



# ECONOMICS & MARKETS RESEARCH

## ANZ AUSTRALIAN MARKETS WEEKLY

### RECOVERY FIRMS UP, INFLATION IS THE IMMEDIATE THREAT

21 JANUARY 2010

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#### CONTRIBUTORS

**Warren Hogan**  
Acting Chief Economist &  
Head of Australian  
Economics and Interest  
Rates Research  
+61 2 9227 1562  
Warren.Hogan@anz.com

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

**Amber Rabinov**  
Economist, Foreign  
Exchange and  
International Economics  
Research  
+61 3 9273 4853  
Amber.Rabinov@anz.com

**Julie Toth**  
Senior Economist,  
Australian Economics and  
Interest Rates Research  
+61 3 9273 6252  
Julie.Toth@anz.com

**Shane Lee**  
Senior Economist  
Australian Economics and  
Interest Rates Research  
Shane.Lee@anz.com

**Dr. Alex Joiner**  
Economist, Australian  
Economics and Interest  
Rates Research  
+61 3 9273 6123  
Alex.Joiner@anz.com

**Melissa Fenech**  
Research Analyst,  
Australian Economics and  
Interest Rates Research  
+61 3 9273 1590  
Melissa.Fenech0@anz.com

#### ECONOMIC UPDATE: 2010 STARTS WITH A BANG

- Australian economic data released in January have been extremely positive, including good retail turnover growth in November, very strong jobs growth in December and high confidence levels among businesses and consumers.
- Underlying inflation pressures remain a significant concern. All eyes are now on Q4's CPI reading, to be released next week.
- Strong activity data combined with these ongoing inflation concerns will likely see the RBA raise rates 25 bps at its February board meeting.

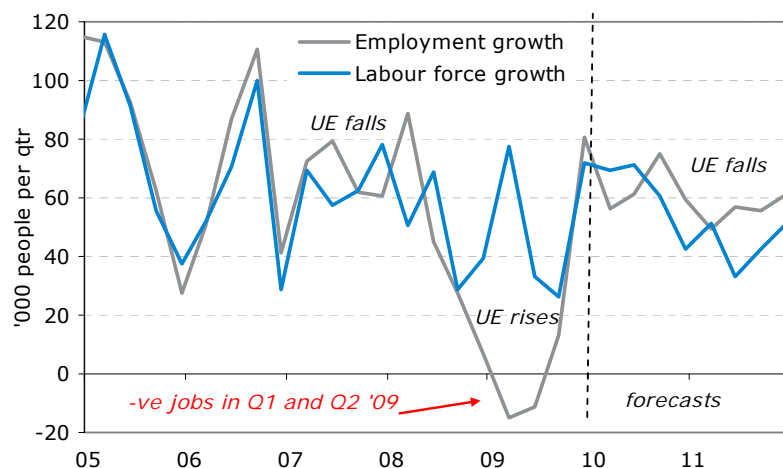
#### FX: INTERNATIONAL EVENTS OUTWEIGH POSITIVE DOMESTIC DATA FLOW

- The AUD/USD has recovered from its pre-Christmas rout, rallying as high as 0.9330 in January in response to far better than expected Australian retail sales and employment data.
- However, recent actions and comments from Chinese authorities tightening the screws on the Chinese economy have seen flows into risk assets reverse, and the likelihood that credit conditions will continue to be squeezed, could limit any near term rallies in the AUD.
- The week ahead should bring the domestic economy back into focus, with Q4 inflation data key ahead of February's RBA board meeting.

#### CHART OF THE WEEK: A REMARKABLY RAPID LABOUR MARKET RECOVERY

Jobs growth caught up to labourforce growth in Q3 2009 and spiked strongly in Q4, resulting in a welcome drop in the unemployment rate to 5.5%. 2010 will see further jobs and labourforce growth, producing a slow fall in unemployment.

FIGURE 1. JOBS GROWTH CATCHES UP TO LABOUR SUPPLY GROWTH



Sources: ABS and ANZ.

## ECONOMIC UPDATE

**Julie Toth**  
Senior Economist,  
Australian Economics  
and Interest Rates  
Research  
+61 3 9273 6252  
Julie.Toth@anz.com

**Shane Lee**  
Senior Economist,  
Australian Economics  
and Interest Rates  
Research  
Shane.Lee@anz.com

**Dr. Alex Joiner**  
Economist, Australian  
Economics and Interest  
Rates Research  
+61 3 9273 6123  
Alex.Joiner@anz.com

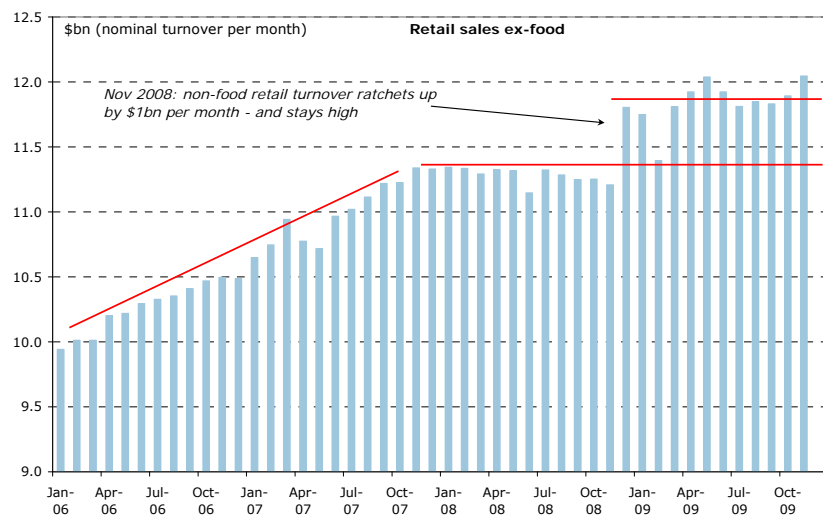
## 2010 STARTS WITH A BANG

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- Underlying inflation pressures remain a significant concern. All eyes are now on Q4's CPI reading, to be released next week.
- Strong activity data combined with these ongoing inflation concerns will likely see the RBA raise rates 25 bps at its February board meeting.

## DOMESTIC ECONOMY LOOKING GOOD SO FAR ...

Australian economic data released to date in January has, on the whole, indicated the economy is now recovering well from the downturn. In particular, household consumption and the labour market are proving resilient, well after the stimulus payment period of early 2009, helping to dispel lingering fears of a post-stimulus slump. Retail trade turnover grew 1.4% in November, far stronger than market expectations, and the strongest monthly growth since the (stimulus-fuelled) month of March. Non-food retailing is showing no signs yet of dropping back to its pre-stimulus levels, reflecting growing population, incomes and confidence since then (see figure 2). Anecdotal evidence and RBA cash supplies data suggest however, that December and January retail turnover may yet prove disappointing, relative to the good sales seen in previous months. If so, this weakness could interrupt the recent trend of strong jobs growth (see below) in the short term, since retail trade is our second largest employing industry overall (behind healthcare and community services) and by far the biggest employer of part-time and casual labour.

FIGURE 2. NON-FOOD RETAIL TRADE TURNOVER STAYS STRONG



Sources: ABS and ANZ

In other positive data from November, building approvals spiked 5.9% in the month on the back of a sharp 27% jump in 'other' dwellings, although detached housing approvals were down 1.9%. This was the first decrease in detached dwellings approvals in 11 months and may have been in response to the winding back of the boost to the first homebuyers grant from September to December last year. Hopefully it does not mark the end of the fledgling recovery in the building sector in response to tighter monetary policy. The 27% spike in private 'other' residential building approvals (apartments, units etc) is promising, but trend levels in this sector remain well down on long term averages. Given the demographic shift towards this type of dwelling, a sustained upswing in the sector is desirable going forward. Looking ahead, recent double-digit price house price growth in the established market should continue to encourage developers to bring on additional supply, despite the likelihood of further increases in interest rates this year. A similar pattern was evident in housing finance approvals in November, with a 2.9%

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**Julie Toth**  
Senior Economist,  
Australian Economics  
and Interest Rates  
Research  
+61 3 9273 6252  
Julie.Toth@anz.com

**Shane Lee**  
Senior Economist,  
Australian Economics  
and Interest Rates  
Research  
Shane.Lee@anz.com

**Dr. Alex Joiner**  
Economist, Australian  
Economics and Interest  
Rates Research  
+61 3 9273 6123  
Alex.Joiner@anz.com

fall in the value of owner-occupied housing finance approvals (down 5.6% in number) but an increase of 2.1% in housing finance approvals for investors.

As with retail trade, these building approvals numbers have direct implications for the labour market, since the construction industry is one of the four largest employing industries in Australia. Of some concern on this front, the Australian Industry Group's monthly Performance of Construction index for December improved, but remained at 'net contraction' levels. The AiG's performance of manufacturing index also moved back into 'net contraction' while the performance of services index fell to exactly neutral (50 points). More comfortably, the employment components of all three AiG indexes was 'expansive' in December, as was the ANZ Job Advertisements series and other indicators of labour demand. Consumer confidence is also back near its recent record high, with the Westpac consumer confidence index up 5.6% in January after two months of decline, moving back towards its recent peak last October, despite the interest rate rises to date.

Australia's labour market has enjoyed an impressive growth streak right through the second half of 2009, with jobs growth rapidly catching up to, and then surging ahead of (rapidly accelerating) population and labourforce growth (see figure 1). This has kept the unemployment rate stable at 5.8% and under, with a welcome drop down to 5.5% in December. By headcount, the Australian economy now employs more people than ever before – 10.9 million. A higher proportion of the workforce are however, now working part-time (less than 35 hours per week), at 30% of the total compared to 28.6% 5 years ago and 26.2% ten years ago. And although the headcount is at a record high, the aggregate hours being worked is about the same as it was a year ago, and 1.8% lower than its peak in July 2008. All of this says that while labour demand is definitely building back nicely, a significant amount of spare capacity or 'underemployment' may yet be lingering in the current employed workforce, to be utilised as well or instead of further headcount increases.

That said, recent trends and the forward indicators of labour demand all indicate that it is now looking unlikely that Australia will suffer unemployment rates over 6% in 2010, as had been widely feared until very recently. Instead, the unemployment rate will probably bounce from its current 5.5% up to 5.7% or even 5.8% in the months ahead, as jobs growth and labourforce growth continue to run neck and neck. Indeed, with the labourforce growing at around 20,000 people per month, it will take only one or two months' of jobs growth of under 10,000 to see the unemployment rate spike up. And given the strong labourforce growth expected this year, even very healthy levels of labour demand (i.e. net jobs growth) may not see the unemployment rate fall back toward 5% till sometime later in 2011.

#### ... BUT SERIOUS INFLATIONARY PRESSURES PERSIST

We forecast the headline CPI will rise by 0.4% in the quarter taking the inflation rate to 1.9%. We also forecast that the underlying CPI to rise by 0.6% and this will slow the underlying rate of inflation from 3.5% to 3.3%. This inflation outcome for the quarter would probably leave the market reasonably split on whether the RBA raises the cash rate at its February Board Meeting and we lean towards no move in the month. However, we also acknowledge that there is considerable risk to a 25bp move. A rise in the underlying CPI of greater than 0.7% would undoubtedly attract a tightening in policy from the Bank and the strength of last week's December Labour Force data would provide support for this.

Inflationary pressures are likely to remerge in Q1 after anecdotal reports of some large increases in the price of transport fares and school fees and a lift in petrol prices. Further out, the strength of the recovery will continue to absorb reasonably limited spare capacity and this will limit disinflation over the medium term.

In Q409 the prices of petrol and many clothing and food and beverage prices should put downward pressure on the CPI. Rises in rents, house purchase, house repair, deposits and loans and pharmaceuticals will offset this broad weakness to some extent. Despite our expectations of a soft CPI increase in Q4, underlying inflationary pressures remain persistent. The number of components of the CPI with inflation rates greater than 2.5% is only now beginning to ease after being above 64% for FY09 (see Figure 3).

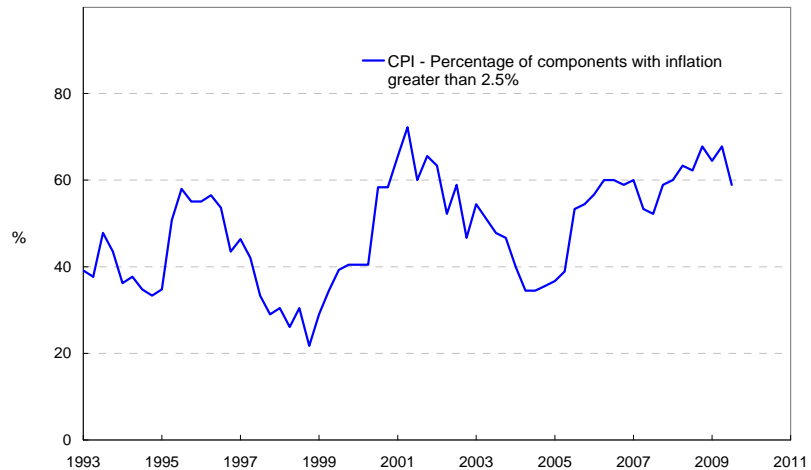
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Rates Research  
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Alex.Joiner@anz.com

**FIGURE 3. INFLATION PRESSURES HIGH IN MOST CPI CATEGORIES**



Sources: ABS and ANZ

The spare capacity created in the economy by the downturn should continue to ease these broad inflationary pressures and the rise of the AUD in H209 should help to some extent as well. The December NAB survey shows that capacity utilisation fell from its peak of 85.1% in October 2007 to 78.9% in March 2009, although since then it has recovered back to 81.1%.

In Q4 we expect petrol prices declined by 3.4% and food prices declined on average by 0.5%, while the stronger AUD and seasonal discounting lowered clothing prices by 0.7%. Utility prices probably rose by around 1% in the quarter after strong gains in Q3. We expect that the price of house purchase (0.9%), rents (1.0%) and house repairs and maintenance (0.9%) all probably posted solid gains in the quarter. We expect that AV equipment (-1.5%) and AV media (-0.8%) saw modest falls along with sports equipment (-0.1%), toys (-0.2%) and sports participation (-0.3%). Deposits and loan prices (3.0%) probably rose strongly on the back of the lift in bank margins on mortgage products, while other financial product prices (1.1%) probably rose in the quarter as well.

We forecast underlying inflation to steadily ease back to 2.6% by the mid-2011 before it begins to rise to 2.8% by mid-2012 (Figure 4). This forecast is based on growth remaining below potential (2.9%) during 2010 before picking up to around trend in 2011. We expect productivity growth to remain weak, but nominal wages growth to remain modest. In the modelling of the inflation outlook we assume oil prices and the currency remain at the average of levels seen during Q4. Clearly, there is some upward pressure on the AUD and this may lower inflation further out over the forecast period if the AUD gets another leg up. Oil prices could well rise if the global economic recovery gathers some steam and this would place upside risks to our inflation forecasts.

Headline inflation will be impacted by sharp price movements within the full CPI distribution and for this reason it is more volatile than underlying inflation. We expect that headline inflation troughed at 1.3% in Q309 and will rise to before it rises to 2.7% in Q110 after some of the weaker CPI price increases in 2009 drop out of the calculation of the annual rate.

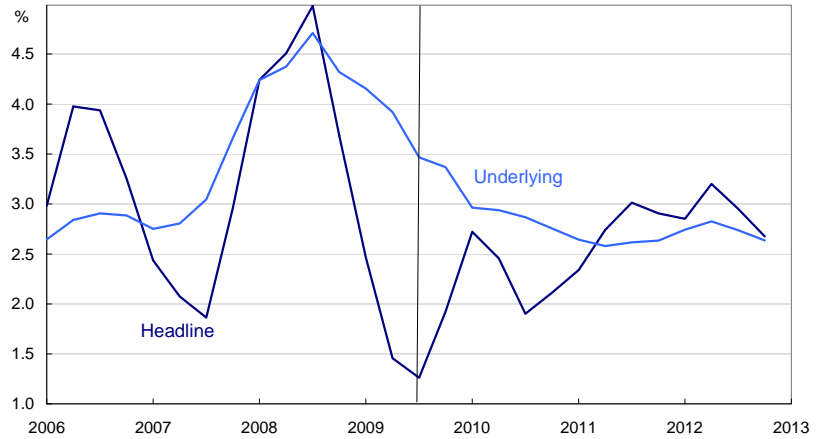
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FIGURE 4. INFLATION IS MODERATING BUT REMAINS OF CONCERN



Sources: ABS and ANZ

**MONETARY POLICY IMPLICATIONS AND RISKS**

The Q4 CPI is the key outstanding data release ahead of the RBA's February board meeting. We expect that the RBA will need to see a very tame number on quarterly core inflation to stop its tightening of policy. As highlighted earlier the recent strength of the activity data is compelling with retail sales and labour force reads the standouts. Further, consumer confidence rose sharply in January after dipping in the previous two months, and is now unusually high given we are really still at the beginning of the economic recovery phase and the interest rate tightening cycle. Building activity too has been able to fend off initial rate rises, up by a larger-than-expected 5.9% in November. Housing finance approvals are down sharply and will continue to fall but this, in the main, reflects the exodus of first home buyers from the market now that the boost the the first home buyers grant has been wound back. Besides, given the recent sharp rise in house prices it is unlikely the RBA will be too concerned if some of the recent heat is taken out of the property market.

For the Q4 CPI data released next week, we think a number of less than 0.6%QoQ for core inflation would be required for the RBA to contemplate a pause at its February meeting - anything higher and we can expect another 25bps hike.

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Australian Economics  
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Research  
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**Shane Lee**  
Senior Economist,  
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Shane.Lee@anz.com

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Alex.Joiner@anz.com

## DATA WRAP (JANUARY TO DATE)

- The **Australian Industry Group's (AiG) performance of manufacturing index** ticked back down into 'contraction' territory in December, dropping from a weakly positive 51.2 to a negative 48.5 points.
- The **HIA's new home sales** grew 0.3% in November after two months of falling.
- The **AiG's performance of services** index dropped from 52.5 to 50.0 points in December, indicating no net expansion.
- **Building approvals** grew 5.9% in November, to be up 33% since last year.
- The **monthly trade balance** for November shrank to \$1.7bn, from a revised \$2.08bn in October.
- **Nominal retail sales turnover** grew by a very strong 1.4% in November.
- The **AiG's performance of construction index** improved from 47.6 to 49.3 points but still indicated net 'contraction' for the industry.
- The monthly **ANZ Job Advertisements** count grew another 6.0% in December, to be 19.1% higher than the trough in July but 22.6% lower than a year ago.
- The number of **owner-occupied home loans** committed fell 5.6% in November, and their value fell 2.9%. The value of **total housing finance** commitments fell 1.6%, but investor approvals grew 2.1% by value.
- **Employment** grew a very strong 35,200 in December, taking the total level to a record high.
- The **unemployment rate** fell from 5.7% to 5.5% in December.
- The **participation rate** stayed steady at 65.2% in December.
- The **TD Securities Inflation Gauge** surged up to 2.6% p.a. in December, from 2.1% the previous month.
- The **Westpac consumer confidence index** increased by 5.6% in January after two months of decline, moving back towards its recent peak last October.
- Monthly **new vehicle sales** grew 3.3% in December, to be up 17.2% from last December, buoyed by a surge in demand from business buyers. Total new vehicle sales for the 2009 calendar year were 7.4% lower than in 2008.

**Amber Rabinov**  
Economist, Foreign  
Exchange and  
International Economics  
Research  
+61 3 9273 4853  
Amber.Rabinov@anz.com

**Melissa Fenech**  
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Australian Economics  
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#### FX: INTERNATIONAL EVENTS OUTWEIGH POSITIVE DOMESTIC DATA FLOW

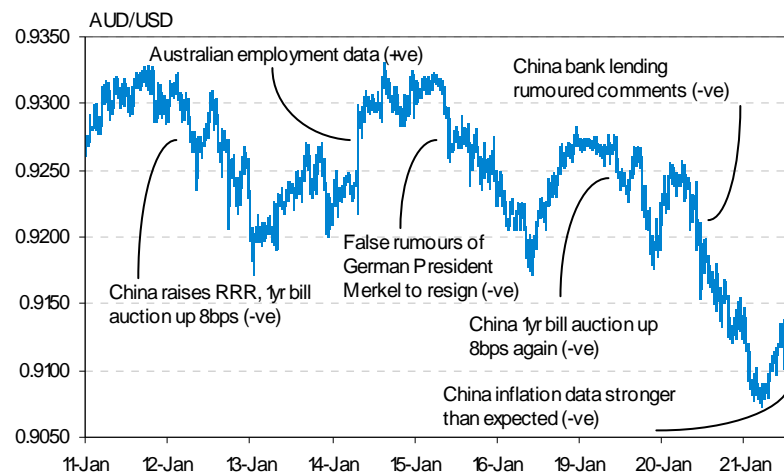
The AUD/USD has recovered from its pre-Christmas rout below 0.8750, rallying as high as 0.9330 on far better than expected Australian retail sales and employment releases. However, recent actions and comments from Chinese authorities tightening the screws on the Chinese economy have seen flows into risk assets reverse, and the likelihood that credit conditions will continue to be squeezed could limit any near term rallies in the AUD. Nonetheless, the week ahead should bring the domestic economy back into focus, with Q4 inflation data key ahead of February's RBA board meeting. Also watch for the market reaction to next week's FOMC meeting, closely followed by the first estimate of Q4 US GDP. Good support for the AUD/USD exists around 0.9080-9100, with dips as low as 0.9030 possible. AUD/USD sellers should watch for a break through 0.9280 on an upside surprise to CPI to target 0.9330.

**AUD/USD Key Levels: 0.9030 – 0.9330**

#### AUD/USD: RIDING THE TIGER

In 2009, the health and momentum of the Chinese economy was a major driver of the AUD/USD, and now in 2010, this influence seems as strong as ever. While this month's strong Australian data flow boosted expectations of a fourth-consecutive 25bp rate hike by the RBA in early February, this positive AUD impact was far outweighed by an effective tightening of credit conditions in China. Over the past two weeks, markets have become increasingly concerned about a slowdown in Chinese growth momentum following the raising of one-year bill rates at two People's Bank of China (PBoC) auctions, a 50bp rise in banks' reserve requirement ratio, and comments attributed to China Banking Regulatory Commission Chairman Liu Mingkang instructing banks to curb their lending (although these comments were later clarified to merely limiting lending of banks failing to meet regulatory requirements to ensure prudent supervision).

**FIGURE 5. TIGHTER CHINESE CREDIT CONDITIONS WEIGH ON AUD**



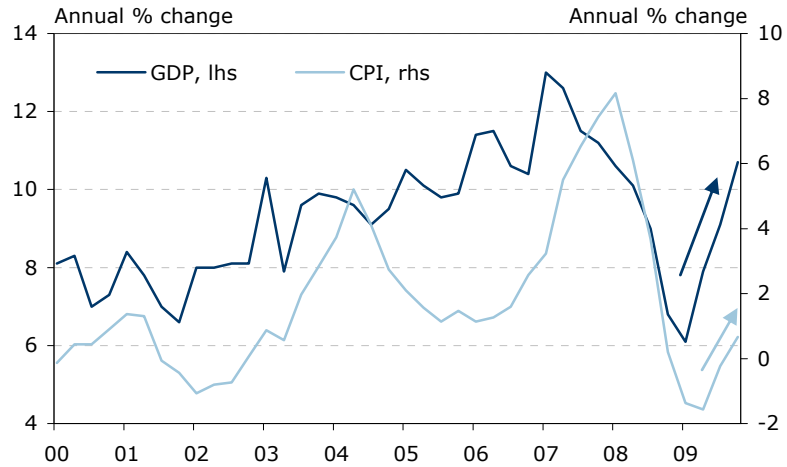
Sources: Bloomberg and ANZ

China's authorities are looking to be pre-emptive in warding off a potential overheating of the economy by mopping up excess liquidity, and today's GDP and inflation data illustrate why. The Chinese economy grew 10.7% through the year to Q4, above potential, and exceeded the government's 8% annual growth target for 2009 by 0.7ppts. Meanwhile, inflation surged to an annual rate of 1.9% in December, with consumer prices rising 1% compared to November levels, and producer prices turned positive for the first time in 11 months. ANZ's analysis suggests that without further monetary tightening, the risk is that Chinese inflation could soar above 7% due to a closing of the output gap and rapid growth in the money supply. Given this, we forecast the PBoC will bring the policy lending rate (currently at 5.31%) back to a more neutral stance of 6 to 7% by the end of the year.

**Amber Rabinov**  
Economist, Foreign  
Exchange and  
International Economics  
Research  
+61 3 9273 4853  
Amber.Rabinov@anz.com

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Research Analyst,  
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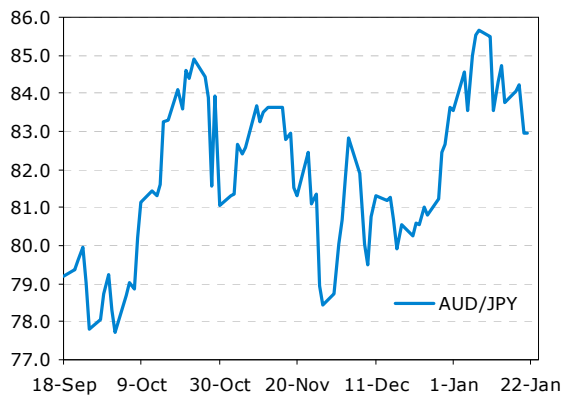
**FIGURE 6. CHINESE ECONOMY GAINS MOMENTUM**



Sources: Bloomberg and ANZ

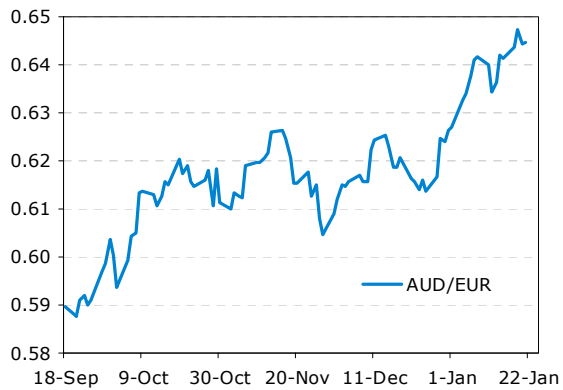
Nonetheless, the outlook for Chinese growth is strong and we forecast the economy to expand by 9.5% in 2010 and 9.8% in 2011. This is good news for the Australian economy and AUD/USD. Despite some tough talk from Chinese steelmakers, demand for Australia's bulk commodities remains strong and we see upside risk to our 40% forecast rise in iron ore and coking coal contract prices for 2010-11. Volumes should also pick up due to improvements in domestic infrastructure, and China's need to buy more from Australia now that India has put a tax on iron ore exports in order to support its domestic steel industry. In the first half of 2010, this supports our expectation that the AUD/USD will rally into the mid-to-high 0.90s, despite some short-term dips as China's authorities look to take some steam out of their economy.

## AUD CROSS VIEW



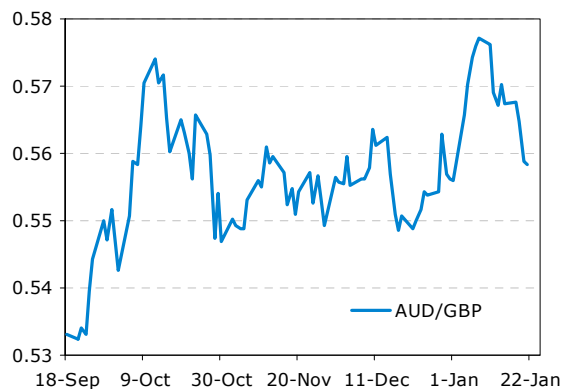
### AUD/JPY KEY LEVELS: 82.00 – 84.40

- Renewed market confidence has boosted risk appetite and along with it, the appeal of the carry trade. The AUD/JPY cross has lifted 2.6% since Christmas with 83.00 looking to be a key level for the currency pair. This week the market will be looking for further signs of monetary tightening by the PBoC and the AUD no doubt will be taking its direction from this.
- A flurry of data out of Japan in the next seven days will probably fail to direct the AUD/JPY, with market confidence and risk aversion most likely to be the key drivers for the cross. Continued restrictive comments from China may see the cross test 82.00 on the downside, while rallies should be capped to 84.40.



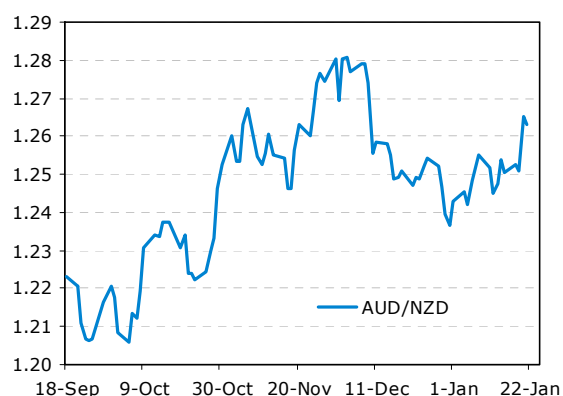
### AUD/EUR KEY LEVELS: 0.6260 – 0.6500

- The AUD/EUR continues to stride from strength to strength in 2010 with the cross gaining almost 3% in the New Year to trade at fresh nine-year highs earlier this week. A weakening EUR is the major driver for this rally as Greece continues to struggle with its deteriorating finances and an official downgrade to their sovereign credit rating.
- Recent comments out of China have dulled demand for the AUD, so we may see the AUD/EUR cool off slightly. If markets continue to shy away from the AUD expect the AUD/EUR to find support at 0.6260, and decreased European stability may extend the currency pair to 0.6500.



### AUD/GBP KEY LEVELS: 0.5540– 0.5670

- The AUD/GBP seems to have established itself in a higher trading range in 2010, with 0.5500 proving to be a critical point of resistance on the down side. The New Year has seen the AUD/GBP retain only 1% of its initial gains as the cross failed to take out the 0.5800 level on an improved outlook for the UK economy in 2010.
- The market will be looking for confirmation that the UK economy emerged from recession in Q4 2009 with GDP figures scheduled for release on Tuesday. A disappointing result could see AUD/GBP rally as high as 0.5670, although a better than expected read could see dips towards 0.5540.



### AUD/NZD KEY LEVELS: 1.2500 – 1.2750

- The AUD/NZD has made moderate gains, up 1.2% from Christmas as the NZD takes a bigger hit from China's comments earlier this week in comparison to the AUD. Weak CPI figures have also weighed on the NZD. Further shocks to the NZD may see the AUD/NZD reach towards 1.2750, with dips finding support at 1.2500.
- With a quiet New Zealand economic calendar next week, expect the AUD/NZD cross to take direction from any further comments out of China. Watch out for Australia's CPI data due for release on Wednesday next week as it will be key in the RBA's interest rate decision when it meets next in February.

## FORECASTS

AUSTRALIAN ECONOMIC INDICATORS	2008	2009 F	2010 F	2011 F
<b>Economic activity (annual % change)</b>				
Private final demand	4.1	0.2	2.8	4.6
Household consumption	2.4	1.4	1.8	3.0
Dwelling investment	2.6	-5.5	9.5	6.0
Business investment	12.4	-2.2	3.4	9.2
Public demand	6.7	2.1	7.0	4.6
Domestic final demand	4.5	0.7	3.7	4.6
Inventories (contribution to GDP )	-0.4	-0.5	0.6	-0.1
Gross National Expenditure (GNE)	4.3	0.1	4.3	4.5
Exports	3.8	1.1	2.3	5.4
Imports	11.4	-7.7	9.5	9.2
Net Exports (contribution to GDP)	-1.6	2.0	-1.5	-0.9
<b>Gross Domestic Product (GDP)</b>	<b>2.2</b>	<b>0.9</b>	<b>3.0</b>	<b>3.4</b>
<b>Prices and wages (annual % change)</b>				
Inflation: Headline CPI	4.4	1.8	2.3	2.8
Underlying *	4.4	3.7	2.9	2.7
Wages	4.1	3.6	2.9	3.3
<b>Labour market #</b>				
Employment (annual % change)	2.2	0.3	2.0	2.1
Unemployment rate (annual average %)	4.3	5.6	5.7	5.2
<b>External sector</b>				
Current account balance: A\$bn	-54.3	-50.3	-58.1	-55.9
% of GDP	-4.4	-4.0	-4.4	-4.0

\* Average of RBA weighted median and trimmed mean statistical measure.

# Actual labour market data for 2008 and 2009, forecasts for 2010 and 2011.

AUSTRALIAN INTEREST RATES	CURRENT	MAR 10 F	JUN 10 F	SEP 10 F	DEC 10 F	MAR 11 F
RBA cash rate	3.75	4.00	4.25	4.50	4.75	4.75
90 day bill	4.19	4.45	4.75	4.85	5.00	5.00
3 year bond	4.74	4.90	5.10	5.15	5.30	5.55
10 year bond	5.50	5.40	5.50	5.45	5.60	5.75
3s10s yield curve	0.76	0.50	0.40	0.30	0.30	0.20
3 year swap	5.37	5.35	5.55	5.60	5.75	6.00
10 year swap	6.11	6.00	6.05	6.00	6.15	6.30
INTERNATIONAL INTEREST RATES	CURRENT	MAR 10 F	JUN 10 F	SEP 10 F	DEC 10 F	MAR 11 F
RBNZ cash rate	2.50	2.50	3.00	3.75	4.00	4.00
NZ 90 day bill	2.78	2.80	3.63	4.22	4.30	4.30
US Fed funds note	0.25	0.25	0.25	0.25	0.75	1.25
US 2 year note	0.89	1.20	1.50	1.75	2.20	2.65
US 10 year note	3.67	4.10	4.30	4.25	4.40	4.45
Japan call rate	0.10	0.10	0.10	0.10	0.10	0.10
ECB refinance rate	1.00	1.00	1.00	1.00	1.50	1.75
UK repo rate	0.50	0.50	0.50	0.50	1.00	1.25

For additional information on interest rates please refer to ANZ's *Interest Rate Strategy Weekly*.



## FORECASTS

FOREIGN EXCHANGE RATES	CURRENT	MAR 10 F	JUN 10 F	SEP 10 F	DEC 10 F	MAR 11 F
<b>Australian exchange rates</b>						
A\$/US\$	0.9124	0.94	0.96	0.92	0.90	0.87
NZ\$/US\$	0.7225	0.72	0.73	0.71	0.70	0.68
A\$/¥	83.30	85.5	84.5	82.8	82.8	81.8
A\$/€	0.6459	0.64	0.65	0.64	0.64	0.62
A\$/£	0.5601	0.57	0.58	0.56	0.55	0.52
A\$/NZ\$	1.2627	1.31	1.32	1.30	1.29	1.28
A\$/C\$	0.9534	0.98	0.98	0.96	0.95	0.92
A\$/CHF	0.9515	0.97	0.97	0.95	0.96	0.95
A\$/CNY	6.2293	6.42	6.56	6.20	5.99	5.72
A\$ Trade weighted index	70.80	72.0	73.2	70.6	68.7	66.4
<b>International cross rates</b>						
US\$/¥	91.29	91.0	88.0	90.0	92.0	94.0
€/US\$	1.4126	1.46	1.48	1.43	1.41	1.40
€/¥	128.96	133	130	129	130	132
£/US\$	1.6289	1.64	1.66	1.64	1.65	1.66
€/£	0.8672	0.89	0.89	0.87	0.85	0.84
US\$/C\$	1.0449	1.04	1.02	1.04	1.05	1.06
US\$/CHF	1.0428	1.03	1.01	1.03	1.07	1.09
US\$ index	78.29	76.4	75.1	77.2	78.2	78.8
<b>Asia exchange rates</b>						
US\$/CNY	6.8271	6.83	6.83	6.74	6.66	6.58
US\$/HKD	7.7679	7.75	7.76	7.77	7.77	7.76
US\$/IDR	9318	9300	9500	9300	9000	8800
US\$/INR	45.93	46.5	46.0	46.0	45.0	44.5
US\$/KRW	1139	1100	1150	1175	1050	1000
US\$/MYR	3.3655	3.34	3.37	3.40	3.40	3.35
US\$/PHP	46.049	46.0	46.5	46.0	45.0	45.0
US\$/SGD	1.3979	1.39	1.40	1.41	1.41	1.40
US\$/THB	32.955	33.00	33.00	32.50	32.50	32.50
US\$/TWD	31.916	31.50	31.90	31.50	30.50	30.00
US\$/VND	18439	18500	18500	18500	19300	19300
<b>Pacific exchange rates</b>						
PGK/US\$	0.3780	0.392	0.381	0.395	0.386	0.372
FJD/US\$	0.5204	0.545	0.540	0.530	0.523	0.510

**IMPORTANT NOTICE**

Australia and New Zealand 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 2 9226 4647 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:**

UNITED STATES OF AMERICA by:  
 ANZ Securities, Inc. (Member of FINRA [www.finra.org] and SEC)  
 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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