ANZ BUDGET REPORT

2001-02

Australia and New Zealand Banking Group Limited
A.C.N. 005 357 522

Inside

Budget outcome

- A raft of new spending commitments since MYEFO and weaker economic growth have reduced the underlying budget surplus from $12.7bn in 1999-00 to $2.3bn in 2000-01 and only $1.5bn in 2001-02. Moreover, without a marked increase in the RBA dividend next year and substantial non-financial asset sales, the 2001-02 underlying budget position would be in substantial deficit.

Budget overview

- There is less to this Budget than meets the eye. There were no measures of any significance which had not been formally announced by the Government earlier in the year or leaked to the media in the weeks leading up to the Budget. Policy initiatives will cost the Budget $3.7bn in 2001-02, rising to $4.9bn in 2002-03 and $6.8bn in 2003-04. Over three years this amounts to a ‘give-away’ totalling $15.3bn.

Economic forecasts

- Treasury’s economic growth projections (2% in 2000-01 and 3¼% in 2001-02) are broadly consistent with ANZ’s forecasts and the wider consensus and imply a solid recovery in activity in the coming year. Moreover, Treasury’s forecasts for a $20bn (3% of GDP) current account deficit this year are met, these outcomes will be the lowest in 20 years. But, while the overall economic outlook is generally optimistic, clear risks remain.

Financial market reaction

- Budgets rarely change the trend for the Australian dollar or interest rate markets, and this one was no different. To the extent that Treasury sees a rebound in Australia’s economic growth this year it reinforces our view that the end of the easing cycle is near (if not already passed). The $A should be supported by the projected falls in the current account deficit and interest differentials.

<table>
<thead>
<tr>
<th></th>
<th>1999-00(a)</th>
<th>2000-01(e)</th>
<th>2001-02(f)</th>
<th>2002-03(f)</th>
<th>2003-04(f)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal balance</td>
<td>13.5</td>
<td>5.4</td>
<td>-0.8</td>
<td>-1.5</td>
<td>2.7</td>
</tr>
<tr>
<td>Underlying cash</td>
<td>12.7</td>
<td>2.3</td>
<td>1.5</td>
<td>1.1</td>
<td>4.1</td>
</tr>
<tr>
<td>Headline cash</td>
<td>22.2</td>
<td>8.5</td>
<td>4.7</td>
<td>0.1</td>
<td>17.6</td>
</tr>
</tbody>
</table>

1 The fiscal balance is the accruals based measure of the underlying ‘cash’ budget position
2 The underlying cash budget position excludes public sector asset sales and net advances to the States
Overview of the Budget

There is less to this Budget than meets the eye. There were no measures of any significance which had not been formally announced by the Government earlier in the year or leaked to the media in the weeks leading up to the Budget.

To be sure, the ‘underlying’ cash surplus (ie, net of sales of financial assets and net repayments of State debt) projected for 2001-02 was, at $1.5 bn, above market expectations which were for the most part in the range $0.5-1 bn (though of course well down from the $4.7 billion projected in November).

But this result was achieved only thanks to a windfall from the Reserve Bank, whose dividend payment to the Government in 2001-02 will amount to $2.8bn, up from $1.3bn in 2000-01; the upwards revision to the estimate of this dividend appears to account for nearly all of the $1.8bn movement since the Mid-Year Review in the Budget’s expected dividend receipts in 2001-02.

This windfall – which reflects the accounting profits generated by the Reserve Bank’s sales of foreign currencies acquired when the $A was much stronger - in turn explains why the impact of ‘parameter revisions’ (Budget-speak for changes in economic and other assumptions underpinning the fiscal arithmetic) on the budget bottom line for 2001-02 was so small. Changes in the Reserve Bank’s dividend are treated as a ‘parameter revision’, not a ‘policy decision’.

Without this windfall, and other things being equal, the underlying cash balance for 2001-02 would have been a small deficit.

The 2001-02 outcome has also been bolstered by the projected sale of some $1.7bn of non-financial assets – which, under the Government’s version of accounting standards, are treated either as negative outlays or as non-tax revenues. These include some $1/2bn in defence asset sales and (presumably, though no details are given) further sales of digital spectrum.

Contrary to some media reports, there was no windfall from the GST – revenue estimates from which were actually revised down – nor in any sustained sense, from company tax collections (which were revised up by $1.6 bn for the current financial year but revised down for 2001-02). The hoped-for windfall from tax reform is either simply not there, or will not be revealed until the further review of the Budget arithmetic required upon the announcement of the election date.

And to offset whatever pleasant surprise there may at first glance have been in the surplus for 2001-02, the surpluses for the ‘out-years’ were much smaller than informal market estimates. The 2002-03 surplus has been cut to just $1.1bn (from $7.6bn in the Mid-Year Review) and the 2003-04 surplus to $2.7bn (from $12.9bn). Also, the accruals measure of the budget bottom line (the ‘fiscal balance’) slips into deficit next year and in 2002-03.

The sharp reductions in the projected cash surpluses for 2002-03 and 2003-04 owe less to the impact of slower economic growth this year and next (‘parameter variations’ have worsened the bottom line for both years by $3.4bn) than to the delayed impact of the Government’s policy initiatives unveiled over the past six months.

Policy initiatives will cost the Budget $3.7bn in 2001-02, rising to $4.9bn in 2002-03 and $6.8bn in 2003-04. Over three years this amounts to a ‘give-away’ totalling $15.3bn, of which $4.9bn is on the revenue side ($2.9bn of it from the government’s ‘concessions’ on fuel excise) and $10.7bn on the spending side.

Official thinking about fiscal strategy has moved a long way in the two years since then Treasury Secretary Ted Evans argued ‘the simultaneous achievement of sustainable [current account] and low and stable inflation outcomes would be put at risk by a complacent attitude to the use of fiscal surpluses’.

One area of the Budget not open to serious criticism is its underlying economic projections. The forecasts of 2% growth for the current financial year and 3½% for 2001-02 are entirely credible; and the projection that unemployment will be at 7% in the June quarter next year (compared with the latest figure of 6.8% for April) is, for an election-year document, surprisingly high (though we would not dispute it). The 2001-02 growth forecast depends on strong rebounds in housing activity and business investment, and on continued growth in exports – both of which appear reasonable prospects at this time.

While many individual Australians will benefit from specific measures funded by the Budget (and the Government no doubt hopes they will show their gratitude later in the year), there is little in the Budget for business other than the decision to allow purchasers of motor vehicles to claim full input tax credits a year earlier than previously envisaged. Contrary to the hopes raised by the Treasurer’s pre-Budget media interviews, neither his speech nor the supporting documents succeeded in ‘laying down markers’ for the longer-term economic future of Australia. In a Budget with few surprises, that may represent its most significant disappointment.
The Budget outcome

Predictably in an election year, the Government has taken a further step away from the fiscal austerity evident in the first Howard/Costello budget of 1996-97. New policy decisions since the Mid-year Economic and Fiscal Outlook (MYEFO) have subtracted $3.7bn from the 2001-02 fiscal balance with additional spending targeted at disaffected sections of the community (i.e., the aged, welfare recipients, rural and regional Australia) in an attempt to lift the Coalition’s flagging electoral prospects.

Weaker than expected economic growth in 2000-01 and new policy decisions have reduced the Budget position well below the MYEFO forecasts. This year’s underlying cash surplus estimate of $2.3bn compares with the MYEFO forecast of $4.3bn. Furthermore, the underlying surplus forecast for 2001-02 of $1.5bn is well below the MYEFO outlook of $4.7bn and is reliant on a $1.5bn increase in the RBA dividend to $2.8bn as well as $1.7bn of non-financial asset sales. Without the inclusion of these measures the underlying budget position would clearly be in substantial deficit in 2001-02. The increased RBA dividend is largely a result of the low $A boosting the value of foreign reserves in 2000. With the $A widely expected to recover strongly this year and next, higher RBA dividends are unlikely to be sustainable.

While a change in GST revenue does not directly affect the Commonwealth’s Budget surplus (as GST revenues are paid to the States), a $2.1bn GST shortfall this year has indirectly affected the Commonwealth budget via a $2.3bn increase in the budget balancing assistance payments to the States.

In hindsight, the sharp easing of fiscal policy in 2000-01 was appropriately counter-cyclical. But with the economy widely expected to recover strongly next year, a further significant fiscal easing would risk being pro-cyclical and thereby exacerbating the ‘boom-bust’ cycle.

While the marked deterioration in the Budget position will disappoint ‘purists’, it is hardly surprising in an election year and (counter-intuitively) may in fact prove fortuitous for the Coalition’s electoral prospects. The Government has been careful not to leave too much cash in the piggy-bank in order to restrict the Labor Party’s ability to make expensive promises in the lead-up to the Federal election later this year.

Nonetheless, after almost a decade of solid growth in the Australian economy, the small projected underlying budget surpluses highlight the limited extent to which the structural budget position has improved since the mid-1990s.

The Budget figuring for 2001-02 and 2002-03 is no longer predicated on the sale of the Government’s remaining 50.1% of Telstra. This accounts for much of the reduction in the outlook for the headline Budget surplus in these 2 years compared with MYEFO. However, the sale is still assumed to eventually go ahead and boosts the surplus estimates substantially in 2003-04 and 2004-05.

Budget figuring

Since the MYEFO, the fiscal surpluses for 2001-02 and 2002-03 have been revised downwards substantially. In 2001-02, policy decisions subtract $3.7bn, comprising $1.1bn less revenue and $2.8mn in additional expenses. The downward revisions are amplified by economic and parameter variations which subtract a further $0.4bn from the surplus (which would have been substantially greater were it not for the increased RBA dividend).

Underlying cash budget balance

Headline cash balance

Budget figuring
The table below sets out the major sources of changes in the accrual accounting measures of the projected Budget bottom line since last December.

### Reconciliation of 2000-01 MYEFO and 2001-02 Budget fiscal balance estimates

<table>
<thead>
<tr>
<th></th>
<th>2000-01 $m</th>
<th>2001-02 $m</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000-01 MYEFO fiscal balance (per cent of GDP)</td>
<td>8,407</td>
<td>3,285</td>
</tr>
<tr>
<td>Changes between MYEFO and 2001-02 Budget</td>
<td>1.2</td>
<td>0.5</td>
</tr>
<tr>
<td>Total policy decisions</td>
<td>-1,649</td>
<td>-3,693</td>
</tr>
<tr>
<td>Parameter and other variations</td>
<td>-1,334</td>
<td>-424</td>
</tr>
<tr>
<td>2001-02 Budget fiscal balance (per cent of GDP)</td>
<td>5,424</td>
<td>-834</td>
</tr>
</tbody>
</table>

### Reconciliation from MYEFO to Budget (accruals basis)

```
$ billion

+-----------------+-----------------+-----------------+-----------------+-----------------+-----------------+-----------------+-----------------+
|                 | Nov '00 forecast| $3.3bn          | $0.4bn          | $1.1bn          | $2.8bn          | Budget          | Net             |
|                 |                 | Economic        | & other         | Net             | Net             | forecast        | revenue         |
| Net             |                 | 'parameter      | 'parameter      | spending         | revenue         |                 | reductions       |
| spending        |                 | changes'        | changes'        | increases        | reductions       |                 |                 |
| increases       |                 |                  |                  |                 |                 |                 |                 |

Source: Budget Papers Statement No. 1 2001-02
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### Key measures impacting on business

As might be expected given the imminence of the next election, most of this Budget’s initiatives are directed towards consumers (ie voters) rather than business. While the Treasurer’s Budget Speech reiterated the company income tax cuts and cuts in other business taxes that were part of the Government’s New Tax System and its response to the Ralph Report, with one exception there were no major measures affecting business in the Budget that had not been unveiled earlier in the year or leaked to the media in recent weeks.

The one exception is that the Government has responded to strong representations from the motor vehicle industry concerning the distorting impact of the phase in of input tax credits on the purchases of motor vehicles by business. In order to avoid a “buyer’s strike” in the months leading up to the GST, the Government phased in input tax credits on the purchase of motor vehicles by business. For the first twelve months after the introduction of the GST input credits were to be denied, 50% credits were to be allowed from July 1, 2001 to July 1, 2002 and full credits from then onwards. Under these rules, in the post GST environment, there was a strong incentive for business to delay purchases. The new measure allows full input tax credit from midnight on budget night.

The Government estimates that this will lower the cost (to a business) of a $35,000 car by $3,200, and of a $330,000 trucking rig by $30,000. This should ‘pull forward’ purchase decisions and assist Australian producers of passenger motor vehicles where fleet sales are important.

*Defence industries* are a potentially a big winner from the (previously announced) Defence White Paper which involves significant expenditure on capital equipment over the next decade.

The Budget funds increases to a range of programmes to assist ‘new technology industries’ under the “Backing Australia’s Ability” initiative unveiled by the Prime Minister in January. New spending under the Government’s Innovation Action Plan amounts to nearly $3 billion over five years, although only $174mn in extra funding is provided for the 2001-02 financial year.

Immediate benefits are to flow to the New Industries Development Programme, the Biotechnology Innovation Fund, the COMET programme a new Pre-seed Fund for new technologies and a National Innovation Awareness Strategy programme. In the out years a significant increase in funds is allocated for expansion of the Cooperative Research Centres Programme and the Innovation Access Programme.

Statement No. 4 in the Budget documents provides a 21-page discussion of the potential impact of information and communications technologies to drive an extended period of strong productivity growth in Australia. Nearly half of this discussion is actually about the US experience; and in the Australian context, Treasury sees government’s role as being largely confined to ‘the maintenance of a good investment climate … vibrant competition [and] more flexible labour markets’.

In response to criticism from the *manufacturing sector* the Government has announced a widening of tariff exemptions under the Policy and Project By-Laws from July 1, 2002. This will reduce business input costs at a cost to revenue of around $40m per year.

As announced in November last year, there are significant funds allocated to upgrading road infrastructure as well as the previously announced funding for rail projects. This expenditure will assist
the engineering and construction industries which have been hard hit in the current economic slowdown. Residential construction is already being assisted by the first home buyers grant.

The communications industry is being given support in providing mobile phone services to rural Australia. Increased government funds to the Natural Heritage Trust from 2002-2003 and previously announced expenditure commitment to the National Action Plan for Salinity and Water Quality will benefit rural based businesses as well as input suppliers into these conservation measures.

Additional assistance to the dairy industry of $142m, on top of the existing structural adjustment payments of $1.78b was provided in the Budget. As with the original package, this is aimed at easing the pain to dairy farmers exiting the industry and the impact on dairy communities.

**Economic assumptions**

Treasury’s economic growth projections appear reasonable and are broadly consistent with our own outlook and the broader market consensus.

**Economic forecasts**

<table>
<thead>
<tr>
<th>2000-01</th>
<th>2001-02</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Economic activity</strong></td>
<td>Budget</td>
</tr>
<tr>
<td>Private consumption</td>
<td>2¼</td>
</tr>
<tr>
<td>Private investment</td>
<td>-25</td>
</tr>
<tr>
<td>- dwelling</td>
<td>-22</td>
</tr>
<tr>
<td>- non-dwelling (a)</td>
<td>5</td>
</tr>
<tr>
<td>- plant &amp; equip(a)</td>
<td>0</td>
</tr>
<tr>
<td>Private demand (a)</td>
<td>2¼</td>
</tr>
<tr>
<td>Public demand (a)</td>
<td>1¼</td>
</tr>
<tr>
<td>Chg. in Inventories</td>
<td>¼</td>
</tr>
<tr>
<td>- private non-farm</td>
<td>0</td>
</tr>
<tr>
<td>- farm &amp; public auth.</td>
<td>1½</td>
</tr>
<tr>
<td>GNE</td>
<td>6</td>
</tr>
<tr>
<td>Exports</td>
<td>0</td>
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<tr>
<td>Imports</td>
<td>1¼</td>
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<tr>
<td>Net exports</td>
<td>1¼</td>
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<tr>
<td>GDP</td>
<td>2</td>
</tr>
<tr>
<td><strong>Other indicators</strong></td>
<td>Budget</td>
</tr>
<tr>
<td>Inflation</td>
<td>- headline</td>
</tr>
<tr>
<td>- ‘ongoing’ (c)</td>
<td>3¼</td>
</tr>
<tr>
<td>Employment</td>
<td>2</td>
</tr>
<tr>
<td>Unemploy. rate(d)</td>
<td>6¼</td>
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<tr>
<td>Average earnings</td>
<td>3½</td>
</tr>
<tr>
<td>Current account $bn</td>
<td>-20½</td>
</tr>
<tr>
<td>- % GDP</td>
<td>-3</td>
</tr>
</tbody>
</table>

(a) excluding private sector net purchases of second-hand public sector assets  
(b) % contribution to growth  
(c) excluding ANTS impacts  
(d) June qtr 2002

Treasury’s year average ‘ongoing’ inflation projection for 2001-02 of 2½% is higher than our own forecast of 2%. However, by convention, Treasury assumes an unchanged exchange rate while we (and the market) forecast an ongoing appreciation of the $A which will reduce price pressures next year.

At 2% for 2000-01, Treasury’s GDP projection matches our own and the 3¼% forecast for 2001-02 is only ¼% above ours. The forecasts foreshadow a strong bounce back in economic activity in the second half of this year, underpinned by accommodative policy and led by a solid recovery in housing demand. Treasury’s year average 3¼% 2001-02 growth forecast implies ‘through the year growth of 4%, which (again) is in line with our forecasts. By convention the Government’s economic growth estimate for the out-years (2002-03 and beyond) is set at 3½%, below our forecasts of 4½% in 2002-03 and 2003-04.

While the overall economic outlook is generally optimistic, clear risks remain. Global growth projections continue to be wound back and a long overdue restructuring in Japan may result in sharply weaker growth in Asia next year. Moreover, despite recent market optimism, it is far from clear that the US economy has commenced a sustainable growth upturn. Domestically, the HIH Insurance debacle (likely to be Australia’s largest ever corporate collapse) may have short-term negative ramifications for the building industry and the wider economy.
Financial market implications

Budgets rarely change the trend for the Australian dollar or interest rate markets, and this one was no different. To the extent that Treasury sees a rebound in Australia’s economic growth to 3¼% in 2001-02 from 2% this year, and the US economy avoiding a hard landing, it reinforces the recent rhetoric from the RBA suggesting that the end of the easing cycle is near (if not already passed).

The budget will have little impact on bond yields, which will continue to be determined primarily by movements in US markets. Over a 12-month horizon we expect yields will be higher than current levels though from a shorter-term perspective, the recent sell-off appears overdone. Inflation fears seem excessive and a continuation of more mixed activity data in the US may see a pullback from current levels.

As the government forecasts the budget to remain in surplus over the forward estimates period, its net debt reduction program will continue. With a $4.7bn headline surplus and maturities of around $6.5bn, the net funding requirement in 2001-02 will be around $1.8bn. At this stage, gross new Treasury bond issuance of around $2-3bn and $200mn issuance of indexed bonds is planned. This implies just under $1bn will be available for the purchase of bonds or financial assets. Any reduction in net debt will be done in the context of maintaining the viability of the CGS market. (A detailed statement on debt issuance and debt reduction strategies will be released by the Australian Office of Financial Management prior to the start of the financial year). A further reduction in government debt would make room for further growth in corporate bond issuance.

The fact that the A$ weakened shortly after the budget release may have simply been due to market conditions during London trade and not necessarily a “verdict” on the budget. Any ‘knee-jerk’ response to the larger than expected surplus for 2001-02 should have been currency supportive, though this was offset by the lower out-year surpluses and dependence of next year’s surplus on a sizeable RBA dividend.

From a medium term perspective, the maintenance of budget surpluses suggests Australia’s economic management should continue to be viewed in a broadly favourable light while the forecast rebound in economic growth implies less scope for further rate cuts here. As well, if Treasury’s forecasts for a $20bn (3% of GDP) current account deficit this year and next are met, these will be the lowest outcomes in 20 years.

Overall, the recovery in the Australian dollar from its low of US0.4775 in early April reflects a less negative US (and world) growth outlook as well as a market reassessment of the more favourable outlook for growth here relative to the US. Of more importance perhaps is the expectation that Australian short-term rates will maintain a significant margin over US rates for some time. Following recent US interest rate cuts, the short-term cash differential between Australia and the US is now 1.0%, the widest it has been since 1996. And bond spreads have moved out to levels, which are now becoming attractive to foreign investors.

Telstra

The Government’s decision to postpone the sale of its remaining 50.1% stake in Telstra has dramatically reduced the headline Budget surpluses for 2001-02 and 2002-03, as well as weakening the underlying budget position in these years via increased public debt interest costs. At yesterday’s closing price of $6.43 the Government’s 50.1% holding in Telstra was valued at $41 billion. This would have allowed the repayment of all remaining Government debt and saved around $1 billion per annum in net interest/dividend payments. However, given the clear political resistance to any further selldown, the Budget presents a more realistic view of the likely fiscal and net debt outcomes for the next two years.

Despite this, the Budget figuring still assumes the sale eventually proceeds. Consequently, the surplus estimates (headline and underlying) for 2003-04 and 2004-05 are boosted substantially, allowing net government debt to be eliminated in 2004-05. However, given the existing political landscape, the assumed sale still remains highly speculative.

Net government debt

![Net government debt chart](chart.png)

Note: Refers to fiscal years ended 30 June (e.g. 2000=1999-2000)
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