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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.

Economic Update

- This week the global financial system entered a new and dangerous phase in the evolution of this credit crisis. Market liquidity is declining and confidence is plummeting. For Australia, the biggest impact has been seen on the equity market and in money markets.
- This week's events highlight once again the potential for dislocations between the RBA cash rate and interest rates in the actual economy.
- Sharp rises in BBSW and falls in OIS rates has seen the OIS/BBSW spread widen to 93bps today. This is a new high for this crisis and represents a significant tightening of local financial conditions.
- These financial pressures (and thus OIS/BBSW spreads) are very difficult to predict but if the current wide levels are maintained up to the next RBA board meeting in October, it would likely be a catalyst for a 25bp to 50bp rate cut, depending on the degree of stress in the system.

Special article

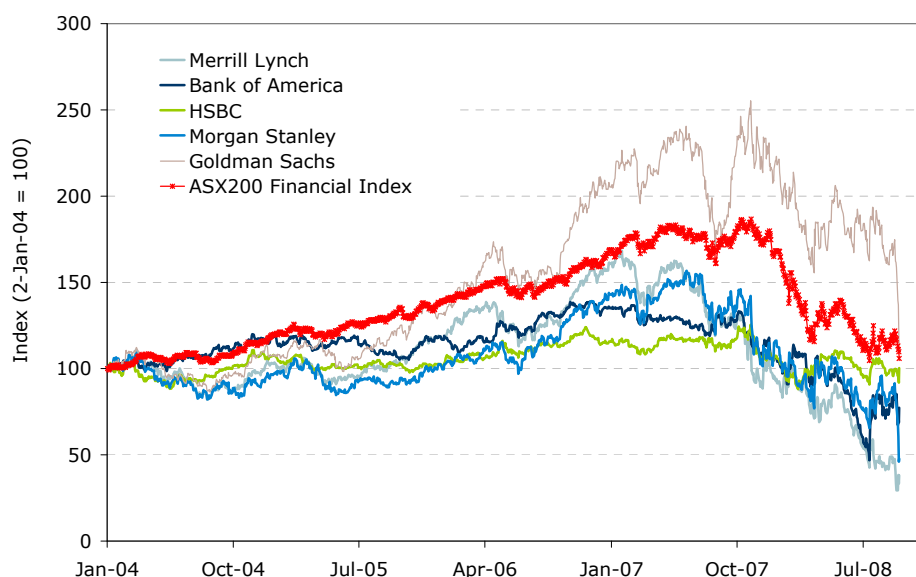
- A primer on this week's events in global financial markets.

Market wrap

- Safe haven flows have pushed bond yields down sharply.
- Heightened risk aversion is creating an unfavourable environment for AUD.
- A shocking week for local equities.

Chart of the week

The global financial sector is under tremendous pressure



Sources: Bloomberg and ANZ

Economic Update

Coming up

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- Anticipated announcements by the **US Treasury** (possibly as early as tonight) on the creation of a vehicle to resolve bad banking debts.
- RBA Financial Stability Review** (Friday 11:30 AEST). This half-yearly review on the health of the Australia's financial system couldn't be better timed!

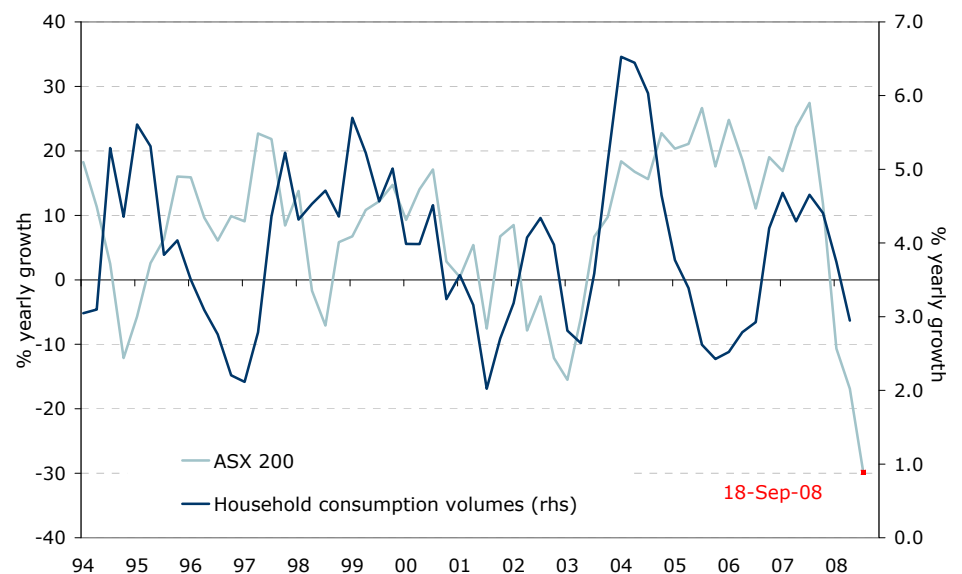
Credit crisis deepening; resolution quickening?

This week the global financial system entered a new and dangerous phase in the evolution of this credit crisis. Until now acute strains within the financial system have been met with concerted action by central authorities to shore up (or transfer ownership of) distressed balance sheets. Financial institutions, it was believed, were too big or too interconnected to other market participants to be allowed to fail. The bankruptcy of the Lehman Brothers holding company this week dispels this belief and heralds a period of more rapid adjustment for the global banking system.

Since last Friday the ASX 200 has fallen by nearly 6% to hit fresh 3-year lows yesterday. Of course, with confidence in the global financial sector under pressure, it has been local financial stocks that have borne the brunt of this sell-off. The ASX Financials index has fallen 10% this week and is now down 37% since the start of this year. While Australian stocks have been punished, they have at least not fared as badly as many global financials (see chart of the week on page 1).

This week's events herald a period of more rapid adjustment for the global banking system

Figure 1: Falling share prices *does* hurt consumer spending



Source: Bloomberg and ANZ

The sharp fall in our equity market, and the incredible uncertainty over the state of the global economy, and indeed parts of the global system, is likely to severely dent surveyed measures of consumer and business confidence in the month ahead. For businesses, this potentially means a delay of business investment and hiring decisions. For consumers, the impact is likely to be more contemporaneous for almost half of Australian household wealth is now held in financial assets. Our bear equity market has already caused household wealth to decline over the last six months – the biggest hit since the early 1990s recession. Unless our equity market rebounds strongly in the next few weeks, another fall in household wealth for the September quarter looks certain. We wouldn't be surprised to see this crimp consumer spending in the months ahead (see figure 1).

Our stockmarket has been hit hard

Which will weigh on household and business spending

A more rapid adjustment brings the end closer

At the moment, Australian banks look to be in better shape than many global counterparts

But there have been big impacts on the A\$ and local commodity prices

The RBA now has to decide what level of the cash rate is required for the appropriate 3-month BBSW rate

The pace of bank adjustment will quicken

The risks over the immediate period ahead have already been highlighted by declining market liquidity, uncertainty around derivative exposures and a renewed spike in risk aversion this past week. That being said, a more rapid adjustment brings the end closer. Not only that, the failure of a financial institutions means that new capital does not have to be raised to cover the write-downs of the failing institution. Banks are constrained in their write-downs by their ability to raise new capital. So some failures help lift these constraints for the overall system. The confidence in the system will not return until investors (and other banks) believe that the balance sheets are not impaired. This week could mark a fast tracking of this process. Statements by US government officials today alluding to the creation of a government facility to assist with debt workouts represents a major step ahead in the eventual resolution of the credit crisis.

Right now the Australian banking sector, in aggregate, is robust. Unlike the banking and finance industry in the US, the Australian banking system has been making profits. While rising, the ratio of Australian banks' non-performing assets to total assets remains low at just 0.4% at June 2008. The ratio of non-performing housing loans to total loans is also just 0.4% (despite higher interest rates this ratio is unchanged from a year ago). This is low by international standards; the ratio of non-performing housing loans in the US was 2.2% in March 2008 (up from 1% a year previous) and in the UK this ratio was 1.3% at June 2008 (up from 1.1% a year ago).

Most importantly in this liquidity constrained environment, Australian banks are still well-capitalised. The Australian banking system has raised 100% of its 2008 funding requirements and is well-advanced on 2009, having taken advantage of their AA ratings while global peer ratings have been moving down¹.

But of course, the severe events reverberating through global financial markets are having a significant affect on local markets. The Australian dollar continues to lose ground, particularly on the major crosses with AUD/EUR hitting a five-year low and AUD/JPY hitting a 3-year low this week. Commodity prices meanwhile have been mixed. Gold reclaimed its safe-haven status to enjoy its biggest ever one-day surge (gaining almost \$100 in 24 hours!). But oil has fallen back below US\$100/bbl and base metal prices have also dropped. For Australia, the most direct impact however has been a sharp drop in our sharemarket and a substantial widening of local funding costs.

The RBA may have to reduce the cash rate to maintain the current setting of monetary policy

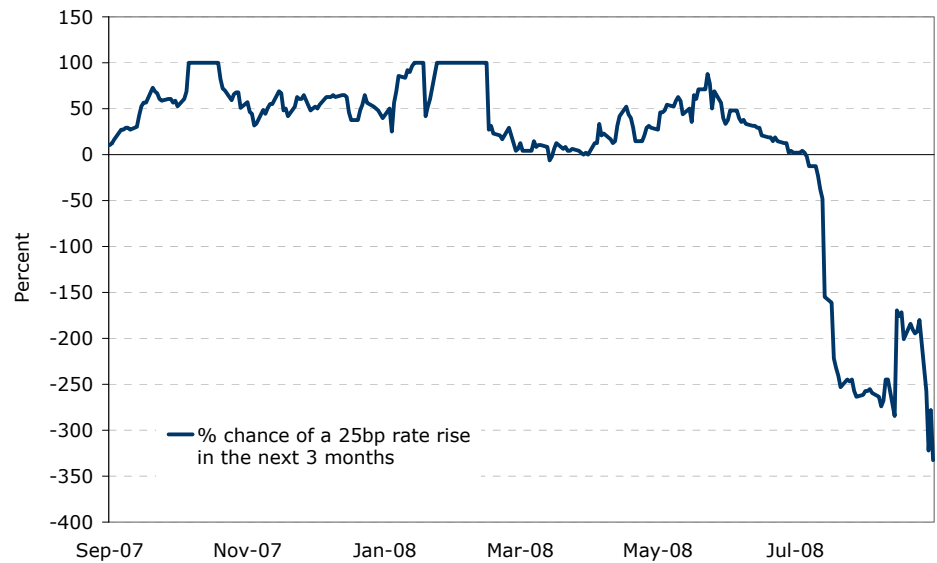
This week's events highlight once again the potential for dislocations between the RBA cash rate and interest rates in the actual economy. While the RBA will use the cash rate as the primary tool of monetary policy, market interest rates and the lending rates for corporations and households are what matters. The best intermediate target for the RBA is the 3-month BBSW rate as it is the pricing benchmark for the private banking system. As such, in times of extreme stresses in financial markets, the monetary policy decision for the RBA has two components. What level of the cash rate is required in order to achieve the appropriate 3-month BBSW rate and then, what level of interest rates in general is appropriate for the economic outlook.

The financial markets now understand this RBA reaction. In the wake of renewed pressures in the global banking system this week the market has moved to price in an aggressive rate cutting profile for the RBA (see Figure 2).

¹ ANZ Credit Research

OIS rates have declined sharply

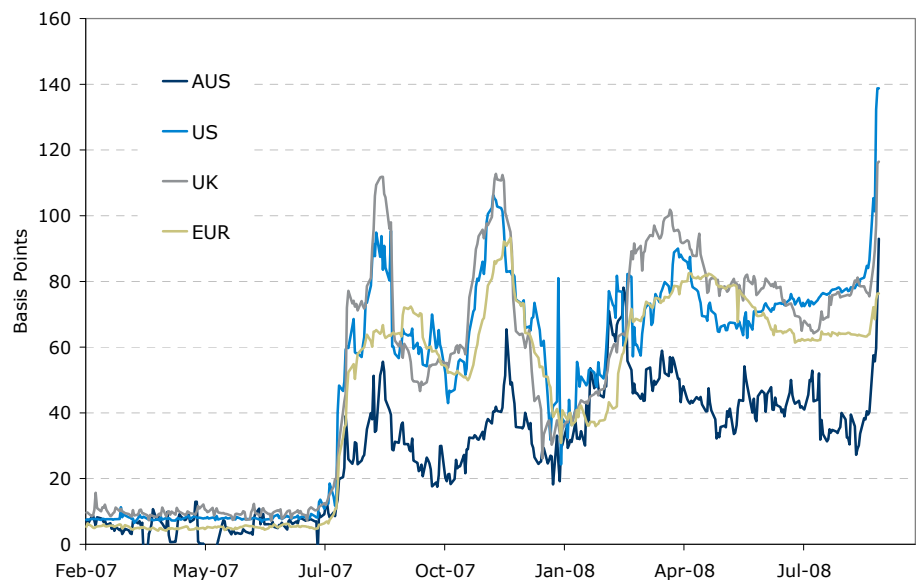
Figure 2: OIS market pricing of the probability of an RBA interest rate cut



Source: Bloomberg and ANZ

But BBSW has actually increased this week despite a large decline in the OIS rates. The result has been a large increase in the OIS/BBSW spread in Australia. In the 3 month sector this has increased to 93bp, from 60bp on Wednesday and 40bp last week (see Figure 3). This is a new record high in the current credit crisis. Even so the *level* of 3-month BBSW has only increased 23bp (to 7.49%) despite intensifying financial pressure in the global system.

Figure 3: 3-month OIS/LIBOR spreads



Source: Bloomberg and ANZ

The market expects the RBA to cut the cash rate (as indicated by lower OIS rate) to offset the implied tightening of financial conditions brought on by the latest wave of financial disruptions. Assuming these financial pressures persist, the RBA must validate this expectation with a rate cut. If they do not, OIS rates will rise and given current spreads in money markets, the BBSW rates will also increase. Indeed, if all of this week's widening of OIS/BBSW spreads resulted in higher BBSW rates (rather than most of it being absorbed in lower OIS rates) then the 3-month BBSW rate would be around 7.78%.

While the level of BBSW has increased

So the spread between OIS/BBSW has widened to a new crisis high

If these conditions persist...

...the RBA must cut rates to avoid a further tightening of local financial conditions

The key point is that OIS rates will not continue to absorb the impact of financial stress if the RBA does not validate the market expectation of rate cuts.

For the Australian banks, the widening of OIS/BBSW spread represents a significant earnings drag which can only be offset by an increase in lending rates (including the standard variable mortgage rate). One of the distinguishing (and strongly positive) features of the Australian economic situation at present is a profitable banking system. Bank profitability is critical to the medium-term economic outlook right now. Existing bank capital is very strong but given that Australian bank share prices have been caught up in the global financials bear market, the ability and/or cost of raising new capital could be problematic.

To avert a situation that we are currently witnessing in the US and UK (where banks have lost their financial flexibility by destroying existing capital and being constrained in their ability to raise new capital), the Australian banking system must remain profitable. The RBA knows this. If current money market pricing persists (i.e. wide OIS/BBSW spreads) and the RBA does not cut the cash rate target, then the commercial banks will either have to hike their lending rates or take an earnings (and presumably a profitability) hit. Given that neither of these two outcomes is at all desirable, the RBA will be forced into further near-term rate reductions if we do not see an easing of pressures in the money market.

The announcement overnight of further liquidity injections from the Fed, BoC, BoE, ECB, SNB and the BoJ will work to take some of these pressures out of money markets in the short-term. Furthermore the RBA has added substantial liquidity into the Australian market this week. These financial pressures (and thus OIS/LIBOR spreads) are very difficult to predict but if the current wide levels are maintained up to the next RBA board meeting, it would likely be a catalyst for a 25bp to 50bp rate cut, depending on the degree of stress in the system.

Key data summary

Please see ANZ's separate publication '*ANZ Data and Event Calendar*' for the schedule and previews of upcoming key local and global data events. Please email emr@anz.com if you would like to subscribe to this publication.

Key points to note from this week's economic releases are:

- **Dwelling starts** fell by 3.7% in the June quarter. This follows an (upwardly revised) 1.0% fall in the March quarter and confirms that housing activity will probably subtract from GDP growth over the second half of this year.
- The **minutes from the RBA's September Board meeting** suggested that interest rates were cut this month to offset the tightening of financial conditions that occurred when commercial banks raised interest rates in July. The minutes implied that, at the time of meeting, the RBA believed further interest rate reductions, if they were to occur, would be modest.
- **RBA Governor Glenn Stevens** spoke but did little to clarify the short-term outlook for monetary policy. In the Q&A the Governor did suggest that Australian corporates were in sound shape relative to some global counterparts.
- **Merchandise imports** fell by 3% (in seasonally adjusted terms) in August, mainly due to lower oil prices.

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There has been a rapid
consolidation in the US
financial system

US government support for
the GSEs and AIG have been
crucial to avoiding a further
deepening of the crisis

Central banks around the
world are pumping extra
funds into the financial sector
to promote liquidity and
provide stability

A quick primer on this week's events

The unusual developments in the global financial markets have rattled investors over the past week. Below is a quick summary of what has happened and why, and what it might mean.

Consolidation in the US financial system. The bankruptcy of Lehman Brothers Holdings and the mergers of Merrill Lynch – Bank of America and HBOS – Lloyds were significant events. The moves were forced by the continued downward spiral of share prices, as investors feared that these financial institutions would no longer be able to raise sufficient capital to finance the loans and other assets that were on their balance sheets. Only one of the three institutions that ceased to exist this week was a commercial bank that holds deposits on behalf of households. The other two were investment banks that have to raise their debt funding from the capital markets. As financial conditions have become tighter and tighter over the past year, it has become more and more difficult for this business model to be maintained. Concern over the investment bank model is what has caused the share prices of the two remaining Wall Street investment bank firms, Goldman Sachs and Morgan Stanley, to remain under pressure this week. In Australia, Macquarie Bank's equity value was also under pressure, but rose quickly on Friday.

US government support for institutions that are core to the US or global financial system. Over the past few weeks the US government has taken the extraordinary step of taking control over three financial institutions: the government-sponsored mortgage giants Fannie Mae and Freddie Mac, and the global insurer American International Group. This was accomplished through the issuance of new, preferred stock that had the effect of making the US government the majority shareholder in these firms, and guaranteeing the payment of the debt that had been issued by these institutions.

Why did the US government take this step? The simple answer is that allowing these institutions to go bankrupt could have conceivably caused a shutdown of the global payments system, thrown the US housing market into chaos and caused enduring harm to the US economy. The steps taken by the US government this week are not the ultimate solutions to the problems facing these institutions, but they do buy some time so as to avoid hasty, destructive actions.

While commentators have called the move a "bailout", this is not entirely correct. The holdings of existing shareholders in Fannie, Freddie and AIG have been completely diluted, and their shareholdings at present are worth very little. Bondholders can be assured that they will continue to receive interest payments, but they are not being bought out of their positions.

Most importantly, all three institutions will be forced to significantly change their businesses, primarily by selling down the assets – such as mortgages or other securities – that are currently on their balance sheets. In the case of Fannie and Freddie, the reduction will be about US\$1.2 tr in the coming years. In the case of AIG, sales could amount to US\$712 bn and entire parts of a company that had a balance sheet of US\$1.04 tr as of June 2008.

Finally, governments around the world have undertaken further policy measures in an aim to shore up financial stability. The US Federal Reserve, European Central Bank, Bank of England, Bank of Japan, Bank of Canada and Swiss Central Bank – and the Reserve Bank of Australia – have all acted to inject funds into the financial markets to promote liquidity in the system and discourage banks from hoarding their cash. Such action helps to reduce the stresses in the short-term interbank market, where just a small rise in funding costs causes significant rises in longer-term borrowing costs for banks and their customers.

In addition to central bank action, the US Treasury and other US authorities have taken steps to address market turmoil. The US Treasury this week announced an increase in its funding program of US\$100 bn (0.8% of US GDP) to provide the Federal Reserve with more capacity on its balance sheet to fund liquidity injections and help reduce the burden of unwanted assets on the credit markets. Separately, the Securities and Exchange Commission has adopted new

US authorities have confirmed plans are underway to establish an agency that will buy bad debt

regulations aimed at reducing short-selling in the equity market, which some observers blame for having caused such a sharp sell off in financial stocks over the past month.

The week ended with statements by US Treasury Secretary Paulson and others confirming plans are underway to establish a (government-funded) agency that will buy bad debt from the financial sector. This would be an institution similar to the Resolution Trust Corporation (RTC) that was established in the wake of the US Savings and Loans crisis of the 1980s. At that time, the total cost to the US taxpayer of this institution was US\$123bn, or 2.1% of 1990 GDP. The establishment of such a vehicle is positive in the sense that it is the first attempt to systematically address the debt overhang now plaguing the US financial system.

Uncertainty in financial markets will persist

What does this all mean for the future? For now, the uncertainty in the financial markets is likely to persist. We may see more rumours of mergers and/or failures by other institutions, in the United States and elsewhere. The reason is that the balance sheets of these large, financial institutions are connected and interwoven with each other in ways through a complex chain of lending and borrowing. When large institutions start to fail, other institutions react by pulling back their loans to those institutions, as well as others. This causes a chain reaction of a progressive reduction in the availability of funds, and as the reduction deepens other institutions face difficulty obtaining the financing they need. A crisis of confidence ensues, and that is what central banks are working assiduously to avert by pumping cash into the global payments system.

Further official support to markets and the broader economy is likely in the weeks ahead

Some observers question whether pumping cash into the payments system is inflationary. Under normal circumstances, the answer might be yes. However, the deflation in asset prices (equity, bonds, and property) that we have seen in the United States puts deflationary pressures on the economy. Economists call it a negative feedback loop, which looks like this: Falling asset prices cause households to feel they are losing wealth. The consumers in these households cut their expenditure, and consumption falls. Producers see falling demand, and cut back on production – and possibly lay off workers. Falling employment causes consumption to fall even more, and the cycle worsens. Such an environment is a recipe for disinflation, or falling inflation. What modern central banks target is price stability – a stable mix of growth and inflation. The steps being undertaken by central banks this week are a bid to re-establish financial market stability, and thereby ensure a desirable mix for growth and inflation is attained. Given the continued uncertainty, we can expect to see more of these sorts of measures in the weeks ahead.

Figure 5: Ratings downgrades of major financial institutions

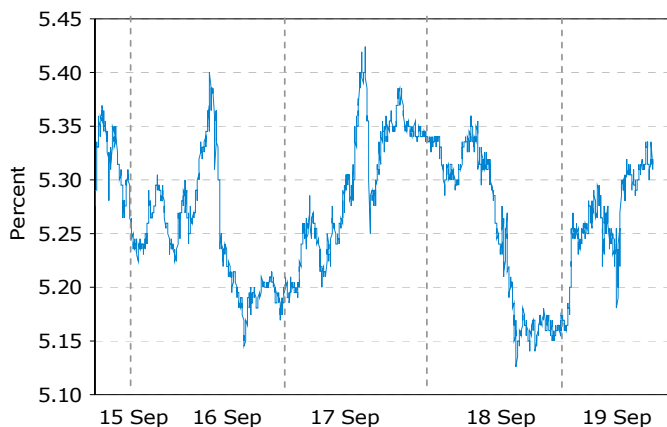
Company	New rating	Date of downgrade
Babcock & Brown	BB/Negative/B	17/09/2008
Deutsche Bank AG	AA-/Negative/A-1+	1/08/2008
Dresdner Bank AG	A/Negative/A-1	18/03/2008
HBOS PLC	A+*/Stable/A-1*	18/09/2008
Morgan Stanley	A+/Negative/A-1	2/06/2008
Societe Generale	AA-/Negative/A-1+	15/02/2008
UBS AG	AA-/Negative/A-1+	1/04/2008
Wachovia Corp	A+/Stable/A-1	22/07/2008
Washington Mutual Inc	BB-/Negative/B	15/09/2008

*Watch

Source: Bloomberg, Standards and Poor's

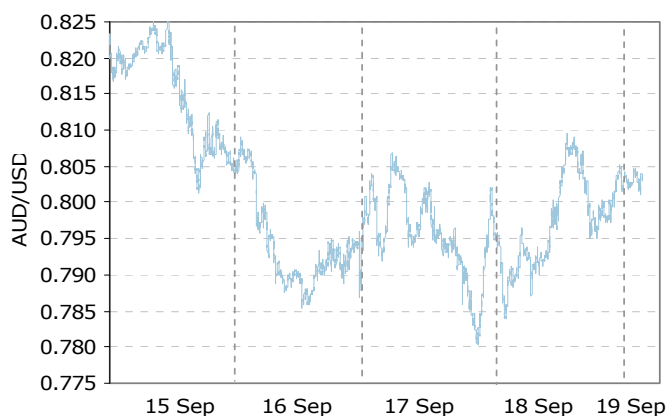
Market Wrap

Chart 1: AUS 3-year yields, intraday



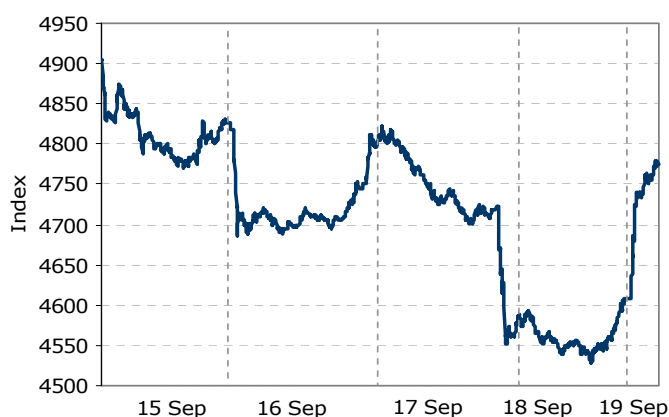
Source: ANZ and Bloomberg

Chart 2: AUD/USD, intraday



Source: ANZ and Bloomberg

Chart 3: ASX 200, intraday data



Source: ANZ and Bloomberg

A wild ride for rates markets

- What a week! Lehman Brothers filing Chapter 11 bankruptcy on Monday, the Fed's \$US85bn rescue package of American Insurance Group on Tuesday, the agreement of Bank of America to acquire Merrill Lynch and Lloyds' purchase of HBOS.
- All of these events have triggered large safe haven flows and smashed investor confidence in the financial system. At the time of writing, AUS 3-year yields were down 27bps to 5.35% versus last Friday's close. The 10-year yield fell 10bps to 5.57%.
- Banks have become reluctant to lend to each other, with interbank lending rates widening substantially in the world's major economies. Bank funding costs have also risen substantially with the Australian 3m BBSW/OIS spread rising to 91.5bps, a record wide and up 50bps from last week's close. Central banks have responded by announcing coordinated efforts last nights to inject liquidity in the market to alleviate pressures in money markets.
- Expect developments in the US financial sector to continue to drive sentiment and market direction. Any announcement on the US government's plan to settle the financial crisis will be key.

AUD takes a hit from surge in risk aversion

- Heightened risk aversion and falling commodity prices as investors continue to unwind positions has not been a favourable environment for the AUD. AUD/USD hit a 2-year low around 0.7800 but has since recovered back to above 0.800 on the sharp rebound in Wall St overnight.
- The AUD was also weaker against the EUR, GBP, CAD and CHF. The AUD even underperformed the NZD, falling to below the 1.20 level this morning. AUD/JPY has been particularly hard hit and touched JPY81.67 this week, a 3-year low. This morning, AUD/JPY had recovered to around JPY85.50, but is still well down from JPY88.9 last Friday.
- Developments in the US financial markets, commodity markets and equity market will continue to drive direction in the AUD. Support at 0.7900 continues to be important after failing to make a sustained break lower. But clearly the risks for the AUD are to the downside in this environment. The August 2007 low of 0.7675 is the next major support level. Any rebound is likely to see good resistance around the 0.8250 level.

ASX200 hit 3-year lows on worries over the global financial system

- Local equity markets were in the red for most of the week on heightened concerns over the events playing out on Wall St as discussed above. There were concerns over local banks exposures to Lehmans and other troubled financial institutions (HBOS, Washington Mutual, Morgan Stanley) and the business models of some local investment banks. Ongoing unwinding of risky positions, particularly in commodity markets has also weighed on markets.
- But we saw an impressive 6.9% jump in the ASX 200 financial index on Friday's open which helped the ASX200 rise over 160 points this morning to 4771.4 at the time of writing.
- Expect developments in the US financial markets and commodity price movements to continue to drive direction in local equities.

Patricia Gacis

ANZ economic and financial market forecasts

Australian economic indicators	2007	2008f	2009f	2010f
Economic activity (annual % change)				
Private final demand	6.0	3.5	3.0	2.9
Household consumption	4.5	2.5	2.3	2.8
Dwelling investment	3.1	0.2	1.3	12.7
Business investment	13.0	9.6	5.8	0.0
Public demand	2.9	5.9	2.9	2.0
Domestic final demand	5.3	4.0	3.0	2.7
Inventories (contribution to GDP)	0.6	-0.2	0.0	0.1
Gross National Expenditure (GNE)	5.9	3.9	2.9	2.8
Exports	3.2	6.1	6.0	4.3
Imports	10.8	11.7	5.3	5.0
Net Exports (contribution to GDP)	-1.8	-1.6	-0.1	-0.4
Gross Domestic Product (GDP)	4.2	2.6	2.6	3.4
Prices and wages (annual % change)				
Inflation: Headline CPI	2.3	4.3	3.0	3.1
Underlying*	3.1	4.4	3.7	3.0
Wages	4.1	4.4	4.4	3.7
Labour market				
Employment (annual % change)	2.8	2.3	0.9	0.9
Unemployment rate (%)	4.4	4.4	5.2	5.5
External sector				
Current account balance: A\$ bn	-67.2	-55.0	-44.4	-75.4
% of GDP	-6.2	-4.7	-3.5	-5.8

*Average of RBA weighted median and trimmed mean statistical measures.

Australian interest rates	Current	Sep 08f	Dec 08f	Mar 09f	Jun 09f	Sep 09f
RBA cash rate	7.00	7.00	6.75	6.75	6.50	6.25
90 day bill	7.49	7.23	7.00	6.95	6.75	6.45
3 year bond	5.38	5.52	5.70	5.50	5.45	5.40
10 year bond	5.60	5.62	5.90	5.75	5.75	5.80
3s10s yield curve	0.22	0.11	0.20	0.25	0.30	0.40
3 year swap	6.58	6.45	6.70	6.43	6.20	5.95
10 year swap	6.44	6.31	6.75	6.44	6.50	6.45
International interest rates						
RBNZ cash rate	7.50	7.50	7.00	7.00	6.75	6.25
NZ 90 day bill	7.85	7.73	7.35	7.30	6.83	6.28
US Fed funds note	2.00	2.00	1.75	1.75	1.75	1.75
US 2 year note	1.82	2.20	2.50	2.25	2.50	3.00
US 10 year note	3.59	4.22	4.40	4.10	4.30	4.40
Japan call rate	0.50	0.85	0.75	0.75	1.00	1.00
ECB refinance rate	4.25	4.25	4.25	4.25	4.00	4.00
UK repo rate	5.00	5.00	5.00	4.75	4.50	4.25

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

Foreign exchange rates	Current	Sep 08f	Dec 08f	Mar 09f	Jun 09f	Sep 09f
Australia and NZ exchange rates						
A\$/US\$	0.8078	0.85	0.86	0.83	0.80	0.78
NZ\$/US\$	0.6726	0.67	0.65	0.68	0.65	0.63
A\$/¥	86.02	91.80	92.88	91.30	88.00	87.36
A\$/€	0.5667	0.59	0.60	0.59	0.59	0.58
A\$/£	0.4469	0.47	0.48	0.47	0.45	0.45
A\$/NZ\$	1.201	1.27	1.32	1.22	1.23	1.24
A\$/CA\$	0.8583	0.90	0.93	0.91	0.90	0.90
A\$/CHF	0.8992	0.93	0.94	0.91	0.91	0.91
A\$/CNY	5.523	5.78	5.81	5.58	5.36	5.21
A\$ Trade weighted index	63.60	67.13	68.30	66.42	64.38	63.07
International cross rates						
US\$/¥	106.5	108	108	110	110	112
€/US\$	1.425	1.45	1.44	1.40	1.36	1.34
€/¥	151.8	157	156	154	150	150
£/US\$	1.807	1.80	1.78	1.77	1.76	1.74
€/£	0.7886	0.81	0.81	0.79	0.77	0.77
US\$/CA\$	1.063	1.06	1.08	1.10	1.12	1.15
US\$/CHF	1.113	1.09	1.09	1.10	1.14	1.17
US\$ index	78.61	78.0	78.7	80.5	82.2	83.7
Asia exchange rates						
US\$/CNY	6.839	6.80	6.75	6.73	6.70	6.68
US\$/HKD	7.781	7.80	7.80	7.80	7.80	7.80
US\$/IDR	9390	9250	9075	9100	9175	9150
US\$/INR	46.49	43.75	44.50	45.00	44.50	44.00
US\$/KRW	1134.3	1050	1090	1095	1100	1095
US\$/MYR	3.4615	3.39	3.42	3.43	3.44	3.42
US\$/PHP	46.74	45.50	46.40	47.10	46.40	45.50
US\$/SGD	1.432	1.43	1.45	1.48	1.46	1.44
US\$/THB	34.16	34.35	35.00	35.10	35.20	34.50
US\$/TWD	32.17	31.75	32.25	33.00	32.50	32.00
US\$/VND	16695	16500	16400	16300	16070	16030
Pacific exchange rates						
PGK/US\$	0.396	0.40	0.43	0.41	0.39	0.37
FJD/US\$	0.609	0.62	0.62	0.62	0.60	0.59

For additional information on foreign exchange rates please refer to ANZ's *FX Weekly*

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