ANZ Pacific Quarterly

Treading in uncharted territory

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Authors:

Amy Auster
Head of Foreign Exchange and International Economics Research
+61 3 9273 5417
Amy.Auster@anz.com

Jasmine Robinson
Senior Economist, Foreign Exchange and International Economics Research
+61 3 9273 6289
Jasmine.Robinson@anz.com

Our Vision:

For Economics & Markets Research to be the most respected, sought-after and commercially valued source of economics and markets research and information on Australia, New Zealand, the Pacific and Asia.

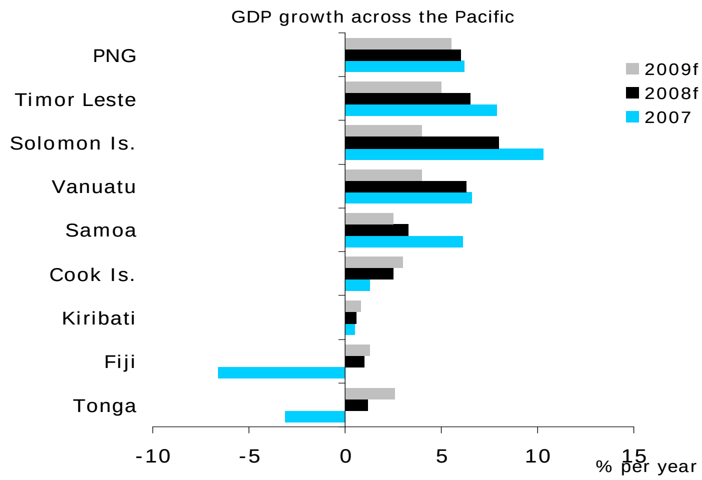
The global credit crunch which unravelled more than a year ago has, in the past quarter, developed into a crisis of "tsunami" proportions, sending global equity markets into a tailspin as financial institutions are hastily bailed out, central banks continue to inject liquidity and governments propose fiscal stimulus measures amidst mounting recession fears. Over the past few months, we have seen several financial institutions nationalised, privately acquired or fail across the US and Europe.

Across the Pacific, relatively underdeveloped capital markets and the presence of well-capitalised banks have helped to insulate the region. However, the real economy is not expected to be immune to the strains in financial markets. While the impact may not yet be apparent, the next 12-18 months will present challenges for the Pacific as the global economic downturn becomes more pronounced. The developed economies are now likely to post their lowest growth since 1982 while emerging Asia is set to record its slowest rate of expansion since 2003. Key areas of impact:

- Fiscal revenues are likely to be adversely affected by the decline in commodity prices, particularly for resource-based economies.
- Inflation, however, should ease as both food and fuel prices soften.
- Investment could be held back as investors postpone projects given uncertainty in financial markets and elevated borrowing costs.
- Value of offshore investments is likely to be eroded by a weak global equity market performance.
- Tourism is likely to take a hit as the outlook for the economies of traditional markets, Australia and New Zealand, are downgraded and their respective currencies remain under pressure.
- Remittances could slow as the economic downturn presents fewer opportunities offshore.
- Balance of payments pressures could re-emerge with current account deficits staying large.

Consequently, we have downgraded some of our forecasts for the Pacific. A mild upturn is forecast for Fiji and Tonga in 2009 as domestic demand picks up from a sluggish base.

Economic performance across the Pacific



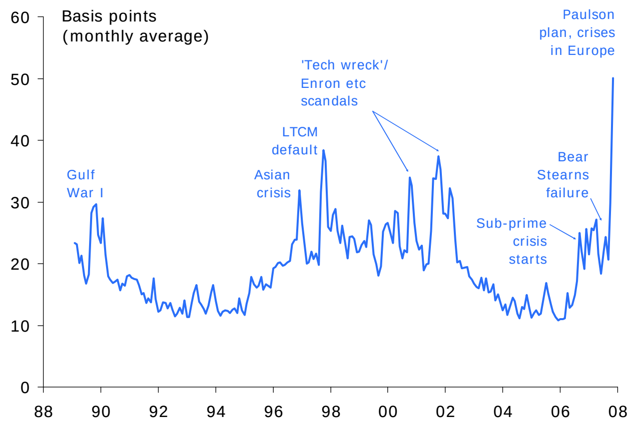
Sources: Asian Development Bank, ANZ Economics & Markets Research

Global economic forecasts downgraded

Global stocks have tumbled, with the equity markets off some 35-50% from their peaks in 2007 such that investors have lost about US$25 trillion or more than 40% of global GDP since October 2007. Risk premium, as proxied by the VIX index of US stock market volatility, is close to an 18-year high. Despite coordinated central bank action to boost liquidity, credit conditions remain tight with short-term interbank spreads staying wide. Thus far, more than US$960 bn in credit losses and write-downs have been incurred globally since the beginning of the credit crunch in July 2007, leading to more than 160,000 jobs having been shed. Capital raisings have jumped to US$820 bn, with a spike seen more recently following government injections.

Stresses in financial markets remain elevated

'VIX' index of implied volatility of the US S&P 500 share index



Sources: US Federal Reserve; Datastream; ANZ Economics & Markets Research

Fiscal and monetary policy expectations across the US and Europe have re-aligned to the prospect of a downturn in growth and an easing in inflation pressure. Central banks have begun lowering interest rates aggressively with further cuts expected over the coming months. Governments have stepped in with bank bail-out packages, wholesale funding guarantees in a bid to activate lending and retail and business deposit guarantees to prevent runs on banks. The recent G20 meeting of central bankers and finance ministers point to governments announcing fiscal stimulus measures in the months ahead with China leading with a US$586 bn package. As far as we can tell, China is only the second country after Australia to have announced a surge in government expenditure to counter slowing growth but other governments should follow.

Over in Australia, the Reserve Bank of Australia, in pre-emptive moves, slashed its policy rate by 200 bps since September, bringing the cash rate to 5.25% and further cuts are anticipated, with our forecast for the cash rate to trough at 4.5% by mid-2009. The government has introduced a A$10.4 bn package aimed at stimulating consumer spending, and further measures to support industry and separately, announced deposit guarantees. In New Zealand, deposit guarantees have also been announced by the government and the central bank is expected to persist with monetary easing with the economy clearly in recession.

These actions are not expected to kick-start the global economy anytime soon but are hoped to stem the financial crisis and prevent a deep recession, with a protracted slowdown the most likely outcome. We have downgraded our world growth forecast given the deterioration in labour market conditions, slowdown in credit activity and consumer and business confidence at an all-time low. We now expect world growth to fall to around 2.5% in 2009, for the first time since 2002. The G7 economies are poised to register their slowest rate of expansion since 1982 while emerging Asia is likely to post growth of less than 7%, the lowest rate since 2003, with China's growth expected to slow to 8% in 2009. Economic growth in both Australia and New Zealand are set to stay below trend over the next 12-18 months, with Australian real GDP growth moderating to less than 2% in 2009 and the New Zealand economy expanding by less than 1%.

Banks operating in the Pacific are well capitalised and Australian banks, which dominate the financial industry, are "AA" rated by Standard & Poor's, highlighting stability in the financial system. Nevertheless, the real economy across the Pacific will begin to feel the impact of the global economic downturn in coming months.

Fiscal revenues likely to be hit

Economies which are reliant on resource revenues to finance fiscal expenditure are likely to be adversely affected by the decline in commodity prices which, we expect, has further to run on the downside. Commodity prices are already responding to the slowdown in global growth and a recessionary environment in the developed world with most prices down sharply from their peaks.

Oil, in particular, has dropped significantly with WTI oil now down by more than half from its peak of US$147/bbl in July. Base metal prices, in particular copper, have tumbled on concerns over demand and improving supplies. Gold has come off its peak earlier in the year with US dollar strength, lower physical demand for the precious metal and more recently, reduced safe-haven flows leading to a sell-off but risk aversion could trigger short-term rallies. Resource-based economies, like PNG and Timor Leste, which have in recent years benefited from the record-high oil price are likely to see revenues dragged down by the projected commodity price decline as lower commodity prices translate into lower tax receipts and royalties.

Commodity price forecasts, end of period

	2008	2009	2010
Oil (WTI US$/bbl)	50	45	62
Copper (US$/t)	3,197	3,417	4,409
Gold (US$/oz)	690	690	750

Sources: Datastream, ANZ Economics & Markets Research

Nevertheless, solid revenue growth during the commodities boom has provided these economies with a buffer against tough times ahead. PNG has recorded fiscal surpluses over the past few years, thanks to windfall revenue and expenditure restraint. Minerals payments to the government have risen from PGK270 mn in 2002 to PGK2.23 bn last year, or 12% of GDP, placing PNG in a good position to adopt counter-cyclical fiscal measures to boost economic activity if required. In Timor Leste, the Petroleum Fund has chalked up some US$3.7 bn as at September 2008 with higher-than-expected oil prices lifting receipts beyond expectations. The current budget was stepped up to US$788.3 mn, substantially higher than the US$347.7 mn planned in the original budget but scope for a similar stimulus is limited by the potential slowdown in oil-related revenue growth in 2009. Elsewhere, recurring fiscal deficits in Fiji and Vanuatu, for instance, make it difficult for governments to implement fiscal stimulus packages. Instead, this will be a time of consolidation as expenditure is trimmed in light of the potential decline in revenue resulting from a slowdown in economic activity. It also represents an opportunity to streamline tax systems in order to enhance future revenue collection.

Private sector investment could be postponed

With limited scope for sizeable public sector development expenditure in the case of most Pacific island economies, the focus shifts to private enterprise. Private sector investment holds the key for sustainable economic expansion at a faster pace over the medium term. Nevertheless, elevated borrowing costs in offshore markets are likely to impact investment decisions with the risk that new projects, in particular, could be shelved or scaled back till the global capital raising environment improves.

For the mining and petroleum resources sector, the impact of the current financial turmoil on investment in exploration and development is less clear given the expectation of a global economic recovery post 2009 and the long-lead times for these projects. While hard commodity prices have come off their peak, they are still expected to remain relatively high and above levels reached just five years ago. Nevertheless, these are large-scale investments and financing pressures could emerge. Likewise, while sectors such as information, communications and telecommunications, commercial agriculture and tourism offer good growth potential, funding concerns could lead to some projects being postponed.

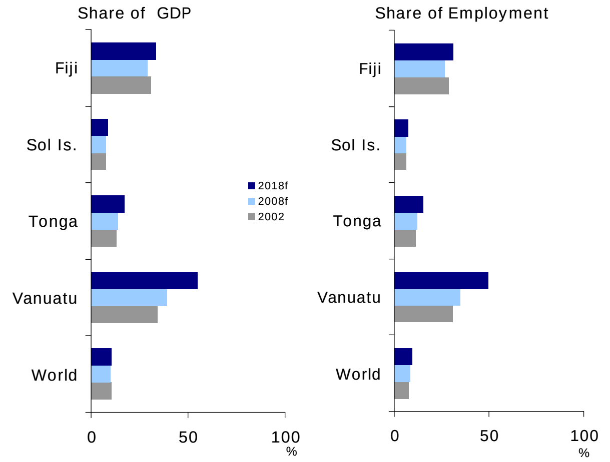
Value of offshore investments eroded

Depending on the asset mix and whether it is held onshore or offshore, the market value of official funds, be it resource-generated or superannuation funds, could be under pressure. Some Pacific island countries, like Fiji, Vanuatu and Samoa, have invested superannuation funds largely in domestic assets and are thus less exposed to the rout in global equity markets but will likely be impacted by the easing in domestic economic growth. According to the ADB, the Solomon Islands National Provident Fund holds up to 30% of assets offshore with about half of that held in cash. In PNG, net assets in the two largest superannuation funds are estimated to have collectively declined by more than 10% since September although they are still much higher than at end-2006. Others, such as Kiribati, Palau and Tuvalu have invested a large share of their trust funds in global equities, and have seen the market value of their portfolio heavily reduced over the past year. Timor Leste, on the other hand, has invested petroleum-related receipts solely in US Treasuries and so have been left largely insulated from the dislocation in financial markets.

Potential for lower visitor numbers

According to the World Travel and Tourism Council, the tourism industry accounts for a fifth of GDP and employment in the Pacific. This is well above the world average of 10% of GDP and 8.3% of total workforce. Separate estimates suggest that the tourism sector currently accounts for 55% of GDP in the Cook Islands. Vanuatu is another tourism-dependent economy with this industry expected to account for more than half of GDP in a decade.

Tourism: focal point of the economy



Source: World Travel and Tourism Council

While there is vast scope to develop the tourism sector, the next couple of years are likely to be difficult for the industry as traditional markets such as Australia and New Zealand enter a period of weak growth. For most Pacific markets, Australia and New Zealand collectively account for more than half of the total visitor traffic. These currencies have also been under pressure and have also weakened against Pacific Island currencies. In addition, high-end travellers who have experienced a significant reduction in financial wealth may also re-consider holiday plans. Scope to diversify into Asia will also be more difficult as the region consolidates. In addition, the expanding budget travel market in Asia offers a more attractive option as a holiday destination during these challenging times.

Remittances may slow

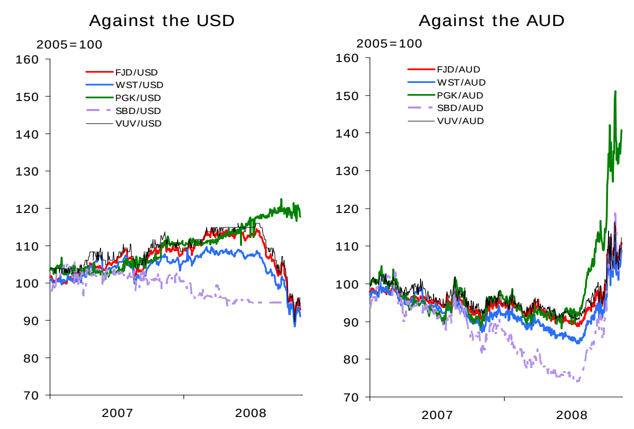
Remittances have been a prominent source of income and foreign exchange in the Pacific region, supported by the substantial migration of residents to other countries such as Australia, New Zealand and North America. In Tonga, remittances totalled over US$100 mn or around 40% of GDP. With the US unemployment rate at a 14-year high of 6.5% and climbing, remittances from the US, which amount to around US$60 mn a year, will be adversely affected by the recessionary conditions. Inward personal remittances have been on a downward trend in Fiji over the past couple of years and are estimated to fall by around 12% to FJ$225 mn this year and down some 30% from a high of FJ$322 mn in 2006.

The outlook for remittance flows has been clouded by the prospects for weak economic growth in major host countries and worsening labour market conditions. One offsetting feature, however, is the seasonal guest worker scheme launched in New Zealand a year ago and is set to be introduced in Australia this season. The scheme in New Zealand allows employers in horticulture and viticulture to recruit up to 5,000 overseas workers a year. Over the course of three years, the pilot scheme in Australia will allow up to 2,500 seasonal workers from Kiribati, PNG, Tonga and Vanuatu to work in the horticultural industry in regional Australia for up to seven months each year.

Balance of payments pressure could re-emerge

With most countries in the Pacific operating large merchandise trade deficits, due to their narrow export base and large import requirements, the services (mainly tourism) and transfers (mainly remittances and aid) accounts are increasingly important sources of foreign exchange.

Exchange rates impact trade balance



Source: Datastream

Prices of cash crops such as palm oil, sugar and coconut oil, cocoa, coffee have already started their descent and the downturn in economic growth could add further downward pressure on prices in coming months. A positive development, however, is that imported commodities, in particular, oil, which accounts for around a quarter of total imports, on average, is likely to cost less.

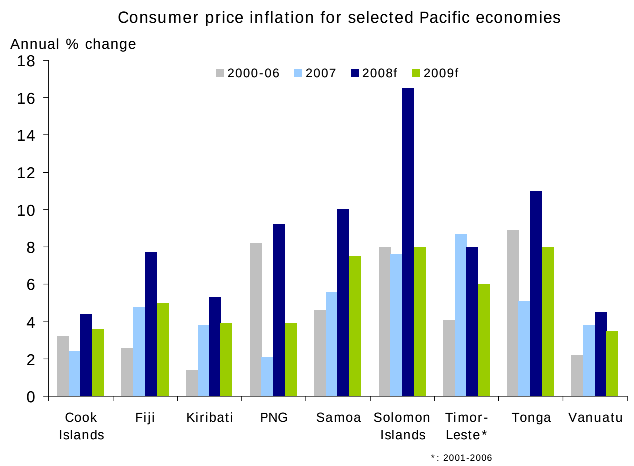
The weak exchange rate will also help to contain the value of A$-denominated imports which are likely to be cheaper as Pacific currencies appreciate against the Australian dollar while the fall in commodity prices are likely to help offset the currency decline against the US dollar. While this is likely to help improve the overall merchandise trade deficit position, the likely slowing of remittance flows and tourism receipts coupled with the risk that investment inflows could ease could see balance of payments pressures re-emerge in some economies.

Import cover, which measures how long foreign exchange reserves can pay for existing levels of imports, will be the indicator to watch in the months ahead. As it stands, central bank data show that PNG, Samoa and Vanuatu are in a relatively comfortable position with import cover equivalent to around 9 months, 5 months and 8 months respectively. Tonga's import cover has averaged at around 4 months this year while Fiji's has been less than 4 months. The Solomon Islands, however, has seen reserves decline some 30% since the start of the year, bringing import cover down to less than 3 months.

Inflation should moderate

For a number of Pacific island economies, annual inflation has been tracking at double-digit rates, largely reflecting the spike in imported prices. Not only did fuel costs escalate, food prices also rose and with these items representing more than half of the CPI basket, the impact on consumers has been more severe. The outlook is for inflation to recede in 2009 as food and fuel costs ease. However, inflation, for most Pacific island economies, is likely to stay higher than the annual average recorded in 2000-2006 as commodity prices are likely to hold up compared with historical standards.

Inflation set to recede

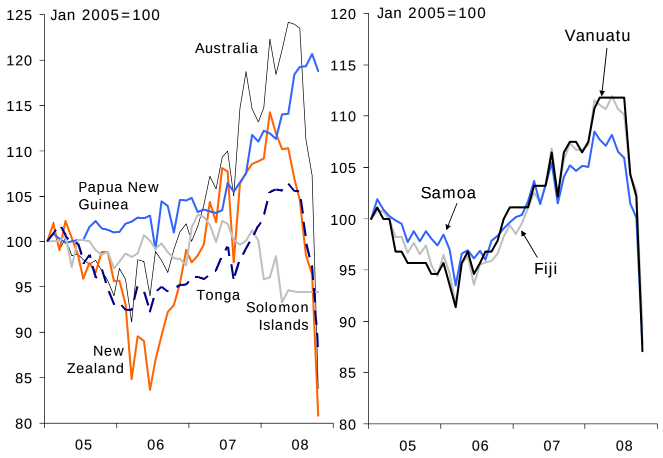


Sources: Asian Development Bank, International Monetary Fund, ANZ Economics & Markets Research

Jasmine Robinson
Senior Economist
Jasmine.Robinson@anz.com
+61 3 9273 6289

Financial Markets Update

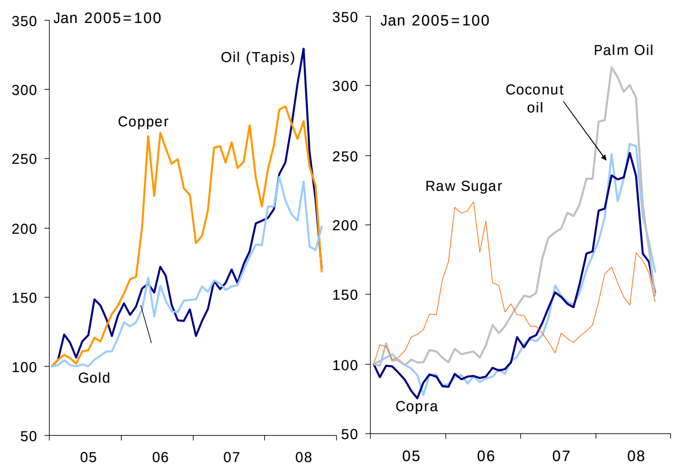
Exchange rates vs US dollar



Exchange rates

- Extreme volatility in financial markets has seen the Australian and New Zealand dollars under pressure while the US dollar's dominance has re-emerged.
- Most currencies across the Pacific have lost ground against the US dollar, depreciating by an average of 10% since the start of the year. An exception is the Kina which has gained some 9.7% since end-December 2007.
- However, against the Australian dollar, these currencies have strengthened, making imports less costly as Australia is a key trading partner for a number of these economies. The sharpest appreciation has been the Kina which has risen by about 42% since end-July 2008. The Solomon Islands' dollar is a close second, rising by some 39% against the AUD.

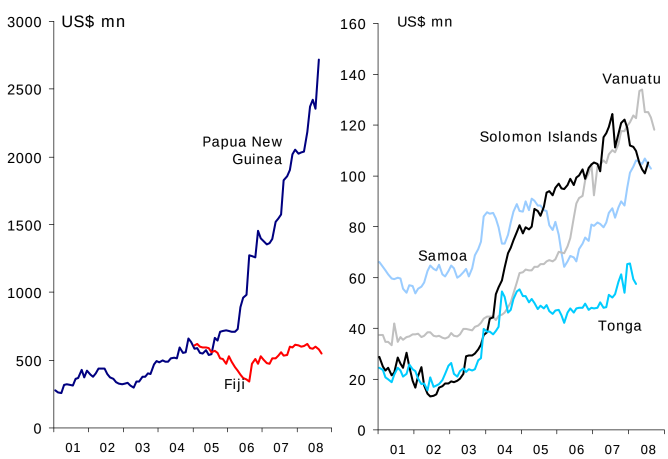
Commodity Prices



Commodities

- Commodity prices have reached their peaked with substantial falls witnessed over recent months as prices respond to the downturn in global demand.
- Oil prices, in particular, have come off from a high of US$147/bbl for WTI, to around US$55-65/bbl, with the US, the biggest oil consumer, in recession and China's economy slowing significantly. This has also exerted downward pressure on biofuel inputs such as palm oil, coconut oil and sugar.
- Gold is off its March 2008 peak with a stronger US dollar and more recently, tentative signs of a return in risk appetite, weighing on the precious metal. However, renewed financial market concerns could trigger short term rallies.
- Base metal prices are likely to ease further as demand concerns and rising supply weigh on prices.
- While commodity prices are poised to decline further over the next 6-12 months, they are likely to remain high by historical standards.

International Reserves



International Reserves

- Import cover, which measures how long foreign exchange reserves can pay for existing levels of imports, will be the indicator to watch in the months ahead.
- The sharp rise in commodity prices in recent years has boosted PNG's reserves to around US$2.7 bn as at August, equivalent to around 9 months of imports. This will help as a buffer in the months ahead as export revenue is adversely affected by lower commodity prices.
- Vanuatu has seen a steady build-up of reserves with import cover of around 8 months.
- According to estimates by the Reserve Bank of Fiji, reserves stood at US$550 mn as at September, sufficient for 3.6 months of imports.

FX and Policy Interest Rate Forecasts

	Oct 08	Current^	Dec 08	Mar 09	Jun 09	Sep 09	Dec 09	Mar 10
FJD/USD, eop	0.561	0.5489	0.56	0.557	0.544	0.524	0.505	0.496
FJD/AUD, eop	0.84	0.8326	0.811	0.819	0.824	0.845	0.871	0.886
Short term rates*	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25
PGK/USD, eop	0.391	0.3915	0.40	0.388	0.375	0.363	0.35	0.353
PGK/AUD, eop	0.585	0.5939	0.58	0.57	0.568	0.585	0.603	0.629
Short term rates**	7.0	7.0	7.0	7.0	6.5	6.5	6.5	6.5
WST/USD, eop	0.343	0.333	0.346	0.342	0.335	0.323	0.31	0.303
WST/AUD, eop	0.509	0.504	0.501	0.503	0.508	0.52	0.534	0.541
USD/SBD, eop	7.7037	7.7088	7.82	7.85	7.87	8.0	8.20	8.20
AUD/SBD, eop	5.144	5.088	5.40	5.34	5.19	4.96	4.76	4.59
USD/TOP, eop	2.149	2.114	2.14	2.16	2.18	2.20	2.26	2.27
AUD/TOP, eop	1.435	1.395	1.48	1.47	1.44	1.36	1.31	1.27
USD/VUV, eop	122.5	120.38	119.7	121.0	123.5	129	134.9	138.1
AUD/VUV, eop	81.82	79.45	82.62	82.26	81.53	79.97	78.27	77.35
Short term rates***	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.25

+:The source of the FX data is Bloomberg. As the currencies are illiquid with wide bid/offer spreads, the rate published is only indicative

*: 91-day RBF notes; **: Kina Facility Rate (KFR); ***: Discount rate; ^: 14 November 2008

Macro Economic Forecasts

Real GDP Growth (%)

	2007	2008f	2009f
Fiji	-6.6	1.0	1.3
PNG	6.2	6.0	5.5
Samoa	6.0	3.3	2.5
Solomon Is.	10.3	8.0	4.0
Timor-Leste+	7.9	6.5	5.0
Tonga*	-3.1	1.2	2.6
Vanuatu	6.6	6.3	4.0

Nominal GDP (US$ bn)

	2007	2008f	2009f
Fiji	2.55	2.77	2.95
PNG	5.62	6.6	7.3
Samoa	0.41	0.46	0.50
Solomon Is.	0.39	0.48	0.54
Timor-Leste+	0.39	0.45	0.51
Tonga*	0.25	0.28	0.31
Vanuatu	0.44	0.49	0.52

Inflation (%)

	2007	2008f	2009f
Fiji	4.8	7.7	5.0
PNG	0.9	10.8	5.4
Samoa	5.6	10.0	7.5
Solomon Is.	7.6	16.5	8.0
Timor-Leste	8.7	8.0	6.0
Tonga	5.1	11.0	8.0
Vanuatu	3.8	4.5	3.5

Fiscal Balance (% of GDP)

	2007	2008f	2009f
Fiji	-1.3	-2.0	-2.0
PNG	1.7	1.0	0.5
Samoa	-1.1	-6.0	-6.0
Solomon Is.	-1.5	-3.6	1.4
Timor-Leste*^	-43	-65	n/a
Tonga	-1.0	-1.5	-1.5
Vanuatu	-0.1	-0.5	n/a

Current Account Balance (% of GDP)

	2007	2008f	2009f
Fiji	-19.3	-24.3	-23.8
PNG	7.9	3.0	1.0
Samoa	-6.1	-7.8	-8.0
Solomon Is.	-2.8	-6.8	-9.6
Timor-Leste~	253.3	230.5	178.0
Tonga	-10.3	-10.4	-9.0
Vanuatu	-9.9	-11.4	-13.2

Foreign Exchange Reserves (US$ mn)

	2007	2008f	2009f
Fiji	615	570	540
PNG	2,100	2,700	2,200
Samoa	90.2	101	95
Solomon Is.	118.2	88	85
Timor-Leste	2,000	3,800	4,200
Tonga	61.9	60	55
Vanuatu	113.8	119	115

*: fiscal year ending June +: non-oil GDP ^: non-oil fiscal balance as % of non-oil GDP ~: % of GNI

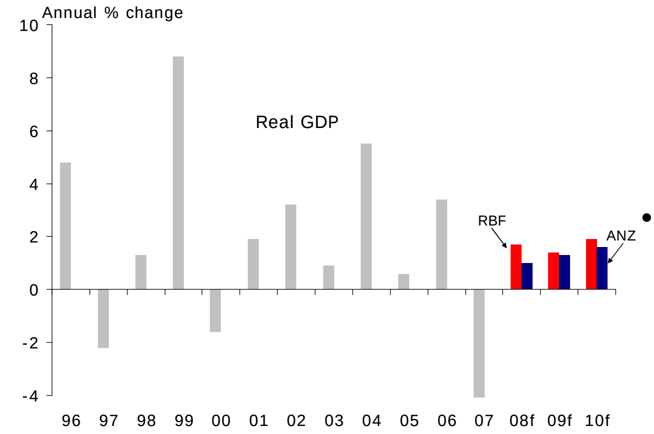
Long Term Foreign Currency Government Bond Ratings

Investment Grade	
Moody's	**S&P**
Aaa	**AAA**
Australia	Australia
Canada	Canada
France	France
Germany	Germany
Japan	Singapore
New Zealand	United Kingdom
Singapore	United States
United Kingdom	
United States	
Aa1	**AA+**
Belgium	Belgium
	Hong Kong
	New Zealand
Aa2	**AA**
Hong Kong	Japan
Italy	
Qatar	
Kuwait	
UAE	
Aa3	**AA-**
Cayman Islands	Kuwait
Cyprus	Qatar
Macau	Saudi Arabia
Oman	Taiwan
Taiwan	
A1	**A+**
China	China
Czech Republic	Chile
Israel	Cyprus
Saudi Arabia	Italy
A2	**A**
Chile	Czech Republic
Hungary	Israel
Korea	Korea
Poland	Oman
A3	**A-**
Malaysia	Malaysia
	Poland
Baa1	**BBB+**
Mexico	Hungary
South Africa	Mexico
Thailand	Russia
Russia	South Africa
	Thailand
Baa2	**BBB**
Mauritius	Tunisia
Tunisia	
Baa3	**BBB-**
India	Brazil
Romania	India
	Colombia
	Peru

Sub-Investment Grade	
Moody's	**S&P**
Ba1	**BB+**
Brazil	Egypt
Colombia	
Egypt	
Panama	
Peru	
Ba2	**BB**
Fiji	**Cook Islands**
Jordan	Jordan
	Uruguay
	Vietnam
Ba3	**BB-**
Indonesia	Indonesia
Turkey	Philippines
Vietnam	Serbia
	Turkey
	Venezuela
B1	**B+**
Papua New Guinea	Argentina
Philippines	Cambodia
Ukraine	Ghana
Uruguay	**Papua New Guinea**
B2	**B**
Paraguay	**Fiji**
Honduras	Paraguay
Venezuela	Kenya
Cambodia	Ukraine
B3	**B-**
Argentina	Bolivia
Ecuador	Ecuador
Bolivia	Lebanon
Lebanon	
Pakistan	
Caa1 and below	**CCC and below**
Cuba	Pakistan
Nicaragua	
Paraguay	

Country Update: Fiji

Economy to post sub-2% growth

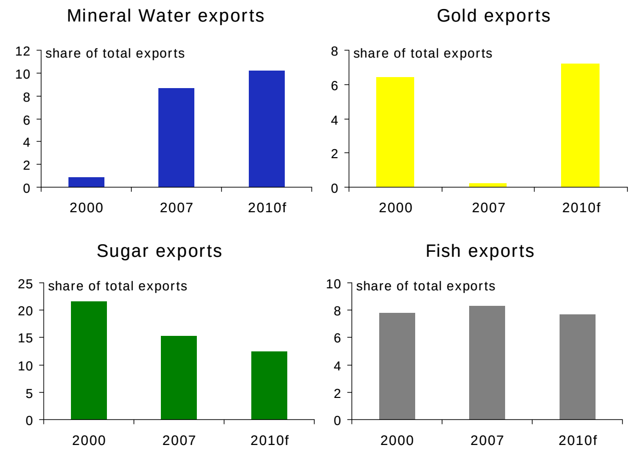


Sources: Reserve Bank of Fiji, ANZ Economics & Markets Research

- The official economic growth forecast for 2009 and 2010 is expected at 1.4% and 1.9% respectively after the economy contracted by a revised 6.6% in 2007, a deeper recession than the previous two over the last decade. With limited scope to implement countercyclical measures given recurring fiscal deficits over the past years and a relatively high debt level, private sector investment holds the key to a faster pace of economic expansion.
- However, investment continues to lag. Domestic credit growth has slowed to an annual rate of around 3% according to IMF data. While the slowdown in credit growth partly reflects weaker consumption-related lending, the uncertain domestic political environment, with elections now not expected to be held for at least 12 months, the downturn in global growth and sluggish domestic economic activity have also weighed on investment decisions. Offshore, stresses in the global financial system have made access to credit more expensive for foreign investors, and could lead some investors to re-visit proposed projects.
- Some bright spots in the economy, however, include the growth of the mineral water market and recommencement of gold production which will generate important export revenue over the medium term. Gold production is forecast to reach 68,000 ounces in 2009 and 76,000 ounces in 2010. This is above its 2006 output of 45,000 ounces but below the 2005 level of 90,000. With the price of gold expected to hold up well, the value of gold exports over the next two years is likely to exceed FJ$100 mn per year, which is a significant improvement from the average FJ$70 mn per year in export receipts over 2000-2006. Mineral water exports are projected to exceed FJ$160 mn in 2010 compared with just FJ$10 mn in 2000 and FJ$105 mn in 2007. Projections show that both exports are likely to collectively account for around 17% of total exports in 2010 against about 9% in 2007.
- Reserve accumulation and high external prices of food and fuel have prompted the Reserve Bank of Fiji to relax policy. In September, the RBF lifted the approval limit for the prepayment of imports to FJ$1 mn from FJ$50,000 previously, allowing greater scope for importers to hedge against higher prices. The RBF also relaxed some exchange controls including an increase in travel allowance and credit and debt card limits. As at September 2008, reserves stood at FJ$897 mn, up 2.9% from a year ago, but remains below 4 months of imports.

Jasmine Robinson

Export diversification



Sources: Reserve Bank of Fiji, ANZ Economics & Markets Research

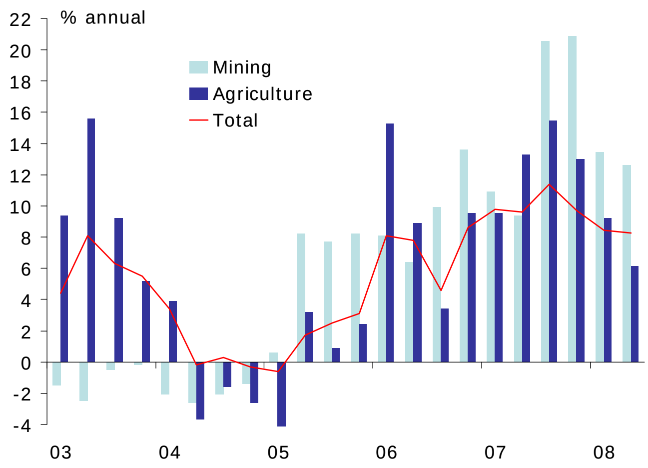
Economic data – Fiji

Quarterly data	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08
Consumer Price Index, % YOY	2.5	3.7	3.6	6.4	5.2	3.9	7.6	6.8
Domestic Credit, % YOY	27.4	23.6	16.7	12.5	8.5	3.2	3.3	3.3
Exports, % YOY	11.7	3.3	-3.1	34.2	-9.7	5.4	39.6	19.6
Imports, % YOY	20.2	4.1	0.2	-3.7	-8.9	12.5	19.6	43.4
Trade Balance, US$ mn	-298.3	-262.2	-253.2	-239.7	-273.5	-310.1	-275.2	-384.4
Official reserves, US$ mn	474.2	526.3	473.3%	535.3	539.2	614.8	601.9	584.7

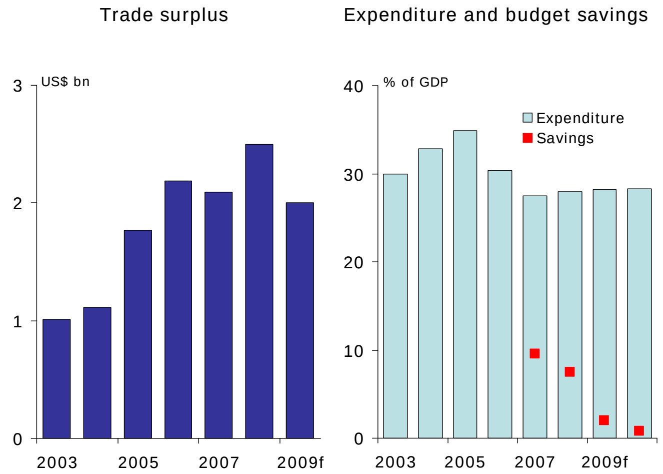
Sources: Datastream, Fiji Islands Bureau of Statistics, IMF

Country Update: Papua New Guinea

Employment index shows growth is tempering



But surpluses mean PNG will get through coming downturn in better shape than 10 years ago



- High frequency indicators show that the economy continues to expand at a solid rate, but is slowing gradually. The employment index, the best available measure of growth, rose by 8.3% per annum in the June quarter, with particularly strong rises in the retail, transport and business services sectors. However, it would seem that the rate of growth is starting to abate after several years of strong results. Overall, we anticipate real GDP growth of 6% this year. Our forecast for real GDP growth is slightly below that of the government's because the high rate of inflation this year will reduce GDP in inflation-adjusted terms.
- PNG is well positioned to face the challenges ahead, including forecast declines in commodity prices. There is a significant balance of payments surplus, with the 12-month trailing trade surplus having reached US$2.4 bn and the level of foreign exchange reserves at Bank of PNG now at US$2.5 bn, or more than 9 months of imports. There is also a cushion on the fiscal side, with a surplus projected and government debt/GDP ratio having already fallen to just 30%. The under-spending of the 2007 and 2008 supplementary budgets (totalling PGK3.2 bn or 16% of GDP) means that there is cash available. At the very least, infrastructure projects that are now getting underway will help maintain growth going forward even as the contribution of net exports to growth declines.
- Inflation has become problematic this year, with headline CPI reaching 13.5% per annum in the September quarter. However, the combination of falling oil prices, the strength of the kina relative to the Australian dollar and softening domestic growth should allow import prices to ease rather quickly going forward. We forecast a decline in annual inflation to around 11% by year-end, and an average CPI rate of 5½% next year.
- As inflation recedes, the Bank of PNG should become more comfortable allowing the kina to depreciate somewhat against the US and Australian dollars. This represents a loosening of monetary conditions that will improve export competitiveness for PNG's agricultural producers and support the non-minerals economy through the coming global downturn. It will also make investment into PNG less expensive for the many projects now underway.

Amy Auster

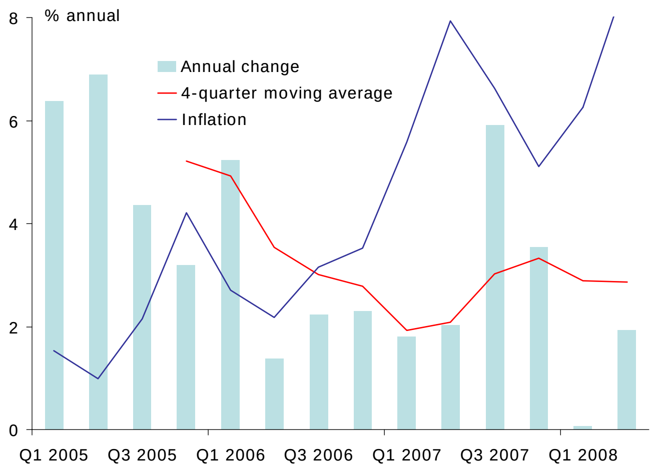
Economic data – Papua New Guinea

Quarterly data	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08
Employment Index, % YOY	5.0	8.9	9.9	9.5	11.7	10.4	8.5	8.3
Consumer Price Index, % YOY	5.3	-0.9	1.1	1.0	-1.6	3.2	7.5	10.7
- BPNG Trimmed mean, % QOQ	1.2	1.7	2.5	2.9	3.6	5.3	8.7	11.4
- NSO exclusion based, % QOQ	-1.0	4.5	7.1	7.5	9.0	6.3	7.7	10.2
Exports, % YOY	27.2	9.6	7.3	14.2	9.3	21.8	37.4	12.2
Imports, % YOY	42.3	51.8	37.4	31.3	28.4	36.0	17.3	25.0
Trade Balance, US$ mn	545	474.2	346.7	748.3	497.7	499.3	607.0	760.7
Foreign Exchange Reserves, US$ mn	1268	1400	1364	1545	1856	2053	2039	2489

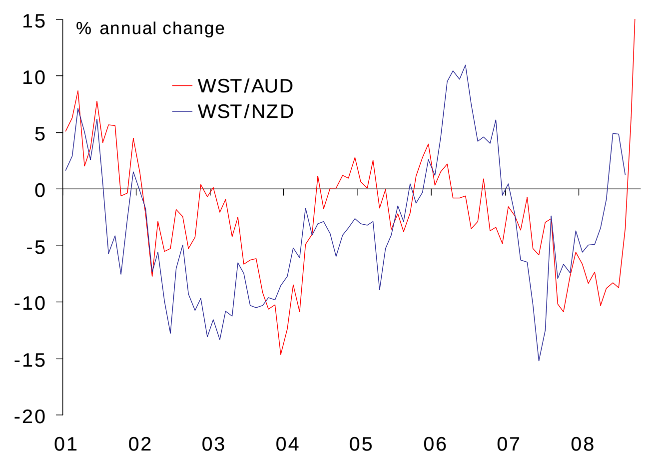
Sources: Bank of Papua New Guinea, IMF

Country Update: Samoa

Economy has slowed and inflation is still a challenge



Tala is much stronger versus AUD and NZD



- The economy is slowing in response to the slowdown in the global economy. The first half of the year saw a decline in export receipts, remittances and visitor arrivals from the same period in 2007, and the falling contribution to growth from construction in the post-Games environment remains a short-term drag relative to recent history. In addition, higher rates of inflation are eating into growth in real terms. Real GDP growth was negative on a quarterly basis in the first and second quarters of this year, and a four-quarter average of real GDP growth has fallen from a peak of 3.3% in Q4 2007 to 2.8% in Q2 2008. The onset of a global recession will continue to represent a negative shock to the Samoan economy for some time to come.
- The Central Bank of Samoa has indicated that it will ease monetary policy in light of the downturn in global demand and domestic growth prospects. This is in line with the policy response by central banks around the world, although in the case of Samoa the fact that annual headline inflation reached 13% in August, according to IMF data, means that some caution is warranted. At the same time, falling oil prices should help insure that disinflation takes hold in the months to come.
- The government's budget policies will also promote growth in the period ahead, as the Ministry of Finance is projection an increase in government expenditure from 36% of GDP in 2007/2008 to 40.9% of GDP in 2008/2009. The fiscal deficit is projected to rise above 5% of GDP in this fiscal year – again an appropriate approach to troubled times, so long as the government's debt ratios remain manageable.
- A positive aspect of falling domestic demand is that it should help the balance of payments position strengthen. The trade deficit reached an historic peak of US$24 mn in July, bringing the 12-month trailing average to US$18.8 mn. Though FX reserves have increased to US$97 mn, or 4.6 months of import cover, compared to end-2007, this situation still bears close watching.
- A weaker tala would also help promote export growth, and discourage import growth in the month ahead. The tala has depreciated by 13% against the US dollar over the past year, but it has appreciated by 20% against the Australian dollar and 15% against the New Zealand dollar as these currencies have fallen dramatically against the US dollar.

Amy Auster

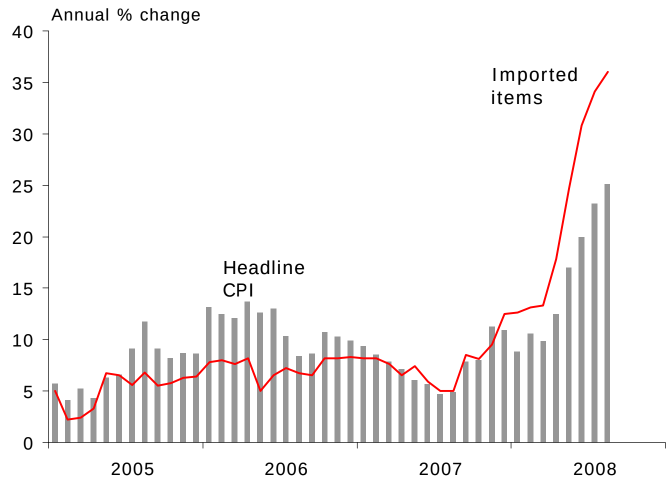
Economic data – Samoa

Quarterly data	Sep 06	Dec 06	Mar 07	Jun-07	Sep 07	Dec 07	Mar 08	Jun 08
Consumer Price Index, % YOY	3.1	4.0	4.6	6.3	7.0	4.5	6.3	8.8
Domestic Credit, % YOY	47.4	31.5	21.1	16.3	20.1	16.2	8.2	12.2
Exports, % YOY	-7.8	5.5	22.1	55.2	72.0	26.5	-8.3	-27.6
Imports, % YOY	29.7	11.6	2.4	15.3	11.8	-12.0	14.1	-3.4
Trade Balance, US$ mn	-19.8	-15.5	-16.9	-20.2	-20.1	-15.5	-19.6	-20.8
Foreign Exchangel Reserves, US$ mn	68.5	75.9	76.2	80.4	82.3	90.2	100.6	101.45

Sources: International Monetary Fund, Datastream

Country Update: Solomon Islands

Inflation stays high

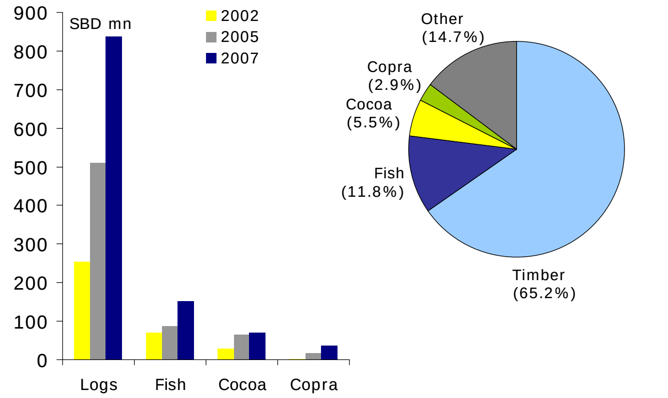


Source: Solomon Islands National Statistics Office

Export trends

Trends in major exports

Share of exports, 2007
Total exports – SBD$1285.6 mn



Source: Central Bank of Solomon Islands

- The Asian Development Bank lifted its growth projections for the economy to 8% in 2008 and 4% in 2009, an upward shift of between 1.5-2 percentage points, following better-than-expected production forecasts for its major exports. This, however, still represents a slowing in real GDP growth from 10.3% recorded in 2007.
- Solomon Island's relatively strong growth performance has been accompanied by high inflation – the fastest among the Pacific economies reviewed in this publication. Inflation has been tracking at double-digit annual rates this year. For the first eight months of this year, consumer prices rose by 15.9% compared with the same period in 2007. This largely reflects the spike in imported inflation which rose by an annual average rate of 22.8% during the same period. Credit growth has also been robust. Average headline inflation for 2008 is now forecast at 16.5% but some moderation is expected in 2009 to around 8% as imported food and fuel costs ease.
- Major exports include timber, fish & fish products, cocoa and copra which collectively constituted 85% of total exports in 2007. Timber exports alone accounted for 65% of total exports. Palm oil has become an important export item with Guadalcanal Plains Palm oil plantations being fully operational late last year. However, the softer commodity price outlook together with an expected fall in logging rates next year are likely to adversely affect export revenue.
- Although some relief is likely to come from lower food and fuel imports, the merchandise trade deficit is likely to remain large and continue to put pressure on the current account. On the services balance, tourism receipts might improve from the low base given the expansion of airline connections. Pacific Blue has announced its launch of direct flights between Brisbane and the Solomon Islands beginning in December. The transfers balance has stayed in surplus, reflecting continued development assistance, but has not been large enough to offset the merchandise trade shortfall.
- Foreign exchange reserves have declined this year, and were estimated at around US$83 mn as at early November 2008 compared with US$118 mn as at December 2007. Import cover is now less than 3 months, representing a serious challenge.

Jasmine Robinson

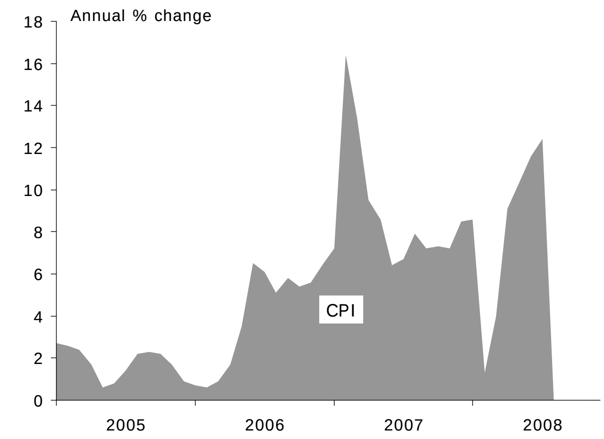
Economic data – Solomon Islands

Quarterly data	Sep 06	Dec 06	Mar 07	Jun-07	Sep 07	Dec 07	Mar 08	Jun 08
Domestic credit, % YOY	48.5	50.7	56.6	54.9	56.3	58.5	63.4	73.9
Consumer Price Index, % YOY	6.3	7.7	8.5	6.3	5.8	10.0	9.7	16.5
Exports, % YOY	11.6	21.1	65.2	45.4	11.8	28.7	19.2	n/a
Imports, % YOY	27.7	27.3	23.5	39.0	20.4	38.5	20.2	n/a
Trade Balance, US$ mn	3.28	0.23	0.88	-0.3	-1.98	-6.6	0.29	n/a
Foreign Exchange Reserves, US$ mn	101.7	103.6	100.9	118.4	115.7	118.2	108.9	99.9

Sources: Datastream, International Monetary Fund, Central Bank of Solomon Islands

Country Update: Timor-Leste

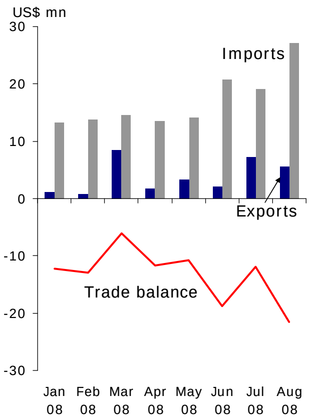
Inflation stays high



Sources: National Directorate of Statistics, Economist Intelligence Unit

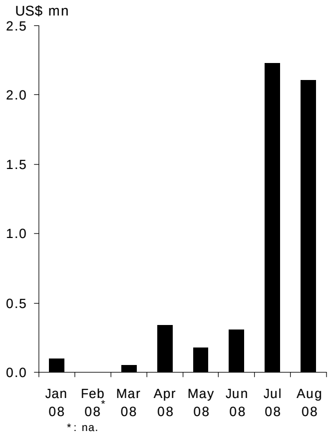
Merchandise trade deficit remains sizeable

Merchandise trade, Jan-Aug 08



Source: National Directorate of Statistics

Coffee exports, Jan-Aug 08



- Fiscal spending has been stepped up with the approval of proposed measures outlined in the mid-year budget. The full-year budget for 2008 is now US$788.3 mn, substantially higher than the US$347.7 mn planned in the original budget. Included in the budget adjustment was the establishment of a US$240 mn Economic Stabilisation Fund (ESF) aimed at ensuring adequate basic food supply, fuel and construction materials at affordable prices. An extra US$185.6 mn to finance development projects and services was also approved. The budget is to be largely financed from the Petroleum Fund with US$396.1 mn termed as "sustainable" transfers and US$290.7 mn as "extraordinary" transfers.
- Economic activity is largely driven by the public sector and international development assistance. However, credit growth has picked up, albeit from a low base, with total loans and advances to the private sector up 13.5% over the year to the June quarter.
- After expanding by around 8% in 2007, real non-oil GDP growth is forecast to moderate to 6.5% this year and ease further to 5% in 2009. Downward pressure on commodity prices, particularly oil, is likely to weigh on the scope for growth in public sector spending over 2009. WTI oil has dropped by more than half from its peak of over US$145/bbl reached in July to under US$60/bbl currently. According to IMF estimates, every US$20 change in global oil/gas prices changes estimated sustainable spending by 10-15% of GDP per year. With government expenditure accounting for around 50% of non-oil GDP, the potential decline in oil revenue as well as interest income limits the scope for a repeat of the 2008 budget next year.
- Inflation continues to be difficult to tackle but some reprieve is expected as commodity prices continue to respond to the downturn in global demand. Inflation accelerated from a low of just 1.3% over the year to February 2008 to 12.4% in the year to July. Food, which constitutes more than half of the CPI basket, and fuel costs have been the main factors behind the spike. However, for the first seven months of this year, inflation averaged 8.2%, which was lower than the 9.7% recorded for the same period in 2007. The outlook is for inflation to moderate given the softer commodity price profile over the next 12 months. Headline inflation is forecast to ease to around 6% in 2009.
- On the trade front, exports have ticked up but the merchandise trade deficit remains hefty. Exports for the first eight months of this year totalled US$30.3 mn while imports (excluding imports by foreign embassies and the UN) amounted to US$136.2 mn.

Jasmine Robinson

Economic data - Timor-Leste

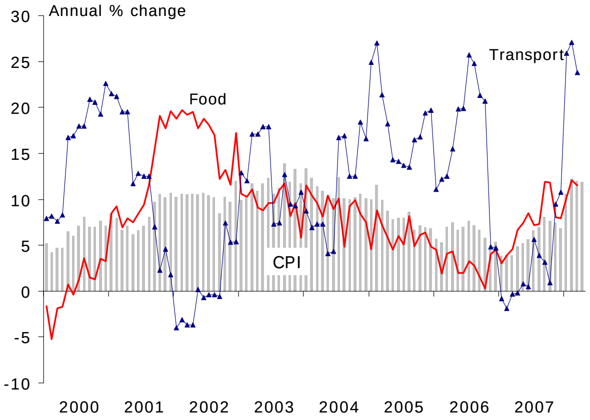
Quarterly data	Jun 06	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08
Consumer Price Index, % YOY	3.9	5.7	5.8	12.3	8.1	7.3	7.4	4.6
- Food, % YOY	3.4	5.7	6.9	17.6	11.5	10.8	10.7	n/a
- Transport, % YOY	11.4	10.9	5.0	11.1	0.6	-1.7	2.3	n/a
Exports+, US$ mn	0.24	3.1	3.1	0.49	0.055	n/a	n/a	10.3
Imports^, US$ mn	10.48	17.3	33.3	16.3	52.3	n/a	n/a	41.6
Trade Balance, US$ mn	-10.2	-14.2	-30.2	-15.8	-52.2	n/a	n/a	-31.2

+: comprising at least 50% local content by value; ^: excluding imports by foreign embassies and the UN

Sources: National Directorate of Statistics, Economist Intelligence Unit

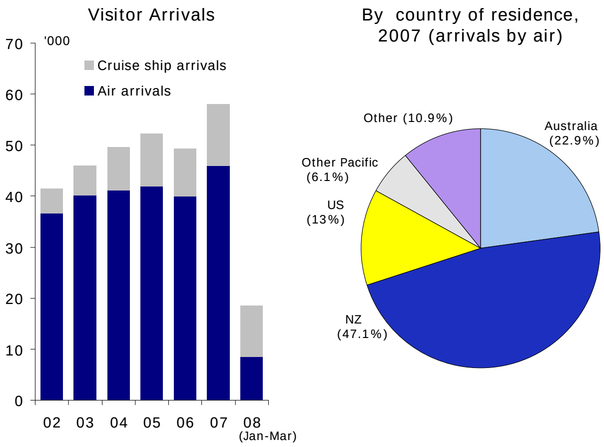
Country Update: Tonga

A mild recovery expected in FY2008/09



Source: Tonga Department of Statistics

Inflation driven by imported items



Sources: Tonga Visitors Bureau, National Reserve Bank of Tonga

- After contracting by more than 3% in FY2006/07 (year ending 30 June), the economy is poised to expand by an above-average rate of growth in FY2008/09 as reconstruction activity gains momentum. The rebuilding of the Nuku'alofa Central Business District has commenced and this is likely to be the main driver of growth over the next 12-18 months. Real GDP is forecast to expand by around 2.6% in FY2008/09 from an estimated 1.2% in FY2007/08.
- To be sure, the king's coronation in August and increased cruise ship business have lifted Tonga's profile as a tourist destination. However, tourism-related businesses are likely to be adversely affected by the deeper-than-expected slowdown in global growth. In addition, the potential for lower remittance flows is also likely to impact household consumption although this could be partly offset by employment gains in the construction sector, in particular. There are signs that credit growth is slowing although it remains in double-digits. IMF data show total domestic credit rising by around 14% over the year to June 2008.
- Inflation eased to 10.3% over the year to September from a peak of 12.6% in the year to May. For the first nine months of this year, inflation averaged 11.3% compared with 5.3% for the same period in 2007. The prospect of a further softening in commodity prices over 2009 should support a moderation in price growth over the coming year with headline inflation forecast to average around 8% in 2009 from an estimated 11% in 2008.
- Tonga's current account deficit is estimated to remain at around 10% of GDP in the current fiscal year. While the value of imports, which is roughly 9 times the value of exports, could decline as food and fuel costs ease, the less favourable outlook for remittances and tourism receipts is likely to see only a mild improvement in the current account deficit in FY2008/09.
- According to central bank data, foreign reserves were lower as at October compared with the previous month. Reserves stood at TP121.6 mn (approx. US$58 mn), equivalent to 4.8 months of imports. This was, however, 6% higher than at end-2007 (TP114.6 mn).
- Concerns remain over medium-term debt sustainability, underscoring the preference for concessional borrowing for infrastructure development, particularly as remittances, an important source of foreign exchange, could slow. According to IMF projections, the debt service ratio is expected to stay around 10-11% over the next few years compared with 7.5% in FY2005/06.

Jasmine Robinson

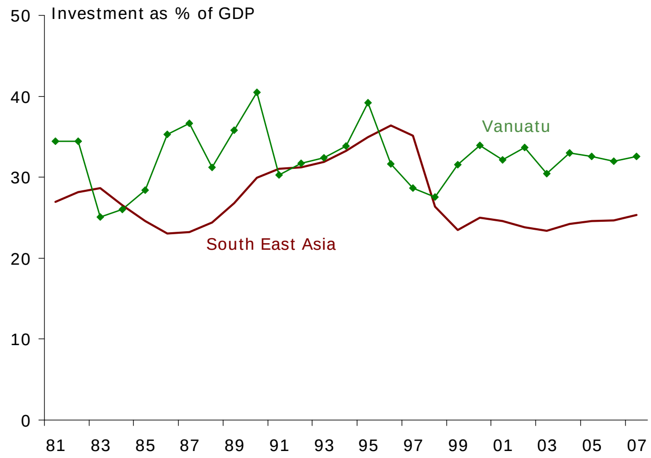
Economic data – Tonga

Quarterly data	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08
Consumer Price Index, % YOY	6.1	4.9	3.9	5.7	8.1	6.8	12.0	12.2
Private Sector Credit, % YOY	17.8	6.7	6.7	9.5	12.4	16.3	15.9	17.1
Exports, % YOY	39.3	0.0	-0.9	-5.2	-0.9	-21.1	14.9	n/a
Imports, % YOY	3.4	19.2	20.3	24.9	20.6	-5.0	-6.8	n/a
Trade Balance, US$ mn	-30.7	-32.9	-30.0	-37.7	-37.9	-32.9	-27.1	n/a
Foreign Exchange Reserves, US$ mn	45.1	44.9	47.0	50.1	54.9	61.9	53.9	49.4

Sources: Datastream, International Monetary Fund, National Reserve Bank of Tonga

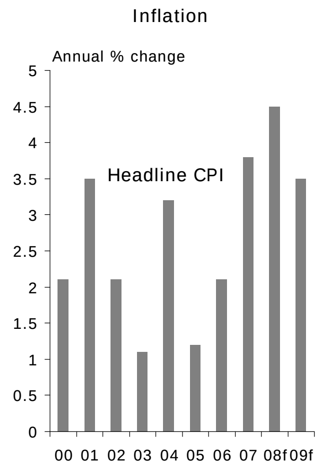
Country Update: Vanuatu

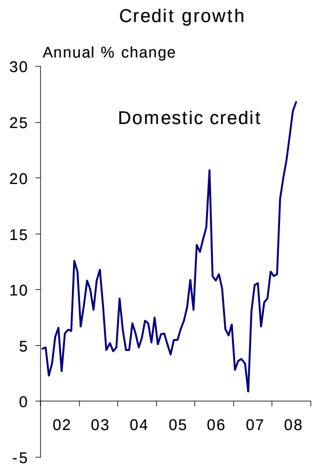
Investment lifts economic expansion



Sources: UN Statistical Division, ANZ Economics & Markets Research

Inflation pressures persist





Sources: Datastream, IMF, ADB

- Real GDP is expected to expand by 6.3% in 2008, representing the fourth successive year of above 6% growth, thanks in part to robust investment, which, as a share of GDP, has been consistently above 30% over recent years. Economic growth prospects, however, have been shaded down as the outlook for the tourism sector is weighed down by the downturn in the global economy and as softer commodity prices adversely impact agricultural export revenues. Vanuatu's main exports include kava, beef, copra, timber and cocoa. Foreign investment activity could also slow amidst the tight credit market environment. Real GDP is forecast to moderate to around 4% in 2009. This represents the slowest rate of expansion since 2003.
- While inflation is lower than the regional average, it remains at the upper end of the Reserve Bank of Vanuatu's 0-4% target band. For the first half of this year, inflation averaged 3.75% but the central bank has revised up its projections for the full-year to 4.3% from 3% earlier. Credit growth continues to expand at a robust pace of over 20% per annum. Concerns over upward price pressures prompted the central bank to raise its key policy rate by 25 bps to 6.25% for the first time in two years. Nevertheless, the medium-term outlook is for inflation to ease as commodity prices, particularly fuel, respond to the slowdown in global growth. Inflation is forecast to moderate to 3.5% in 2009.
- The possible adverse impact on tourism earnings and export receipts are likely to add pressure on the current account with the deficit forecast to widen to around 13% of GDP in 2009 from an estimated 11% of GDP in 2008. Vanuatu has built up relatively healthy foreign exchange reserves, with import cover of around 8 months in the first half of this year. This will help to cushion the impact of a wider current account deficit and potential slowdown in growth in foreign investment inflows.
- On the political front, a coalition government, led by Edward Natapei, leader of the Vanua'aku Party, took office following elections in September. However, achieving a stable political environment will be difficult with no party having received a clear majority and the coalition only holding a slim majority of five seats in the 52-seat parliament. This has raised calls for legislation to impose a moratorium on no-confidence motions for at least a year after a general election to enable effective policy implementation.

Jasmine Robinson

Economic data – Vanuatu

Quarterly data	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08
Consumer Price Index, % YOY	2.1	2.0	3.5	4.1	4.0	4.2	3.6	3.9
Tourist Arrivals, ´000	39.7	38.1	42.7	39.9	37.3	47.2	49.4	n/a
Exports, % YOY	-21.6	47.8	7.9	9.9	28.1	-4.9	25.0	30.7
Imports, % YOY	8.1	-26.7	74.8	-35.5	37.5	55.2	108.8	14.7
Trade Balance, US$ mn	7.4	11.9	-20.3	-8.0	4.6	-21.7	-98.8	1.4
Foreign Exchange Reserves, US$ mn	86.8	99.3	99.1	102.9	106.8	113.8	116.6	119

Sources: Vanuatu National Statistics Office, Datastream, IMF Direction of Trade Statistics

Contacts

ANZ Economics & Markets Research

Saul Eslake	Chief Economist	+61 3 9273 6251	Saul.Eslake@anz.com
Fiona Allen	Business Manager	+61 3 9273 6224	Fiona.Allen@anz.com

Industry and Strategic Research

Tony Pearson	Deputy Chief Economist	+61 3 9273 5083	Tony.Pearson@anz.com
Mark Rodrigues	Senior Economist	+61 3 9273 6286	Mark.Rodrigues@anz.com
Julie Toth	Senior Economist	+61 3 9273 6252	Julie.Toth@anz.com
Paul Deane	Rural and Regional Economist	+61 3 9273 6295	Paul.Deane@anz.com

Australian Economics and Interest Rates Research

Warren Hogan	Head of Australian Economics and Interest Rates Research	+61 2 9227 1562	Warren.Hogan@anz.com
Katie Dean	Senior Economist	+61 3 9273 1381	Katie.Dean@anz.com
Riki Polygenis	Economist	+61 3 9273 4060	Riki.Polygenis@anz.com
Dr. Alex Joiner	Economist	+61 3 9273 6123	Alex.Joiner@anz.com
Patricia Gacis	Strategist	+61 2 9227 1272	Patricia.Gacis@anz.com

Global Markets Credit Research

Jason Hill	Global Markets Credit Analyst	0434 312 356	Jason.Hill@anz.com

Commodities Research

Mark Pervan	Head of Commodities Research	+61 3 9273 3716	Mark.Pervan@anz.com
Amber Rabinov	Economist	+61 3 9273 4853	Amber.Rabinov@anz.com
Doug Whitehead	Soft Commodity Strategist	+61 3 9273 6684	Doug.Whitehead@anz.com
Natalie Robertson	Graduate Analyst	+61 3 9273 3415	Natalie.Robertson@anz.com

Property and Financial System Research

Paul Braddick	Head of Property and Financial System Research	+61 3 9273 5987	Paul.Braddick@anz.com
Ange Montalti	Senior Economist	+61 3 9273 6288	Ange.Montalti@anz.com
Dr. Alex Joiner	Economist	+61 3 9273 6123	Alex.Joiner@anz.com
Stephanie Wayne	Research Analyst	+61 3 9273 4075	Stephanie.Wayne@anz.com

Foreign Exchange and International Economics Research

Amy Auster	Head of Foreign Exchange and International Economics Research	+61 3 9273 5417	Amy.Auster@anz.com
Tony Morriss	Senior Currency Strategist	+61 2 9226 6757	Tony.Morriss@anz.com
Jasmine Robinson	Senior Economist	+61 3 9273 6289	Jasmine.Robinson@anz.com
Amber Rabinov	Economist	+61 3 9273 4853	Amber.Rabinov@anz.com

Foreign Exchange and Interest Rates Research (London)

Tim Riddell	Currency and Interest Rate Strategist		Tim.Riddell@anz.com

Asian Economics Research (Singapore)

Paul Gruenwald	Head of Asian Economics	+65 6419 7902	Paul.Gruenwald@anz.com
Ivy Tan	Associate Director, Credit Research	+65 6419 7914	Ivy.Tan@anz.com
Tamara Henderson	Director, Currency & Rates Strategy	+65 6216 1845	Tamara.Henderson@anz.com
Joshua Saldanha	Associate Director, Macroeconomics	+65 6216 1838	Joshua.Saldanha@anz.com
Chang Wei Liang	Research Intern, Markets Asia	+65 6216 1838	WeiLiang.Chang@anz.com

New Zealand Economics Research (Wellington)

Cameron Bagrie	Chief Economist, New Zealand	+64 4 802 2212	Cameron.Bagrie@anz.com
Khoon Goh	Senior Economist	+64 4 802 2357	Khoon.Goh@anz.com
Philip Borkin	Economist	+64 4 802 2199	Philip.Borkin@anz.com
Steve Edwards	Economist	+64 4 802 2217	Steve.Edwards@anz.com
Kevin Wilson	Rural Economist	+64 4 802 2361	wilsonk1@anz.com
David Croy	Interest Rate Strategist	+64 4 802 2286	David.Croy@anz.com

Research and Information Services

Mary Yaxley	Head of Research and Information Services	+61 3 9273 6265	Mary.Yaxley@anz.com
Marilla Rough	Senior Information Officer	+61 3 9273 6263	Marilla.Rough@anz.com
Manesha Jayasuriya	Publications Coordinator	+61 3 9273 4121	Manesha.Jayasuriya@anz.com

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Australia and New Zealand Banking Group Limited is represented in:

AUSTRALIA by:

Australia and New Zealand Banking Group Limited ABN 11 005 357 522

100 Queen Street, Melbourne, Victoria, 3000, Australia

Telephone +61 3 9273 6224   Fax +61 3 9273 5711

UNITED KINGDOM by:

Australia and New Zealand Banking Group Limited

ABN 11 005 357 522

40 Bank Street, Canary Wharf, London, E14 5EJ, United Kingdom

Telephone +44 20 3229 2121   Fax +44 20 7378 2378

UNITED STATES OF AMERICA by:

ANZ Securities, Inc. (Member of NASD and SIPC)

6th Floor 1177 Avenue of the Americas

New York, NY 10036, United States of America

Tel: +1 212 801 9160   Fax: +1 212 801 9163

NEW ZEALAND by:

ANZ National Bank Limited

Level 7, 1-9 Victoria Street, Wellington, New Zealand

Telephone +64 4 802 2000

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