Government's sensitivity analysis confirms that a 1% fall in nominal GDP as a result of permanently lower commodity prices, would wipe \$9.1bn off the Budget balance over two years.** Note that this is higher than the \$7.2bn that was estimated in the Government's sensitivity analysis at MYEFO. On the flipside, a higher terms of trade, above the Budget's relatively conservative forecasts (for 2011-12), would, all other things equal, also drive notably higher budget surpluses over the projection period. This is why it is important to focus on the structural budget surplus over time, to have a buffer for the next inevitable downturn in the terms of trade.

Given this context, it is important to note then that the **Government has used a combination of spending cuts and tax increases, rather than parameter changes, to preserve the planned return to surplus in 2012-13 (see Figure 2).** Parameter changes do still assist the return to surplus, mainly as payments slow and tax receipts start to recover as nominal GDP growth stays high.

But more importantly, the Government's policy decisions add about \$2bn to the surplus in 2012-13. This reflects both higher tax savings (ie. tax increases) as well as lower spending growth, with real spending expected to fall slightly, by 0.1% in that year.

FIGURE 2. RECONCILIATION OF GENERAL GOVERNMENT UNDERLYING CASH BALANCE ESTIMATES (A\$BN)

	2010-11 (e) \$bn	2011-12 (f) \$bn	2012-13 (f) \$bn	2013-14 (p) \$bn
Underlying Cash Balance (MYEFO 2010-11)	-41.5	-12.3	3.1	3.3
Parameter Variations	-6.0	-7.8	-1.6	-0.9
Receipts	-10.0	-5.6	-0.3	1.7
Payments	-4.0	2.2	1.3	2.6
No policy change underlying cash balance	-47.5	-20.1	1.5	2.4
Policy decisions	-1.9	-2.6	2.0	1.3
Receipts (a)	0.1	-0.4	2.0	1.9
Payments	2.0	2.2	0.1	0.6
Underlying Cash Balance (Budget May 2011)	-49.4	-22.6	3.5	3.7
% of GDP	-3.6	-1.5	0.2	0.2

Source: Treasury

In the short-term, the deterioration in the budget (ie. in 2010-11 and 2011-12) is due to both policy decisions (ie. increased payments) and unfavourable parameter variations (ie. a worse than expected economic environment). The policy decisions hurting the budget mainly appear due to natural disaster relief. On the revenue side, the biggest hit has been to tax receipts, which the Government attributes to weaker economic growth (again mainly due to natural disasters) as well as the stronger A\$ and larger than anticipated losses during the global financial crisis still weighing down capital gains and/or company tax receipts.

If we have one minor gripe, it is that real government spending growth rebounds from -0.1% in 2012-13 to +1.9% in 2013-14 (remaining at +1.9% in 2014-15). This is higher than the real spending growth of 1.6% in 2013-14 that was projected at MYEFO. That said, we would note that fresh policy decisions do not appear to have unduly added to this pick up in the growth rate of spending. Instead, it largely appears to reflect unfavourable parameter variations (including higher rates of indexation for government payments, including social security payments, because of higher wages and prices). Moreover, the Government is to be congratulated for keeping real spending growth at an average of 1% per year over the forward estimates (the lowest average growth rate for a five year period since the 1980s).

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FIGURE 3. REAL GOVERNMENT SPENDING GROWTH

	2010-11 (e)	2011-12 (f)	2012-13 (f)	2013-14 (p)	2014-15 (p)
Real payment growth	0.7	0.5	-0.1	1.9	1.9

Source: Treasury

THE ECONOMIC FORECASTS

- In broad terms, the **Budget economic forecasts for 2011-12 seem very credible**, with few major thematic differences to our forecasts. Investment spending drives growth in the economy, which also benefits from a recovery from natural disasters, while fiscal consolidation is an offset in the first two years of the budget forecasts.
- **The Treasury terms of trade forecasts for 2011-12 look to be conservative in comparison to our forecasts**, which is not altogether a bad thing - it is certainly better for the Budget to err on caution for such an important economic parameter. We expect the terms of trade to rise 11.5% in 2011-12, while Treasury forecasts a slight fall of 0.25%. As a result, the Treasury forecast for nominal GDP in 2011-12 of 6.25% also looks conservative against our forecast of 8.2%. In the out years, Treasury is working with the assumption of a 20% decline in the terms of trade over a 15 year period. There is a definite risk of this being overshot when the terms of trade actually turns, if historical norms are correct.

FIGURE 4. ECONOMIC OUTLOOK, GOVERNMENT VS ANZ

(% annual change)	2010-11(e)		2011-12 (f)		2012-13 (f)		2013-14 (p)		2014-15 (p)	
	Budget	ANZ	Budget	ANZ	Budget	ANZ	Budget	ANZ	Budget	ANZ
Real GDP	2.25	2.0	4.00	2.5	3.75	4.3	3.00	4.0	3.00	3.6
Nominal GDP	8.00	8.0	6.25	8.2	5.75	7.3	5.25	5.9	5.25	3.8
Headline Inflation*	3.25	3.1	2.75	2.8	3.00	3.1	2.50	3.0	2.50	2.7
Employment Growth	2.75	3.0	1.75	2.3	1.75	2.5	1.50	2.3	1.50	1.9
Unemployment Rate**	5.00	4.8	4.75	4.5	4.50	4.6	5.00	4.9	5.00	4.9
Terms of Trade	19.25	20.1	-0.25	11.5	-3.00	-1.2	-0.75	-4.4	-0.75	0.0
Trade Weighted Index^	78.0	74.3	78.0	76.8	78.0	71.3	-0.9% ¹	66.4	-0.9% ¹	66.4

*Year end June quarter, ^annual average level

** Average June quarter

¹Implied decline in the real exchange rate

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- The **Treasury uses the technical assumption of the TWI remaining constant in the first two years**, and beyond that has introduced a new technical assumption that the exchange rate varies in line with its long-term historical relationship with the terms of trade, for internal consistency. In the projection period, this implies a 0.9% decline in the real exchange rate each year over 15 years. Again this assumption could well prove conservative and the negative impact on GDP due to an elevated currency may be less than expected.
- The **Government's labour market forecasts imply only a slow further fall in the unemployment rate**, where ANZ is expecting a quicker decline. If we are correct, the risk is somewhat greater pressure on wages.
- While the areas noted above give scope for upward revisions to the budget deficit/surplus track, **we see a key risk to the budget forecasts to be in real GDP for 2011-12**. We forecast real GDP in Q1 2011 to be negative, predominantly due to the impact of the Queensland floods. This restrains our 2011-12 forecast for real GDP to 2.5%.

KEY POLICY MEASURES

- After initially warning that the Budget would be tough and welfare recipients would be hit hardest, **the Treasurer delivered a mixed package of modest measures** arguing that the Government was aiming to share the benefits of the mining boom.
- With multi-billion dollar spending announcements on education, health and the regions, there were strong influences from the independent MPs and the Greens, with this being the first Budget of a minority Government.
- Flood recovery spending of \$6.6bn, was previously flagged with assistance to individuals and local governments of around \$1.3bn. Around a third of this was paid for by a temporary flood levy and the rest from delaying infrastructure projects or cutting climate change programs, including the carbon capture and storage program.
- Mr Swan announced a total package of \$2bn for **health**, including mental health, although around \$500m falls outside the four years forward estimates area. Regional health projects were prioritised.
- The training and vocational education budgets were lifted, with a range of small measures aiming to lift workforce participation amongst single parents, jobless families, the young, old and disabled and very long-term unemployed.
- **High income earners were targeted** in the welfare cutbacks, for example with the Low Income Tax Offset for unearned income (eg. trust fund distributions) for minors, cutting FBT benefits for cars, ending the Dependent Spouse Tax Offset and Family Tax Benefits indexation paused for two years.
- But **other welfare areas were generously increased**, including Family Tax Benefit A for families with older teenagers (\$772m) and a bringing forward of the Low Income Tax Offset for low income earners (\$1.25m). Pensioners as expected were delivered free TV set top boxes, the ability to earn \$125 a week extra without threatening the pension, and there was extra money for World War II and Korean prisoners of war.

- The **public service** efficiency dividend target savings of \$1 and \$2.46bn are to be drawn from the Defence budget.
- **Infrastructure Australia** will be given a broader role. Tax provisions have been introduced to give incentives to private sector investors by ensuring tax losses on infrastructure projects can be accessed at the early stages of a project and regardless of changes of ownership.
- Despite the rumours there was no change to negative gearing on investor-owned housing, the child care tax rebate or medical health research, although funding to the more general research program was reduced.
- The Government will face a more difficult than usual task in getting its contentious measures through Parliament, with support from either the Opposition or a combination of Independents and Greens needed on all measures. Where the Greens and the Opposition agree not to endorse cuts to welfare or other measures such as the Fringe Benefits Tax cuts, these will undo the Government's planned savings. The Government has still not been able to get its 2009 proposal to means test the Private Health Insurance Rebate through parliament. Failure to pass this policy would eliminate just under \$2bn in planned savings.

FIGURE 5. MAJOR TAX SAVINGS MEASURES

Measure	Description	Cost over five years to 2014-15 (\$bn)
Reform Family payments to reduce eligibility and indexing	Pause indexation and put upper limits on age of dependents that fall under the FTB A	2.0
Temporary flood and cyclone reconstruction levy	Flagged in the January floods rebuilding package	1.7
Defence - increased efficiencies	Defence Department savings, reduced supplier costs and a net reduction in 1000 civilian workers over the 2011-12 to 2013-14 period	1.2
Public sector efficiency dividend	Reduce the level of funding provided to the public sector	1.1
Reform the car fringe benefits tax rules	20% flat rate for valuing the FBT on cars	1.0
Defer infrastructure projects	Flagged in the January floods rebuilding package	0.9
Phase out the dependent spouse tax offset	To be phased out for people under 40 except for invalid dependent spouses	0.8
Remove minor's eligibility for low income tax offset	Minors will no longer be able to use the low income tax offset to reduce income tax due on their non-work income, such as that from dividends, interest or rent	0.7
Medicare Benefits Schedule - pathology services	In line with the Pathology Funding Agreement which reduces Government outlays	0.4
Abolish Entrepreneurs' Tax Offset	Deterrent for small businesses to grow. Policy is too complex and poorly targeted	0.4

Source: Budget Paper No.2

FIGURE 6. MAJOR EXPENDITURE MEASURES

Measure	Description	Cost over five years to 2014-15 (\$bn)
Defence operations	Various	1.5
Natural disaster rebuilding	Assistance to individuals and local governments affected by the floods and cyclone Yasi	1.3
Low income tax offset - bring forward	Increase the proportion of the low income tax offset that is delivered through workers' week-to-week pay packets from 50% to 70%	1.3
Migration program	The Skill Stream planning level has increased by 12,000 places and the Family Stream has increased by 4,050 places on the 2010-11 program planning levels.	1.0
Mental Health Boost	Range of measures	0.9
Increase FTB A for families with older teen children	Increase in maximum rate of Family Tax Benefit Part A for 16-19 year olds by \$160 per fortnight to align with the 13-15 year old rate if the teenager is in full-time study	0.8
Rewards for great teachers	Top 10% of high performing teachers to receive bonuses of up to 10% of salary	0.4
Tax write-off for small business purchasing vehicles	Instant tax write-off of the first \$5,000 of any motor vehicle purchased from 2012-13	0.4
Help for students with disabilities and a better start for children with disabilities	\$200 million for schools and teachers and \$147 million for early intervention services grants for families	0.3
Digital television switchover	Recipients of the maximum aged, disability, carer or veteran pension to receive a high-definition digital set-top box	0.3
National school Chaplaincy Program - extension	Additional funding for up to 1,000 additional schools in disadvantaged, regional or remote areas	0.2

Source: Budget Paper No.2

IMPLICATIONS FOR THE BOND MARKET

The most interesting aspect of the Budget for debt markets was a discussion around the future size and operation of the market for Commonwealth Government Securities (CGS). The government took advice from a panel of financial market participants and regulators, and **agreed on a commitment to keep a deep and liquid bond market at around current levels of 12-14% of GDP** despite forecast surpluses in coming years. **The Government will need legislative changes to allow this higher level of issuance.**

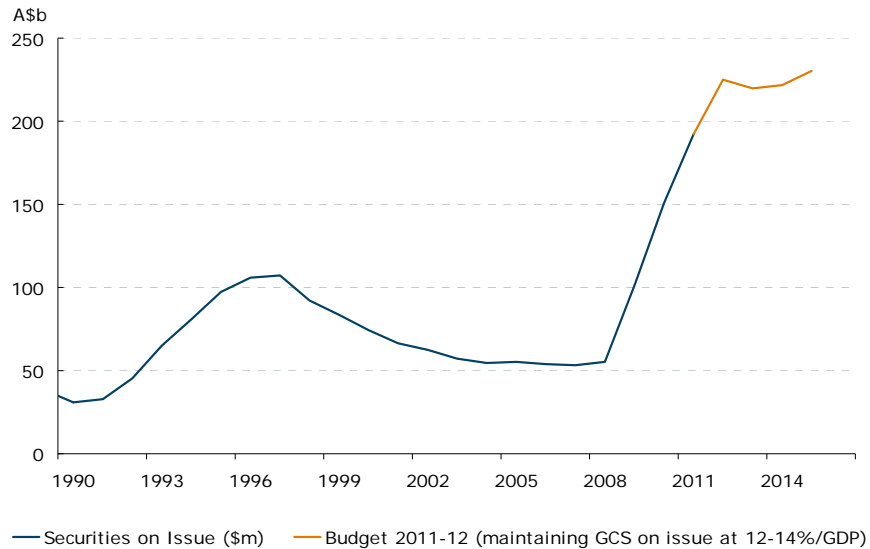
The aim of maintaining a market "of sufficient size" is to address the challenges of the new global liquidity standards for banks under the Basel III regime and to support the futures market. The discussion notes an increase in passive investors in Australian bonds, an increased allocation to Australia of official foreign exchange portfolios and larger holdings of government bonds that "will have significant implications for liquidity" in the CGS market.

The Government has flagged that in order to maintain the size of the bond market it will eventually begin to "accumulate financial assets." These are expected to be held in highly liquid assets.

The face value of total stock of Commonwealth Government Securities on issue is expected to be A\$192bn as the end of FY2010-11 with A\$33bn of net issuance expected over the next financial year to put total CGS on issue around A\$225bn at the end of FY2011-12. Treasury bond issuance is expected to be around A\$51bn next year. The commitment to see the market remain around 12-14% of GDP should see bonds on issue hold roughly around this level or even edge slightly higher as GDP grows.

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FIGURE 7. COMMONWEALTH SECURITIES ON ISSUE



Sources: AOFM, Budget Papers, ANZ

Net debt is expected to peak at 7.2% of GDP in 2011-12 before dropping to 5.8% over the forward estimates. Although slightly worse than we previously expected. This is an impressive level by international standards and supports the clear AAA credit profile of the Australian Government.

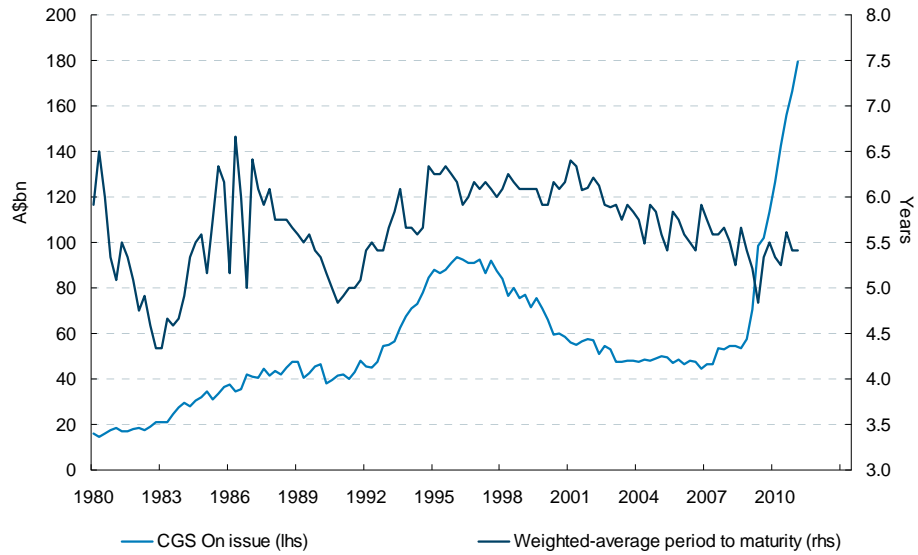
There has also been a very welcome and explicit commitment to see the market for inflation-linked bonds grow over coming years. New issuance is projected at a modest A\$2bn over the coming year to take total issuance towards \$16bn. The Government will support an increase in indexed bonds towards 10-15% of the total bond market. This would put this market on course to grow towards something in the A\$25-35bn range over coming years.

The Government also commits to lengthen the CGS yield curve incrementally, in a manner consistent with prudent sovereign debt management and market demand. A higher proportion of indexed bonds and a mild reduction in T-Notes on issue would serve to lengthen the average duration of CGS on issue. T-Notes on issue will not fall below A\$10bn. The current weighted-average maturity of CGS is 5.4 years while the average since 1980 has been nearer to 5.7 (see Figure 8 below).

Even with this discussion, it is still not clear if there will be sufficient A\$ government bonds on issue to ensure liquidity heading into the new Basel III accords that are due to be fully implemented from 2015, especially if a strong A\$ continues to underpin offshore demand for bonds. Overseas ownership of CGS is already above 80% according to RBA data.

The AOFM clearly has a good deal of flexibility over the composition of debt considering this new framework. These are our rough estimates of the possible composition of the bond market in coming years based on the factors discussed above.

FIGURE 8. COMMONWEALTH SECURITIES ON ISSUE AND DURATION



Sources: RBA, ANZ

FIGURE 9. COMMONWEALTH SECURITIES OUTSTANDING

End period, AUD bn	2008- 09	2009- 10	2010- 11	2011- 12	2012- 13	2013- 14	2014- 15
AUD Benchmark CGS	78	125	161	194	190	192	192
T-Notes	17	11	17	15	11	10	10
Indexed Bonds	6	11	14	16	19	23	28
Total CGS Outstanding	101	147	192	225	220	225	230

Sources: AOFM, Budget Papers, ANZ

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