

Outlook for the region in 2008

December 2007

Inside:

Main Article	1
Financial Markets Update	6
FX & Policy Rate Forecasts	7
Macro Economic Forecasts	7
LT FC Govt. Bond Ratings	8
Country Updates	9

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Our Vision:

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

The Pacific region is ending 2007 on a high note, as growth is likely to have reached a cyclical peak across much of the region this year. High commodity prices are supporting exports and government revenue in several key economies, while others are starting to experience gains from investment in sectors such as tourism. The notable exceptions for the Pacific are Fiji and Tonga, where the economies are expected to contract this year.

In this report, we present our forecasts for the region for 2008. The outlook is favourable, but with a sense of heightened risk. Real GDP growth for 2008 is expected to be solid, but softer than in the past year for most economies. At the same time, inflation pressures are expected to remain high as a result of higher oil and food prices. Consequently, central banks may have to continue to lift interest rates in some countries, or maintain relatively strong exchange rates in order to dampen imported inflation.

Macroeconomic forecasts for 2008

	Real GDP growth		Inflation	
	2007e	2008f	2007e	2008f
Cook Islands	2.5	3.5	2.8	2.0
Fiji	-4.5	2.0	5.5	4.5
Kiribati	2.5	1.6	0.2	1.0
PNG	6.2	6.0	2.1	4.3
Samoa	3.3	1.0	5.9	4.0
Solomon Islands	5.4	4.2	6.3	7.3
Timor-Leste ⁺	22.0	3.5	8.7	5.5
Tonga [*]	-3.5	0.8	5.3	5.5
Vanuatu	5.0	4.0	2.5	3.0

⁺: non-oil GDP; ^{*}: fiscal year beginning July

Sources: ADB, IMF, Economics@ANZ

The persistent weakness of the US dollar is posing challenges for central banks in the Pacific that have traditionally held their currencies against the Australian and/or New Zealand dollars. Subtle changes in exchange rate regimes are underway, as the strength of antipodean currencies has undermined the competitiveness of Pacific exports relative to exporters in Asia. More shifts could be underway in the coming months, as we expect the US dollar to remain weak and the Australian and New Zealand dollars to stay relatively strong.

The commodities boom is also expected to persist in the coming year, continuing to create a point of differentiation among Pacific economies. Countries that are net exporters of energy or other commodities – Papua New Guinea, Solomon Islands and Timor-Leste – are expected to experience trade surpluses, continued accumulation of foreign exchange reserves and robust domestic liquidity conditions. Countries that are not exporters of these commodities will need to look for new opportunities for economic growth and development; Vanuatu appears particularly successful in this regard with its surging tourism industry.

2008 may also see changes in the Pacific arising from the arrival of the Rudd government in Australia. Issues central to the Pacific islands – such as climate change, innovation in alternative energy, regional trade agreements and labour mobility – are likely to be re-assessed by the government in the coming months.

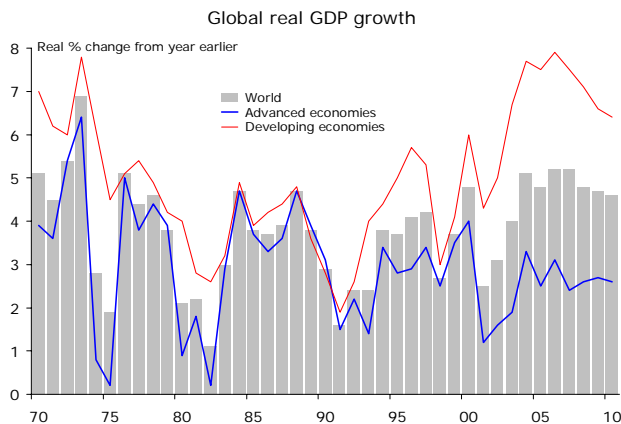
External conditions remain supportive

Our outlook for the global economy is covered in other publications by ANZ, and does not need to be repeated here.¹ However, the external environment remains an important driver of the small, open economies of the Pacific and so a brief overview of the forecasts for the global economy in 2008 is warranted.

The shadow cast from the ongoing credit crunch in the United States has tempered our forecast for US growth in the year ahead. Global growth is forecast to come in at an annual rate of 4.7% as against growth of 5.1% this year and 5.2% in 2006. However, trend growth for the global economy is estimated at around 3.7%, so we continue to forecast above-trend growth.

A key factor behind our global growth forecast is China, which is the second largest economy in the world. Real GDP growth in China will exceed 11% per annum this year, and is still expected to exceed 10% per annum in 2008. So long as Chinese growth remains this strong, it is difficult for global growth to dip below trend. Moreover, China is emblematic of the broad trend across all developing economies, where the rate of growth has accelerated from an average of 4.9% per annum from 1995-1999 to 6.2% per annum from 2000-2005 and a stunning 8.3% per annum since 2005.

Global growth to remain strong thanks to developing economies

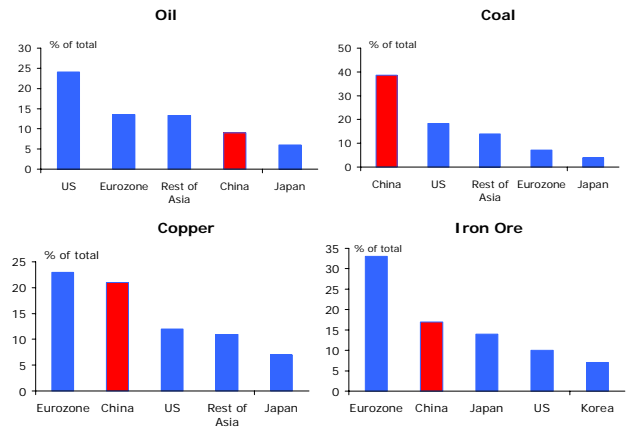


GDP converted to US\$ using purchasing power parity (PPP)
Sources: Datastream, IMF and Economics@ANZ

A key driver of the strong rate of growth in developing economies – particularly China and India – is urbanisation and industrialisation. This process is causing unprecedented growth in demand for hard commodities, particularly in energy and base metals. China is now the single largest global consumer of most energy and metals, with the exception of oil. Our forecast for continued strong growth in China and India (real GDP forecast to rise 8.5% next year) means commodity demand and therefore prices are likely to remain at elevated levels.

Chinese demand drives commodities boom

Comparison of share in global demand for key commodities



Commodity price forecasts, end of period

	2007	2008	2009
Oil (WTI/bbl)	90	80	70
Coking coal (US\$/t)	96	125	120
Gold (US\$/oz)	820	780	685
Copper (US\$/t)	7054	6614	5732
Sugar (USc/lb)	11.0	11.0	12.2

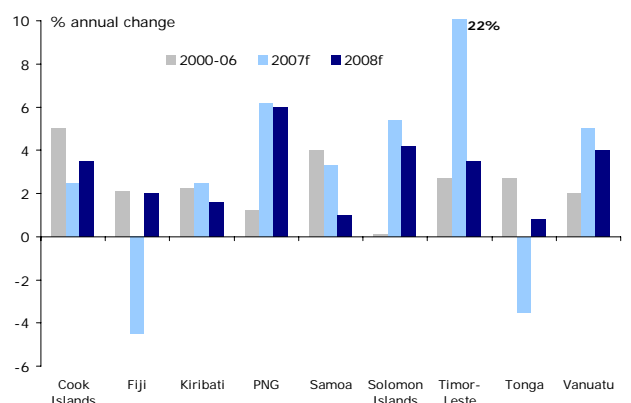
Sources: Datastream, Economics@ANZ

Natural resources a growth driver

Across the Pacific Islands, the extent of resources wealth – or lack thereof – appears to be a key point of differentiation for growth prospects in the coming year. The economies that experienced real GDP growth of 5% per annum or above this year were those countries with a natural resources base – PNG, Solomon Islands and Timor-Leste. The growth rate in 2007 for these economies was well above the average over the 2000-2006 period, as seen in the chart below. Vanuatu has also experienced surging growth as a result of tourism-driven investment into the economy.

PNG, Solomons and Timor-Leste the strong growth performers

Recent and projected real GDP growth for selected Pacific economies



Sources: Asian Development Bank, International Monetary Fund, Economics@ANZ

As can be seen from the chart, the non-resources based economies experienced slower growth this year, and both Fiji and Tonga are expected to have

¹ Please see our web site: <http://www.anz.com/go/economics>

contracted. For both of these countries, political upheaval in the past year proved to have serious economic consequences.

Going forward into 2008, growth in the resource-boom economies is expected to temper somewhat due to both the base effect and a mild softening of commodity prices. However, the growth rate for PNG, Solomon Islands and Timor-Leste is expected to remain well above the average per annum rate of real GDP growth over 2000-2006. Growth in these economies will be led by exports, continued investment into the resources sector and most likely increased consumption as windfall government revenues are redistributed through the economy. Vanuatu's growth rate is also expected to accelerate next year with tourism projects coming on stream.

Growth forecasts for the other non-resourced based economies are less optimistic. We expect Fiji to stage only a mild recovery in the coming year as we think the measures taken to rein in the trade deficit will keep consumption and investment soft, while continued political uncertainty will make it difficult for the tourism industry to stage a strong recovery. Growth in Samoa is also expected to weaken in 2008, as the investment and consumption that occurred ahead of the South Pacific Games in September fades away.

Inflation a persistent threat

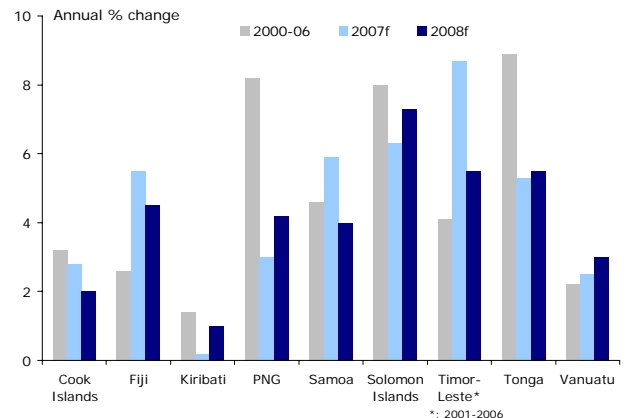
While growth is expected to soften broadly across the Pacific next year, we believe inflation will remain a persistent threat. Oil prices have fallen below US\$90/bbl but are expected to remain elevated. This high cost of energy is a significant issue for those Pacific economies that are net importers of oil; in the case of Fiji, energy now accounts for 30% of the import bill.

In addition, the global consensus that higher oil prices are here to stay is creating further impetus for investment in biofuels, which is in turn leading to increased demand for agricultural products that are part of biofuels production. Although it is easier to grow more corn than it is to find a new source of crude oil, in the short run the historically high demand for key agricultural goods is causing price spikes in globally traded soft commodities. Finally, Pacific economies that import substantial quantities of food from Australia are being affected by higher prices from the persistence of drought conditions, particularly for wheat.

As can be seen in the chart below, we expect average inflation over the course of 2008 to rise above the 2007 level. It is only in the Cook Islands, Samoa, Fiji and Timor Leste where inflation is expected to moderate.

Inflation outlook is more mixed

Consumer price inflation for selected Pacific economies



Sources: Asian Development Bank, International Monetary Fund, Economics@ANZ

Exchange rates to move in 2008

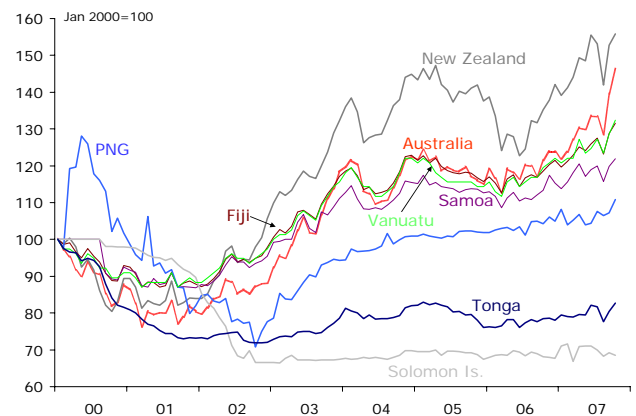
The risk that inflation may accelerate next year raises an interesting question as to how central banks will handle monetary policy. A number of central banks in the region have traditionally used their exchange rates to manage inflation expectations. That is, because of the high import content of basic necessities such as food and raw materials, central banks understood that by keeping the exchange rate steady against major trade partners, the price of goods was unlikely to change rapidly or dramatically. Since the region's largest single trade partners are Australia and New Zealand, the A\$ and NZ\$ have always been closely watched by Pacific central banks.

The past few years have presented a changing landscape for this approach to maintaining price stability, however. The Australian and New Zealand dollars have reached record highs against the US dollar, as well as the euro and the yen. The Australian dollar trade weighted index appreciated by 6.2% in 2007 to date, while the New Zealand dollar appreciated by 2.6%.

A number of central banks followed the historic pattern over the past few years and maintained a stable cross rate with the Australian dollar.

Several currencies trade with A\$

Spot FX rate for selected countries vs US\$, indexed



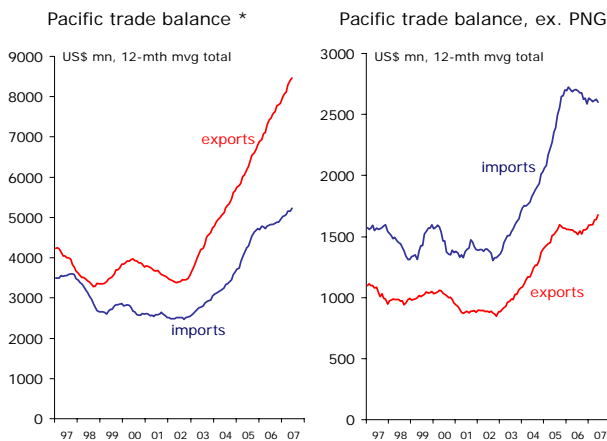
Sources: Datastream, Economics@ANZ

As can be seen in the above chart, the currencies of Fiji, Vanuatu, and Samoa closely tracked the movements in the Australian dollar over 2006 and most of this year. The PNG kina has appreciated over this period as well, albeit at a slower pace than the Australian dollar.

More recently, however, the Samoan tala has weakened relative to the currencies of Fiji and Vanuatu. The tala is managed against a basket of currencies. Based on our estimation of the basket, it would appear as though the authorities have been allowing the tala to weaken slightly against the basket of currencies. Our forecast for the tala in 2008 assumes that the currency will remain weak relative to its basket.

The main immediate reason for Pacific central banks to pursue a slightly weaker currency is to help improve the balance of payments. All else being equal, a strong currency makes exports more expensive and imports cheaper – encouraging a widening trade deficit that will eventually cause the economy to slow. Across the Pacific, the trade deficit has been rising over the course of the past several years, with Fiji and Samoa experiencing the greatest declines. The charts below show the trade balance for the entire Pacific on the left, and the trade balance of the Pacific excluding PNG on the right. It is evident that over the past few years, import growth has far outpaced export growth.

Pacific trade imbalance



*: PNG, Solomon Islands, Fiji, Samoa, Tonga, Vanuatu
Source: IMF Direction of Trade Statistics

We believe that the Reserve Bank of Fiji may also look to follow a similar path as the Central Bank of Samoa in the coming year. The Fijian economy is experiencing problems with a high trade deficit that is putting pressure on its foreign exchange reserves. FX reserves are reported by the Reserve Bank of Fiji to have improved to US\$598 mn (above 4 months of imports) as of October but this estimate includes foreign currency holdings held by institutions such as the Fiji National Provident Fund. It is difficult to know the precise reserves position, but it is clear that the balance of payments position remains weak as the current account deficit is set to widen to 22.8% of GDP this year from 20% of GDP last year.

The authorities in Vanuatu may have less impetus to allow for a weaker currency at this time, because

the country's current account deficit is being easily financed by surging foreign investment into the tourism sector. We do not expect much change there in 2008.

From a broader economic perspective, it makes sense that the exchange rates in the Pacific region may diverge according to the differing structure of the local economies. The Australian dollar has appreciated on the back of strong commodity prices and relatively higher domestic interest rates (compared to other OECD countries). Countries such as Samoa, Fiji, Tonga or Vanuatu do not export hard commodities and do not have high interest rates, so do not share the features that would cause their currencies to trade alongside the Australian dollar. In fact, the high cost of raw materials that represent a *positive* terms of trade boost for Australia actually represent a *negative* terms of trade shock for most the Pacific.

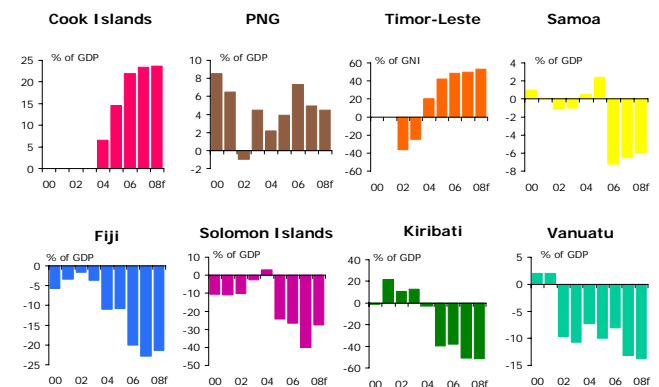
The opposite trend is occurring in PNG, where the central bank seems to have encouraged the currency to appreciate against the Australian dollar in order to help contain inflation pressures. The PNG kina weakened to below PGK/AUD0.40 as of September and remained below that level until mid November, when it started to noticeably rise against the Australian dollar. We expect the kina to remain above PGK/AUD0.40 for at least the first half of 2008.

Liquidity conditions similarly diverge

The balance of payments position for various countries in the Pacific has played a significant role in the growth prospects. Balance of payments surpluses naturally support growth as the surplus implies an accumulation of profit and/or investment in an economy. Countries such as PNG and Solomon Islands with a balance of payments surplus have seen an accumulation of foreign exchange reserves. This has led to higher domestic liquidity and credit growth. On the flip side, countries with a balance of payments deficit have experienced tight liquidity conditions and lower growth prospects.

Pacific balance of payments

Current account balances as percentages of GDP



Source: ADB: IMF World Economic Outlook database (October 2007)

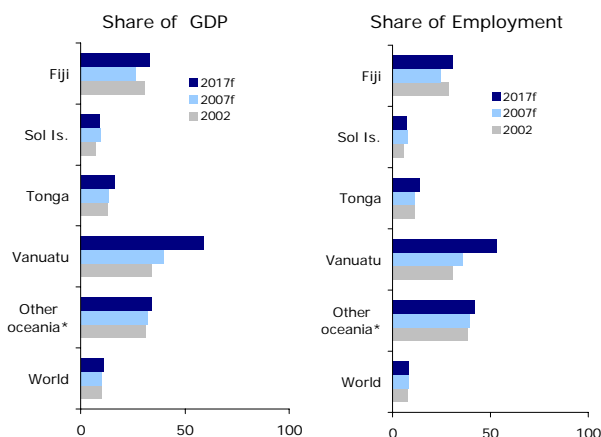
Over the past six months, base money – or the cash in circulation plus deposits in an economy – has

risen by more than 20% per annum in PNG and the Solomon Islands. In contrast, base money growth in the other economies has been less than 15% per annum. The rate of base money growth provides an indication of the liquidity available in the economy to support credit growth and therefore investment; as such, the relative divergence of base money growth rates in PNG and the Solomon Islands as against the other economies implies a higher potential rate of growth for these two economies in the coming months. Moreover, the rate of growth in base money tends to be volatile in the low-growth economies. The benefits of high liquidity must be managed against the risks that high base money growth potentially poses for inflation, however.

Samoa experienced tight liquidity conditions earlier this year as the central bank acted to cool import growth amid a widening trade deficit. Import demand was related to surging consumption and the need to import intermediate and final goods ahead of the South Pacific Games in September. Now that the event has passed, domestic demand has slowed and import growth has naturally declined. Domestic liquidity conditions are normalising but there is little demand for credit as the economy appears set to experience a classic post-event slump.

Liquidity conditions in Fiji are improving after tightening significantly earlier this year following Reserve Bank measures to tighten credit so as to reduce imports. The measures worked, and now a surplus of deposits is building up in the banking system. However, with ongoing political uncertainty and the economy in a slump, demand for credit has dried up. As the outlook stabilizes and construction resumes, liquidity conditions are likely to tighten again because the structural causes of Fiji's balance of payments deficit remain unchanged. A weaker currency would help to alleviate these issues by making exports – including tourism – more competitive while making it more attractive to move the production of goods such as foodstuffs for the tourism industry onshore.

Weaker FX rate supports even tourism



Sources: World Travel & Tourism Council

Watch the politics in 2008

The past year was a year of political upheaval in the Pacific. There were election-related riots in Timor-

Leste and the Solomon Islands; a coup in Fiji; and political discontent in Tonga. On the flip side, the passing of relatively smooth and peaceful elections in PNG in September looks to have been an historic event that may well have ushered in an unprecedented period of political stability.

In the coming year, perhaps the most interesting political story to watch will be the evolution of relations between Australia and its Pacific Island neighbours. There is little question that diplomatic relations between Australia and a number of Pacific countries have deteriorated over the past several years. Events such as the PNG Supreme Court rejection of provisions in the Enhanced Cooperation Agreement; the Julian Moti affair; the protest by PNG PM Michael Somare over his treatment at Brisbane airport; the threats by Solomon Islands PM Manassah Sogavare to terminate the Australian-led RAMSI mission; the standoff with the Fiji interim government, all mark low points in cross-Pacific relations.

The arrival of Kevin Rudd as Australia's Prime Minister has great potential to open a new chapter in the relationship between Australia and the Pacific. Issues such as labour mobility, climate change and multilateral trade policies are all likely to receive a fresh look.

The new Rudd cabinet includes Duncan Kerr as Parliamentary Secretary for the Pacific, which is an important signal that the Pacific will receive greater attention. Kerr, the Federal Member for Denison in Tasmania, served as Minister for Justice and Attorney General under the Keating government and was subsequently the Shadow Minister for Immigration. Prior to entering politics, Kerr was a practicing attorney and served as the Dean of the Faculty of Law at the University of PNG, among other posts.

In addition, Bob McMullen has been appointed Parliamentary Secretary for International Development. The creation of this role is likely to herald significant changes in the way that AusAID functions and could bring about a rise in the amount of funds allocated to overseas aid. In a speech at the Lowy Institute last July, then-candidate Rudd laid out a plan for a "Pacific Partnership for Development and Security" focused on improving the economic prospects of the region through health, education, infrastructure, youth unemployment, microfinance, governance and security assistance. The dialogue between Australian and the Pacific will be a new one in 2008.

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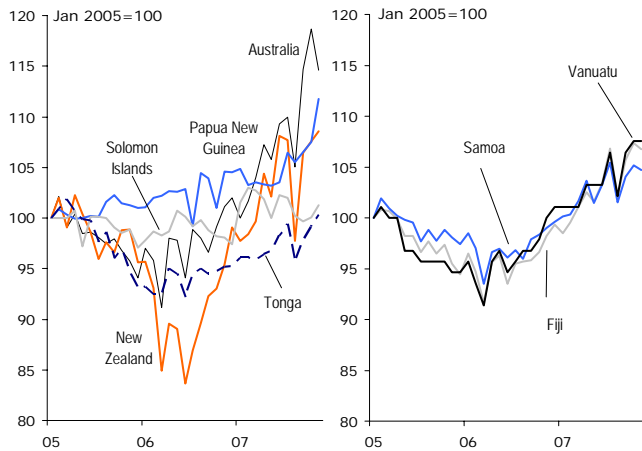
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Financial Markets Update

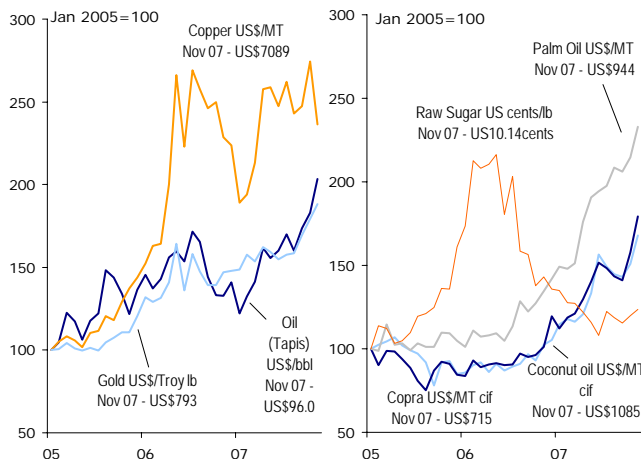
Exchange rates vs US dollar



Exchange rates

- The deterioration in the outlook for the US economy has seen investors desert the US dollar which has sunk to record lows in recent weeks.
- Having initially made strong gains against the weaker US dollar, the Australian dollar has been unable to completely shake off its 'risky' label, losing ground over the last month, as investors favoured a flight to quality and wound back carry-trades. In contrast, the New Zealand dollar has held onto recent gains, spurred by a hawkish central bank.
- The lower Australian dollar has weighed on the currencies of Vanuatu, Samoa and Fiji, which have all weakened slightly this month.
- The soaring gold price has underpinned a sharp rise in the PNG kina. The kina has now gained 5% against both the US dollar and the Australian dollar since September.

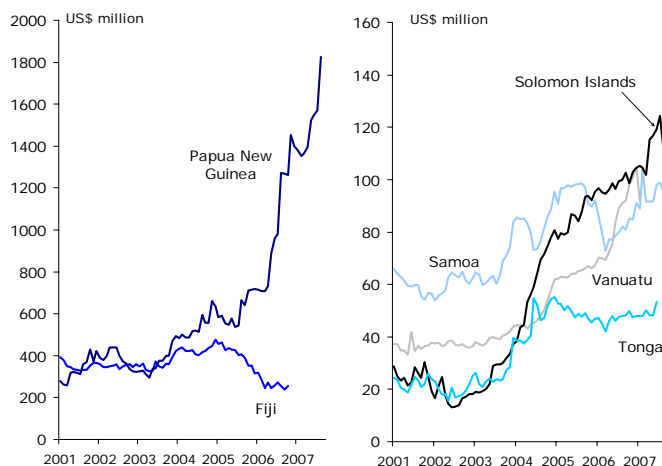
Commodity Prices



Commodities

- Oil prices have spiralled to record highs in the last month, as tight global supply has more than offset a weakening global economy. West Texas intermediate oil prices stormed to US\$99/bbl in late-November, pushing the price of Tapis above US\$100.
- Soaring oil prices have taken the price of energy-substitutes along for the ride. Since the start of this year, palm oil prices have risen around 60% and copra and coconut oil prices have increased by around 50%.
- In contrast, sugar prices have crept only slightly higher in recent months, weighed down by a global supply glut.
- A rise in risk aversion and a sharp drop in the US dollar have seen investors flock to hold gold in the last few months, pushing the price of this precious metal above US\$800/oz.

International Reserves



International Reserve positions

- Papua New Guinea's international reserves are continuing their meteoric rise, underpinned by soaring commodity export values, especially for gold. PNG's reserves now total US\$1.8bn, an increase of 30% since the start of this year.
- International reserves held by the Solomon Islands have fallen back from this year's highs as recent aid disbursements, which initially went into reserves, have been rolled out into planned spending. The recent appreciation of the Solomon Islands dollar has also made a slight dent to the US dollar value of reserves.
- International reserves held by Samoa, Tonga and Vanuatu have remained relatively stable this year, as continued foreign exchange earnings from remittances and tourism have offset the impact of their appreciating currencies.

FX and Policy Interest Rate Forecasts

	Oct 07	Dec 07	Mar 08	Apr 08	May 08	Jun 08	Sep 08	Dec 08
Fiji								
FJD/USD, eop	0.655	0.652	0.66	0.66	0.66	0.66	0.64	0.63
FJD/AUD, eop	0.70	0.73	0.695	0.692	0.690	0.687	0.693	0.698
Short term rates*	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25
PNG								
PGK/USD, eop	0.36	0.366	0.390	0.393	0.397	0.40	0.380	0.355
PGK/AUD, eop	0.385	0.411	0.411	0.413	0.415	0.417	0.409	0.400
Short term rates**	6.0	6.0	6.0	6.0	6.0	6.5	6.5	6.5
Samoa								
WST/USD, eop	0.414	0.403	0.401	0.402	0.403	0.405	0.396	0.387
WST/AUD, eop	0.443	0.452	0.421	0.421	0.421	0.421	0.426	0.430
Tonga								
USD/TOP, eop	1.89	1.88	1.86	1.86	1.85	1.85	1.87	1.89
AUD/TOP, eop	1.76	1.67	1.77	1.77	1.77	1.78	1.74	1.70
Vanuatu								
USD/VUV, eop	95.8	99.4	94.6	94.3	94.06	93.8	96.1	98.5
AUD/VUV, eop	89.5	88.5	89.8	89.9	89.9	90.1	89.4	88.7
Short term rates***	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0

+: 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 Repo Facility (KFR); ***: Discount rate

Macro Economic Forecasts

Real GDP Growth (%)

	2006	2007e	2008f
Fiji	3.4	-4.5	2.0
PNG	2.6	6.2	6.0
Samoa	2.6	3.3	1.0
Timor-Leste⁺	-1.6	22.0	3.5
Tonga⁺	-3.5	0.8	1.3
Vanuatu	5.5	5.0	4.0

Nominal GDP (US\$ bn)

	2006	2007e	2008f
Fiji	2.55	2.56	2.73
PNG	5.24	5.67	6.14
Samoa	0.45	0.49	0.52
Timor-Leste⁺	0.49	0.65	0.71
Tonga⁺	0.23	0.24	0.26
Vanuatu	0.40	0.43	0.46

Inflation (%)

	2006	2007e	2008f
Fiji	2.5	5.2	4.5
PNG	2.3	2.1	4.3
Samoa	3.8	5.9	4.0
Timor-Leste	4.1	8.7	5.5
Tonga	7.0	5.3	5.5
Vanuatu	1.6	2.5	3.0

Fiscal Balance (% of GDP)

	2006	2007e	2008f
Fiji	-4.0	-2.0	-2.0
PNG	3.1	1.7	1.5
Samoa	-1.2	-0.5	-0.8
Timor-Leste[^]	-29	-34	n/a
Tonga	-2.3	-1.0	-1.5
Vanuatu	-0.5	-0.7	n/a

Current Account Balance (% of GDP)

	2006	2007e	2008f
Fiji	-20	-22.8	-21.3
PNG	7.3	4.9	4.5
Samoa	-7.2	-6.5	-6.0
Timor-Leste[~]	48.5	50	53
Tonga	-6.8	-5.0	-5.5
Vanuatu	-8	-13.2	-13.7

Foreign Exchange Reserves (US\$ mn)

	2006	2007e	2008f
Fiji	260	270	280
PNG	1,423	2,100	2,300
Samoa	215	185	195
Timor-Leste	1,000	2,000	3,500
Tonga	44.9	50	55
Vanuatu	99.3	118	130

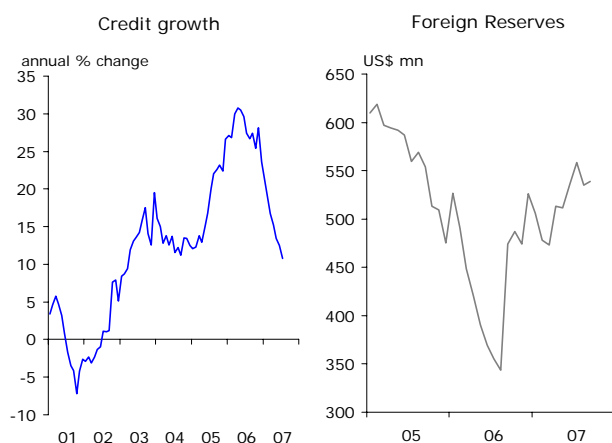
*: fiscal year beginning July +: non-oil GDP ^: non-oil fiscal balance as % of non-oil GDP ~: % of GNI

Long Term Foreign Currency Government Bond Ratings

Investment Grade		Sub-Investment Grade	
Moody's	S&P	Moody's	S&P
Aaa Australia Canada France Germany Japan New Zealand Singapore United Kingdom United States	AAA Australia Canada France Germany Singapore United Kingdom United States	Ba1 Brazil Costa Rica Egypt Morocco Panama	BB+ Egypt Peru Brazil Costa Rica
Aa1 Belgium	AA+ Belgium New Zealand	Ba2 Colombia Fiji Guatemala Jordan Peru	BB Cook Islands Jordan Panama Guatemala Vietnam
Aa2 Hong Kong Italy Qatar Kuwait UAE	AA Hong Kong Japan	Ba3 Indonesia Turkey Vietnam	BB- Indonesia Philippines Serbia Turkey Venezuela Ukraine Uruguay
Aa3 Cayman Islands Macau Oman Taiwan	AA- Kuwait Qatar Taiwan Saudi Arabia		
A1 China Cyprus Czech Republic Saudi Arabia	A+ Italy	B1 Pakistan Papua New Guinea Philippines Suriname Ukraine Uruguay	B+ Argentina Ghana Pakistan Cambodia Papua New Guinea
A2 Chile Hungary Israel Korea Poland	A Chile China Cyprus Czech Republic Israel Korea Oman	B2 Honduras Venezuela Cambodia	B Fiji Paraguay
A3 Malaysia	A- Malaysia Poland	B3 Argentina Bolivia Lebanon	B- Bolivia Ecuador Lebanon
Baa1 Mexico South Africa Thailand	BBB+ Hungary Mexico Russia South Africa Thailand	Caa1 and below Cuba Ecuador Nicaragua Paraguay	CCC and below
Baa2 Mauritius Tunisia Russia	BBB Tunisia		
Baa3 Bulgaria India Romania	BBB- Romania India Colombia Morocco		

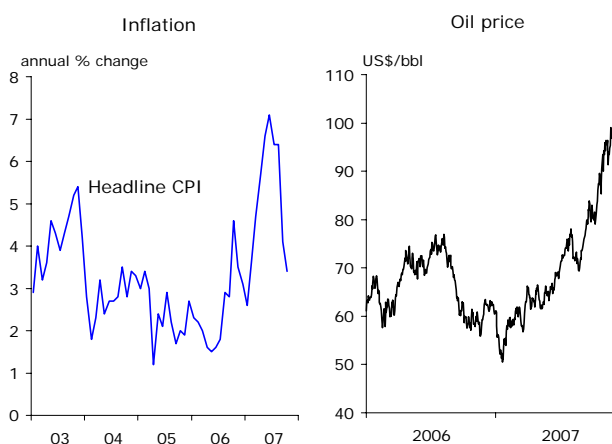
Country Update: Fiji

External pressures ease



Sources: Datastream, IMF, Reserve Bank of Fiji

Inflation moderates but upside pressures emerge



Sources: Datastream, IMF, Reserve Bank of Fiji

- In a positive move, Standard & Poor's lifted its outlook for Fiji's foreign currency bond rating from negative to stable, supported by a stabilisation of near-term external pressures. According to official data, Fiji's foreign reserves climbed to FJD930 mn as at October 2007 which is equivalent to 4.3 months of imports. This is in contrast to a low of FJD593 mn as at August 2006 (2.5 months of imports). The accumulation of reserves is partly attributed to the US\$150mn bond issue in November 2006, repatriation of funds as well as measures to constrain import growth. Annual domestic credit growth continues to slow to 10.8% in July 2007 compared with an average of 28% in 2006. The stability in reserves has prompted the central bank to loosen exchange control measures further. However, external pressures are likely to persist as high oil and food prices impact on the value of imports.
- Inflation has also receded and is officially forecast to end the year at 3.5% YOY, assisted by the restoration of market produce. For the first ten months of this year, inflation averaged 4.9% YOY. Again, there are upside risks to the forecast from high fuel prices and cost of imported food for the tourist industry. We have projected annual inflation to average at 5.2% in 2007 but some easing is expected in 2008 to 4.5%, largely reflecting base effects.
- The economic outlook is for growth of 2% in 2008. This is only a mild recovery after the contraction in 2007. There is upside potential to the growth projection coming from a stronger-than-expected recovery in the tourism sector in 2008, particularly if travel advisories are relaxed. Visitor arrivals thus far, have been weak, falling by an annual 5.4% in the first 8 months of this year and this has depressed earnings which dropped by 9% YOY in the first half of this year.
- The re-opening of the Vatukoula gold mine is also positive for growth. Gold exports were among Fiji's top 5 exports in 2006, with receipts of around US\$25 mn when the gold price averaged just over US\$600/oz. With gold forecast to range between US\$750-850/oz over 2008, export receipts will be given a much-needed boost.
- Overall, a more sustained upturn in economic growth will largely depend on the resumption of investment and new aid flows.

Jasmine Robinson

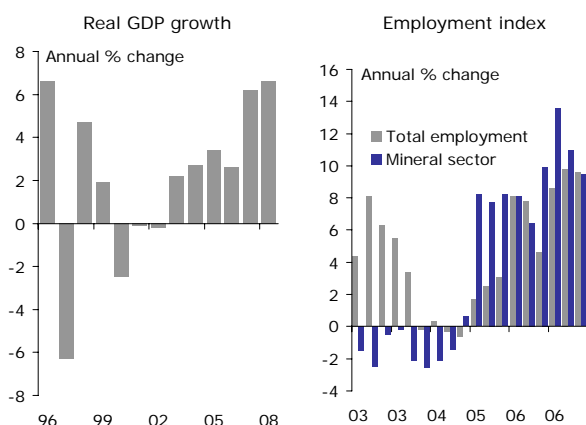
Economic data – Fiji

Quarterly data	Dec 05	Mar 06	Jun 06	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07
Consumer Price Index, % YOY	2.2	2.1	1.6	2.5	3.7	3.6	6.4	5.2
Domestic Credit, % YOY	26.6	30.0	29.6	27.4	23.6	16.7	12.5	n/a
Exports, % YOY	-9.2	-0.5	-21.5	11.7	3.3	-3.1	34.3	-9.7
Imports, % YOY	4.4	17.9	7.7	20.2	4.1	0.4	-3.2	-7.9
Trade Balance, US\$ mn	-250.3	-247.8	-299.3	-298.3	-262.2	-253.9	-241.9	-278.5
Foreign Exchange Reserves, US\$ mn	284.8	215.7	226.2	205.4	n/a	n/a	n/a	n/a

Sources: Datastream, Fiji Islands Bureau of Statistics, IMF

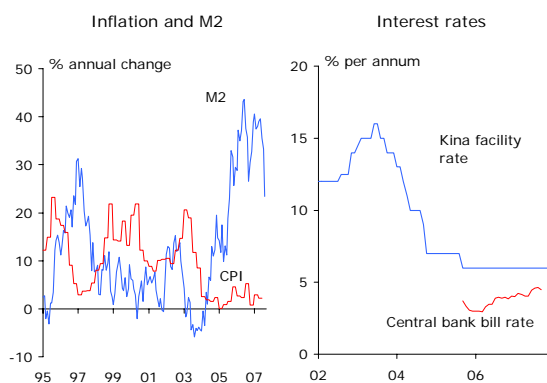
Country Update: Papua New Guinea

Strong growth anticipated



Source: PNG Treasury, BPNG, Economics@ANZ

High liquidity will put pressure on inflation and interest rates



- The government has revised up its estimate for GDP growth in 2007 as well as its forecast for growth next year. Real GDP is now estimated to have risen by 6.2% per annum this year, up from a previous forecast of 5.0%. The 2008 budget assumes growth of 6.6% next year. Since no data on national accounts has been released since 2002, it is difficult to analyse the sources and evolution of GDP growth. However, it is clear that both the mining and non-mining sectors are performing strongly; the budget estimates non-mining real GDP growth of 6.5% this year and next.
- Bullish growth forecasts are supported by the strong results in available data on economic activity. The employment index rose by 9.6% YOY in the June quarter and was up by 7.8% year-to-date. Strong growth in employment was recorded across the retail, construction and agricultural sectors in the first half of the year, suggesting broad-based growth.
- Growth appears to have been helped along this year by fiscal policy. Government revenue has come in 42% above budget thanks to a higher tax take across the board and 21% rise in minerals revenues. However, expenditure was also 26% above budget and 19% above 2006 levels. The budget surplus is expected to decline from 3.1% of GDP in 2006 to 1.7% of GDP this year and 1.0% of GDP next year, which represents a significant loosening of fiscal policy over the period.
- A revision to inflation data in the first half of the year has taken annual headline inflation to only 1.0% in the June quarter. However, trimmed mean inflation has accelerated by more than a percentage point to 2.8% on an annual basis as of June. Strong growth, high liquidity and easy fiscal policy will put upward pressure on interest rates; though the kina facility rate has been static at 6% since the start of the year, the central bank bill rate has risen from 4.0% to 4.5%.
- External balances will continue to support growth. The 12-month trailing trade surplus has declined from a peak of US\$2.3 bn in the third quarter of 2006 to US\$2.0 bn in the June quarter amid weak export volumes and surging imports. While declining, the trade surplus is still large and the intervention by the BPNG in the foreign exchange market to smooth the path of the kina is leading to ever-rising foreign exchange reserves. Foreign exchange reserves have nearly reached US\$1.8 bn and will likely hit US\$2 bn by the end of this year.

Amy Auster

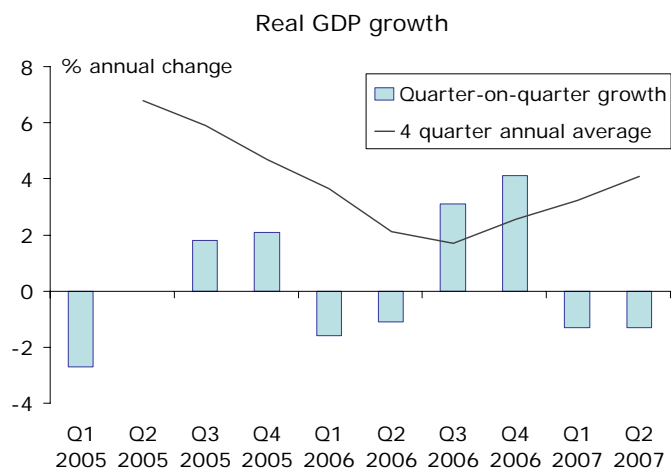
Economic data – Papua New Guinea

Quarterly data	Dec 05	Mar 06	Jun 06	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07
Employment Index, % YOY	3.1	8.1	7.8	4.6	8.6	9.9	9.5	n/a
Consumer Price Index, % YOY	4.6	2.7	2.3	5.3	-1.0	1.0	1.0	n/a
- BPNG Trimmed mean, % QOQ	0.1	0.0	0.7	0.5	0.5	0.7	1.1	n/a
- NSO exclusion based, % QOQ	-0.5	0.1	0.9	-1.5	5.3	1.3	1.4	n/a
Exports, % YOY	26.1	24.3	47.6	27.0	9.6	0.8	9.3	n/a
Imports, % YOY	2.2	-1.5	36.3	42.3	51.7	33.7	29.3	n/a
Trade Balance, US\$ mn	573.2	454.0	725.7	543.4	474.0	303.1	700.0	n/a
Foreign Exchange Reserves, US\$ mn	717.5	708.6	960.1	1267.6	1400	1363.6	1545.4	n/a

Sources: Bank of Papua New Guinea, IMF

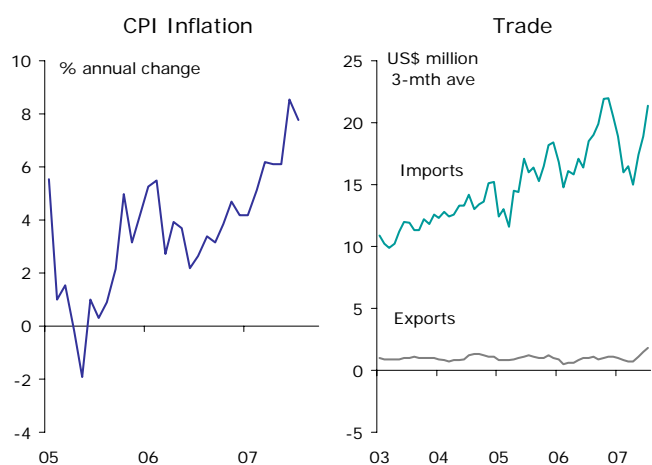
Country Update: Samoa

Economic performance below par in H1 2007



Source: IMF, Samoan Authorities

Inflation has accelerated while trade deficit remains a problem



Source: IMF, Samoan Authorities

- The government reported that real GDP growth rose by 4.6% on an annual basis in the June quarter, after rising by 4.8% per annum in the March quarter. The main explanation for the strong rate of annual growth was the fact that growth was weak in the first half of 2006 due to weather conditions that forced agricultural output to collapse by 10% in real terms from the March to the June 2006 quarter. Looked at on a quarter-by-quarter basis, growth was negative in both the first and second quarters of this year as agriculture remained weak and commerce recorded only mild gains. We expect the economy to record strong gains in the third quarter, reflecting a burst of tourism and commerce around the South Pacific Games in September. Thereafter, however, the slowdown is expected to resume and annual growth is likely to end the year below 4%.

- Part of the rationale for our tepid growth outlook is the steps taken by the central bank to curtail import demand this year. The trade deficit has steadily deteriorated over the past few years, with the 12-month trailing deficit widening from US\$14 mn at this time two years ago to US\$18.5 mn at present. Exports have been volatile, while imports climbed steadily in the early part of this year. The result was negative for the overall balance of payments. In addition, remittances have been somewhat weaker this year, falling by nearly 6% year-to-date on an annual basis. The foreign exchange reserve position reflected the deterioration in the balance of payments, with FX reserves falling from US\$98 mn in February to a low of US\$86 mn in May.

- In response, the central bank tightened liquidity conditions. It also appears to have allowed the tala to trade weaker relative to the basket of foreign currencies against which it is benchmarked. These actions plus the end of the Games have seen reduced imports and improving domestic liquidity. The rate of base money growth has risen from 8.7% per annum in June to 13% per annum in August and 12% per annum in September.

- Inflation had been accelerating strongly this year, but appears to have subsided somewhat in recent months. Annual headline CPI was 4.2% in January and rose quickly to a peak of 8.5% in June before declining to 7.3% in September. However, inflation is not as declining as quickly as might be expected in the aftermath of the South Pacific Games; the central bank may need to tighten conditions a bit again if inflation fails to moderate.

Amy Auster

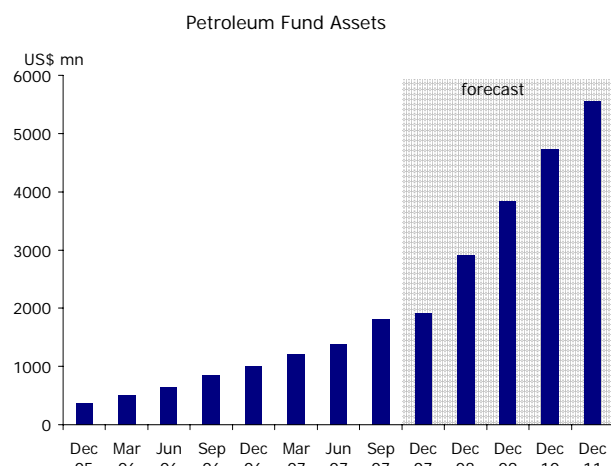
Economic data – Samoa

Quarterly data	Sep 05	Dec 05	Mar 06	Jun 06	Sep 06	Dec 06	Mar 07	Jun-07
Real GDP, % YOY	4.1	1.1	2.2	1.1	2.5	4.5	4.8	4.6
Consumer Price Index, % YOY	2.1	4.2	2.7	2.2	3.2	4.2	6.1	8.5
Exports, % YOY 3mma	-18.3	-0.9	-20.0	-18.3	-7.7	12.8	34.0	55.6
Imports, % YOY 3mma	21.1	22.6	45.6	-3.1	29.9	12.8	8.0	17.2
Trade Balance, US\$ mn	-14.5	-15.5	-19.0	-16.5	-19.8	-15.5	-16.9	-20.3
International Reserves, US\$ mn	92.3	87.7	68.2	73.7	76.4	79.8	98.8	93.4

Sources: Bloomberg, Datastream, Samoa Ministry of Finance

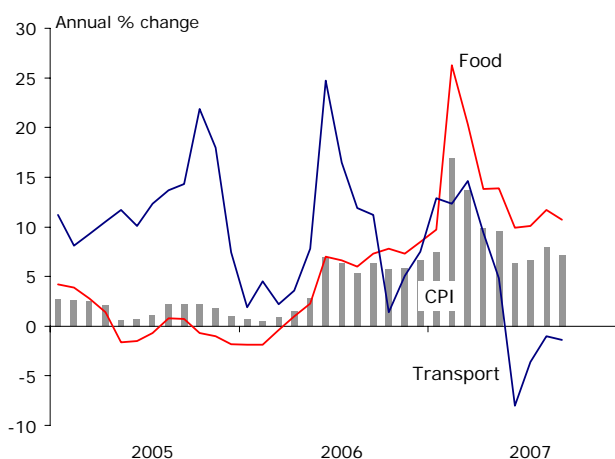
Country Update: Timor-Leste

Petroleum funds set to escalate



Source: Banking and Payments Authority

Inflation moderates but weak USD will fuel price pressures



Source: National Directorate of Statistics, Timor-Leste

- The Petroleum Fund continues to grow at a solid pace, thanks to high oil prices. As at September 2007, funds amounted to US\$1.82 bn, up from US\$1.4 bn as at June. At this pace, the estimated fund accumulation of US\$1.9 bn by the end-2007 looks likely to be exceeded. Longer-term projections show a sharp increase in revenue to reach US\$5.5 bn by 2011.
- On the fiscal side, the acceleration in oil & gas revenues as well as donor funding will continue to lift scope for increases in budget spending on infrastructure, health and welfare. However, budget execution remains an issue with capital spending in the past, having fallen short of budgeted increases. From 1 January 2008, the budget will be formulated on a calendar year basis.
- On the trade front, the merchandise trade balance continues to be hugely in deficit as import requirements climb. Timor-Leste's main non-oil domestic export is coffee. The outlook for coffee earnings is expected to improve given the recovery in coffee prices and rebuilding of stock after the disruption to activity in 2006. Nevertheless, the merchandise trade shortfall will remain large in 2008. The current account, however, will continue to show strong surpluses. This is because oil revenues are treated either as royalties and come under the income account or tax revenue which comes under transfers. The current account balance is forecast to exceed US\$800 mn in 2008 from an estimated US\$411 mn in 2006 according to the IMF.
- Inflation has edged up to above 7% YOY in August and September as growth in food prices remained in double digit. Average annual inflation for the first nine months of this year was 9.5%. We have forecast inflation at 8.7% in 2007 before moderating to around 5.5% in 2008 as supplies are restored. However, the weakness in the US dollar, which is expected to persist over the next 3-6 months, is likely to fuel imported inflation and remains an upside risk to our inflation projections. Timor Leste adopted the use of the US dollar as its official currency in 2001.
- Non-oil GDP growth is expected to expand by 3.5% in 2008 after the estimated 22% jump in growth for 2007. Unemployment, however, is expected to remain high and the immediate challenge is to address the plight of the thousands displaced and still residing in camps in Dili. Estimates suggest that the urban unemployment rate is more than 20% and the overall poverty rate is above 40%.

Jasmine Robinson

Economic data - Timor-Leste

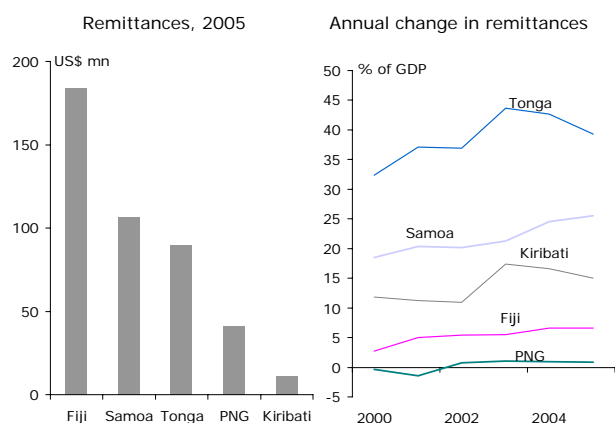
Quarterly data	Dec 05	Mar 06	Jun 06	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07
Consumer Price Index, % YOY	1.7	0.7	5.4	6.0	6.1	12.7	8.6	7.3
- Food, % YOY	-1.2	-1.4	5.3	6.6	7.9	18.8	12.5	10.8
- Transport, % YOY	15.8	2.9	16.3	13.2	4.6	13.3	2.1	-2.0
Exports ⁺ , US\$ mn	2.6	1.5 [*]	0.2 [*]	3.1 [*]	3.2	n/a	n/a	n/a
Imports [^] , US\$ mn	19.7	19.6 [*]	10.5 [*]	17.3 [*]	33.3	n/a	n/a	n/a
Trade Balance, US\$ mn	-17.1	-18.1 [*]	-10.3 [*]	-14.2 [*]	-30.1	n/a	n/a	n/a

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

Sources: National Directorate of Statistics, Economist Intelligence Unit

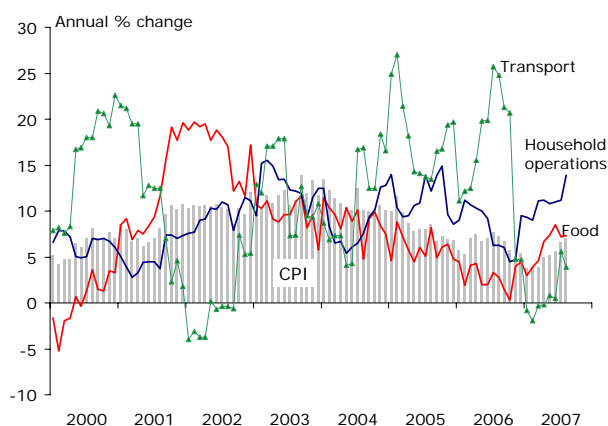
Country Update: Tonga

Remittances important to the economy



Sources: IMF, Economics@ANZ

Inflation edges up



Source: Tonga Department of Statistics

- After contracting by an estimated 3.5% in FY2006/2007 (fiscal year beginning July), a mild recovery is forecast for the Tongan economy with growth forecast to expand by 0.8% in FY2007/08 and 1.3% in FY2008/09. Rebuilding efforts are taking longer than expected, hence the more modest upturn in activity.
- Against this backdrop, remittances are likely to play an even more significant role in assisting families ride out this sluggish period of activity. Relative to size of the economy, Tonga is the largest recipient of remittances which represented some 40% of GDP in 2005 compared with 23% of GDP in 1997. Remittances from New Zealand to Tonga are likely to climb over the next year following the introduction of the seasonal work scheme in 2007, which allows workers from a number of Pacific island economies, including Tonga, to meet shortages in the horticulture and viticulture areas.
- Over the medium term, reconstruction efforts will assist in lifting economic activity. In addition, the recently-agreed 5-year Country Partnership Strategy programme between the ADB and Tonga will help to alleviate poverty through infrastructure expansion, prudent fiscal management and private sector development. The ADB has proposed a financial assistance package of US\$21.3 mn under this strategy.
- Meanwhile, inflation has edged up in the second half of this year to 6.9% YOY in August 2007 after moderating in the first half. Domestic price pressures from the household sub-sector (eg. utilities, communications services, furniture and appliances) have emerged, rising by 13.9% YOY in August, the highest rate since July 2005. Growth in food prices continue to exceed overall inflation while transport costs are creeping up. For the first eight months of this year, annual inflation averaged 5%. This is still lower than the 6.8% YOY recorded for the same period in 2006. However, upside risks to inflation from high oil and food prices are likely to persist. We have forecast inflation to average 5.5% in 2008 from 5.3% in 2007.
- Foreign exchange reserves rose to US\$49 mn as of July 2007 compared with US\$45 mn at the end of 2006, thanks largely to multilateral and bilateral financial assistance. This is equivalent to around 4 months of imports.

Jasmine Robinson

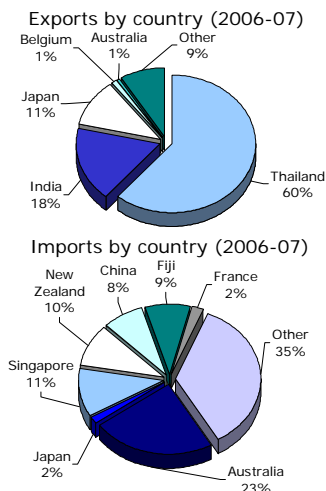
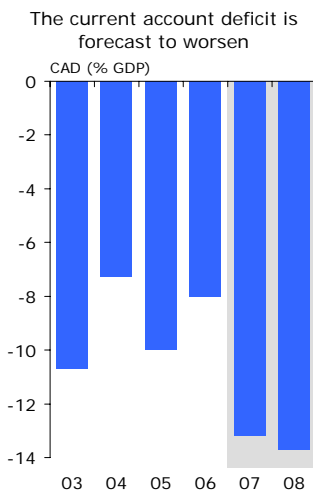
Economic data – Tonga

Quarterly data	Dec 05	Mar 06	Jun 06	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07
Consumer Price Index, % YOY	7.0	6.1	7.1	7.2	5.4	3.7	5.2	n/a
Private Sector Credit, % YOY	39.8	35.0	23.2	15.0	11.1	7.8	10.3	n/a
Exports, % YOY	-56.1	25.3	13.5	39.3	-0.1	-2.0	-1.3	n/a
Imports, % YOY	-9.0	4.8	5.4	3.4	19.2	17.8	21.1	n/a
Trade Balance, US\$ mn	-26.1	-24.2	-29.2	-30.7	-32.9	-29.3	-36.2	n/a
Foreign Exchange Reserves, US\$ mn	44.0	39.2	43.2	45.1	44.9	47.0	50.1	n/a

Sources: Datastream, IMF

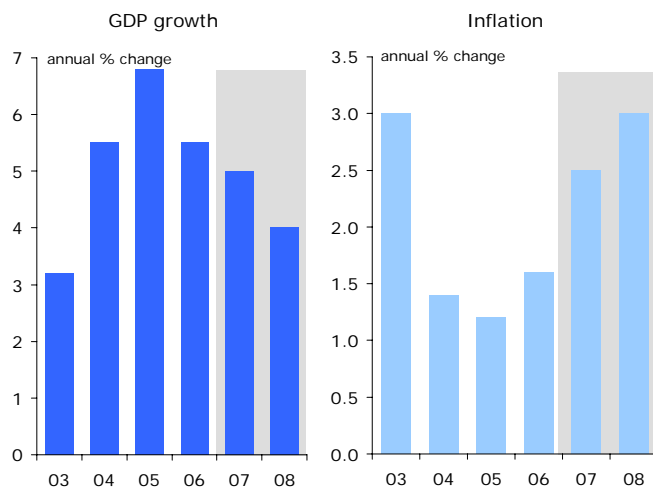
Country Update: Vanuatu

Asia a key trading partner



Sources: Economics@ANZ, IMF, Datastream.

Growth set to slow as prices tick up...



Sources: Economics@ANZ, IMF World Economic Outlook.

- The latest bout of high oil prices is likely to be hurting the Vanuatu economy given the country's high oil dependency, and may have an impact on inflation over the coming quarters. However, the strength of the vatu (up around 10% against the USD over the past year), which moves closely in line with the AUD and NZD, should help to mitigate the impact on imported inflation.

- Direction of trade statistics compiled by the IMF show some interesting trends in Vanuatu's trade patterns. Vanuatu's trade relationship with Asia has strengthened over the past two decades, with Thailand now the most important destination for the country's exports, accounting for nearly 60% of all exports in 2006 (up from just 3.6% in 2000). Australia's significance as an important source of imports has remained stable over the past 15 years, with Vanuatu sourcing over 20% of its imports from Australia on average over the 2000s. The significance of Japan as a source of imports has steadily declined from over half of all imports in 1990 to just over 12% in 2006. However, imports from Singapore and China have steadily grown over this time period, accounting for 12.7% and 7.1% of Vanuatu's imports respectively.

- At the end of 2007, Vanuatu, along with other Africa, Caribbean and Pacific (ACP) zone countries, will lose its right to export goods duty free to EU markets. An interim agreement will apply from 1 January 2008, which will eventually be replaced with a comprehensive Economic Partnership Agreement (EPA). Pacific Island trade is of very minor importance to the EU. Given this fact, the EU is not willing to negotiate on the details of the EPA, the EU head of delegation in the Pacific, Roberto Ridolfi, stating that the EU "really had nothing to lose if the islands decided not to sign the agreement or the EPA".

- Current strength in the price of oil will no doubt be hitting Vanuatu hard. Going forward, the IMF forecasts real GDP growth to continue to slow into 2007 and 2008 to 5% and 4% respectively. Growth will largely be driven by tourism due to the purchase of a new aircraft by the national carrier, Air Vanuatu, and continuing political instability in neighbouring Pacific islands. Strength in the construction industry should also persist through to 2008, spurred on by Vanuatu's key Millennium Challenge Program goal of improving its infrastructure in its fight to ease poverty. The IMF also expects the pace of inflation to quicken, with prices likely to rise by 2.5% in 2007 and 3% in 2008. Despite around 15% of the population living in poverty, the country topped the list in a recent survey on happiness, with Vanuatu dubbed "the happiest place on earth."

Amber Rabinov

Economic data – Vanuatu

Quarterly data	Dec 05	Mar 06	Jun 06	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07
Consumer Price Index, % YOY	1.8	1.9	2.2	1.8	1.7	2.8	n/a	n/a
Tourist Arrivals, '000	-	13.8	15.1	19.8	19.5	16.5	18.8	n/a
Exports, % YOY	-44.6	50.4	-13.1	-23.7	44.1	10.4	7.9	n/a
Imports, % YOY	34.0	-27.7	51.2	7.9	-26.8	72.2	-36.9	n/a
Trade Balance, US\$ mn	-29.8	10.9	-56.2	5.9	10.3	-18.9	-9.2	n/a
Foreign Exchange Reserves, US\$ mn	62.2	64.5	78.3	86.8	99.3	n/a	n/a	n/a

Sources: Vanuatu Statistics Office, Datastream, IMF DoTs

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